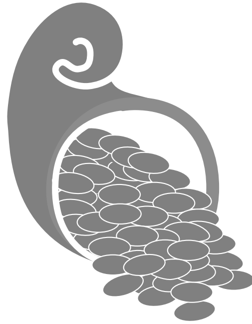
FINANCIAL ABUNDANCE GUIDE

An Easy to Understand Guide for Securing a Prosperous Future



FINANCIAL ABUNDANCE GUIDE

An Easy to Understand Guide for Securing a Prosperous Future

Wayne Farlow, CFP®

Financial Abundance, LLC
Westminster, Colorado

FINANCIAL ABUNDANCE GUIDE
By Wayne Farlow

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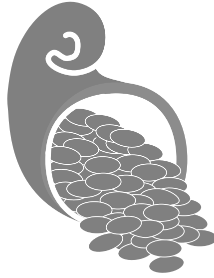

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About the Author

Wayne Farlow earned a Bachelor of Science degree in Mathematics and a Master's degree in Biomedical Engineering, both from Duke University. In 1983, he was awarded the professional designation of Certified Financial Planner (CFP®).

Wayne spent 30 years of his career as a business executive. After 11 years with Digital Equipment Corporation, he was instrumental in the successful development of four early stage, venture capital-backed companies. He held executive positions including VP of Sales and Marketing, Executive Vice President and President/CEO. Wayne was instrumental in taking two of these companies public.

During his years in executive management, Wayne maintained his CFP® certification. He practiced financial planning by helping family and close associates.

In 2002, Wayne founded a fee-only based financial planning company that has evolved into Financial Abundance, LLC. Appalled by some of the investment products that his clients had been sold, Wayne chose to provide only financial planning services, paid on an hourly basis. With this compensation approach, he is able to provide advice with no possibility of a conflict of interest with his clients.

Wayne has found that many clients were previously confused on how to build their financial security. His clients often remarked that he was their first financial advisor who could explain complex financial information in a manner that they could understand.

Combining his successful entrepreneurial business skills, his 24 years of knowledge and experience as a Certified Financial Planner (CFP®) and his ability to explain complex financial information to clients with a non-financial background, Wayne has authored and published the Financial Abundance Guide.

Disclaimer

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The information contained within is intended a general guide and not as the ultimate source of financial planning information. The guide contains financial information that is current only up to the printing date.

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Acknowledgements

It would be impossible to cite all of the sources that have been used in preparing this guide. The list of my reference sources includes departments of the federal government, Internet sites, periodicals, books and information from many individuals.

I am grateful to Reed Gleen for editing, Renee Peterson for cover design, John Chitty for interior design and typography and Carolyn Farlow and Norma Moore for proofing and proofreading.

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Special friends who provided guidance and support include Gerry Witmore, Nyla Witmore, Norma Moore, Andrea Meyer, Judy Potter, Dennis Grant, Jan Thomas, and Leonard Johnson.

Finally, I am eternally grateful to my wife, Janet Farlow, and my father, Roy Farlow. Janet has been my "technical consultant," reading every page and informing me when the content was too technical for a non-financial person to understand. My father taught me that I was capable of reaching any goal, with hard work and dedication. Both Janet and Dad have been my inspiration to write this guide.

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Foreword

Wayne Farlow asked me to review his book and offer suggestions. It was so well written and comprehensive, that I had precious few comments.

I recommend the Financial Abundance Guide as a reference that anyone serious about financial planning have available. It covers a wide range of topics from tax effects to the many peculiarities of Social Security benefits. Some of this material is hard to find even with a diligent Web search.

This is an excellent source for many of the details that can affect both how much people should save before retirement or spend after retirement. The details can make a big difference. I have illustrated this in two books I was asked to write for Wiley & Sons: J. K. Lasser's Your Winning Retirement Plan and Getting Started in a Financially Secure Retirement. If I had Mr. Farlow's book at my side, the tasks would have been easier.

I have assisted journalists from *The Wall Street Journal* several times to illustrate that the majority of Web and commercially available retirement programs would come up with vastly different conclusions using the same circumstances for each program input. In some cases, pre-retirement projections by some would show no more savings were needed with others showing that very large new annual savings additions would be required.

By reverse engineering, I was able to uncover the source of the problems, in most cases, of commercial planning errors. The causes were often the kind of things addressed in Mr. Farlow's book. For example, taxes can make a large difference as can misunderstanding whether an input should be a present

or a future value or whether it should be inflation adjusted or not. Mr. Farlow's book is very careful about such things.

This is a reference that should be useful to both professional financial planners and laymen who are willing to apply themselves to the task and either use a comprehensive commercial planning program or have the technical and financial knowledge to produce their own spreadsheets.

The Financial Abundance Guide should also be a good reference for financial journalists who often need this kind of background, not just to write the articles, but also to know what kind of questions to ask when they interview experts for their views. The same could be said of clients who are seeking help from a professional. A little preparation, with help from this book, could pay big dividends by getting to the crucial points early and decisively.

Henry K. (Bud) Hebeler
www.analyzenow.com

Preface:
Using this Guide

Financial Abundance Guide has been created to allow you the maximum flexibility in how you choose to use the information contained within.

The first six chapters include information and strategies to help you save money by reducing the amount of taxes you pay.

Whether you are paying for health insurance, selling a vacation home, saving for educational expenses or preparing for retirement, the Financial Abundance Guide will provide cost saving strategies that you can begin using today.

The guide can even help your philanthropic intentions by providing strategies on how to provide more to your favorite charities, without increasing the after-tax cost of your current giving.

The final four chapters provide insight and strategies on how to maintain and increase your present financial abundance.

Financial Abundance Guide provides information on how to more safely invest your resources and how to minimize your financial risk through the use of appropriate insurance products. It also provides strategies on how to secure and maintain an abundant retirement, as well as insight on how to assure that your remaining estate goes to your intended heirs.

Many people will find this guide helpful by reading it from cover to cover. When read this way, I recommend that you highlight any information that you may want to use immediately. When you have finished reading the book, return

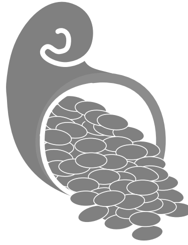
to the highlighted areas and make a list of the items which require your immediate attention.

Other readers will not have the time or the inclination to read the entire book. You may wish to read only the chapters that address your immediate financial concerns. Once this is completed, read the Summary and a Strategies section at end of each of the remaining chapters. If you find any ideas or financial strategies of immediate value, review those sections and highlight any helpful information.

Financial Abundance Guide is intended to serve as a financial planning reference guide. Before meeting with your legal, investment, tax, accounting or financial planning professional, prepare by reviewing the section(s) that will be addressed at your meeting. With this preparation, you will know what questions to ask and you may better understand the information provided by your advisor.

You will find over 60 vignettes to help explain and clarify some of the more technical financial information contained in this guide. While the guide is intended to be comprehensive enough to be used by financial planners, its easy-to-read style is aimed at anyone who wishes to take more control over their financial lives.

At the web site financialabundanceguide.com, you should find any changes to our laws that might alter the information contained in this guide. You will also find updated tax related numbers that may change annually. Financial Abundance Guide, in conjunction with the web site, can provide you with easy-to-use financial planning information designed to help you live in financial abundance.



Introduction: Living in Financial Abundance

> *"No passion so effectually robs the mind of all its powers of acting and reasoning as fear."*
>
> –Edmund Burke

Having funds to buy a house, cars and groceries and enjoy vacations is often taken for granted. But do you ever wonder if your finances can meet all of your family's obligations plus occasional extra luxuries? Does the fear of unforeseen future events and expenses ever create too much anxiety?

It did for me!

Living in constant fear that I would someday be broke, I ignored my abundant financial resources. If my daughter ordered a steak when we went out to dinner, I would be concerned at her "wastefulness" and anxious about the high price.

Living in financial fear, I was operating from a position of scarcity. I constantly questioned whether my financial resources would be enough to meet my family's future needs.

As a *Certified Financial Planner* (CFP®), I have helped many people realize

Certified Financial Planner (CFP®): A certification mark for financial planners conferred by the Certified Financial Planner Board of Standards. To use this designation, candidates must meet education, examination, experience and ethics requirements.

that their financial resources could meet their future financial needs. In spite of doing this for others, I could not convince myself that my financial resources were adequate.

If you feel this way, it may be time to discover how to live from a position of abundance.

Although my financial resources have not changed, I have learned to live from a position of financial abundance. Living from abundance requires:

1. Spending less than you earn.
2. Using every legal method to maximize financial resources and minimize taxes.
3. Managing investments and risk to protect your financial resources.
4. Knowledge that you can control your personal finances.
5. Faith that your financial resources will meet your family's future needs.

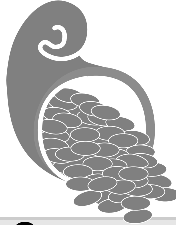
With "inner abundance," I now live life to its fullest, trusting that my financial future is secure. Financial abundance has also increased my gratitude, allowing me to give more generously to the charitable causes that I support.

Are you interested in living from a position of financial abundance?

Meeting current financial obligations, saving for your family's education and retirement expenses while increasing charitable giving are the outcomes of living in financial abundance.

The Financial Abundance Guide will help you take control of your finances. In it, you will find strategies to reduce your taxes, increase your wealth and protect your financial assets.

With a better understanding of your financial health and new approaches to meeting your financial goals, your fears of financial scarcity will be reduced. By implementing the recommended strategies, living in financial abundance can become a reality.



CHAPTER 1

The First Step: Spend Less Than You Earn

"Never spend your money before you have it."
–Thomas Jefferson

Unless you are retired or financially independent, you must spend less than you earn in order to reach a position of financial abundance. By spending less than you earn, you will have excess earnings, the first step in achieving financial health.

Let's find out how financially healthy you are.

First, identify all of your income sources:

Income

Employment (Wages, Salaries and Tips)
Net Business (reported on your Tax Form Schedule C)
Partnership (reported on K-1s)
S Corporation
Trusts
Pensions
Net Rental income
Alimony
Annuities

Royalties
Unemployment Compensation
Social Security
Disability
Federal Income Tax Refund
State Income Tax Refund

To determine annual employment income, multiply gross paycheck income by the number of paychecks received annually. If paid every other week, multiply your paycheck's total amount by 26.

For self-employment, use the amount entered for Net Profit (line 31) in Schedule C of your income tax return for annual employment income.

Do not include *Capital Gains*, Interest or Dividends in the sources of income. Unless you are retired, this income should not be used for current expenses.

Capital Gain/Loss: The difference between the amount received and the cost, when a capital asset is sold.

Next, identify all of your expenses:

Expenses

Monthly expenditures can be variable.

Obtain your credit card statements and bank statements for the past six months. Put each expenditure into one of the categories listed below.

Add the expenditures in each category for the past six months. Divide the total expenditures by six and place that number by the corresponding expense.

If you use cash for some of your expenses, estimate the amount of cash used monthly and assign this amount to the appropriate expense categories.

Monthly expenditures can include:

Mortgage Payments
Home Owners Association Dues
Auto Payments
Auto Expenses
Groceries
Eating Out
Educational Expenses
House Expenses (including Repairs)
Clothing Expenses
Hair and Beauty Needs
Federal Taxes Withheld
State Taxes Withheld
Social Security and Medicare/Medicaid Payments
Medical Insurance
Disability Insurance
Medical Expenses, including Medicine/Prescriptions
Nonreimbursed Business Expenses
Credit Card Interest Payments
Monthly School Tuition
School Supplies
Entertainment
Telephone
Utilities
Cable
Water
Trash Collection
Club Dues
Miscellaneous Expenses

Multiply the monthly expenditures by 12 to determine the annual expenditure amount for each item.

Quarterly, semiannual or annual expenses may include:

Home Insurance
Auto Insurance
Life Insurance

College Tuition
Property Taxes
Federal Quarterly Income Taxes
State Quarterly Income Taxes
Vacations

Multiply quarterly expenses by four and semiannual expenses by two to determine the annual expenditure.

Total all annual expenditures to calculate your yearly expenses.

Subtract yearly expenses from yearly income to determine your current *excess earnings*. Excess earnings can be invested in your financial future and used to make philanthropic contributions.

Excess Earnings: The amount remaining when yearly expenses are subtracted from yearly income.

This exercise will take time and discipline to complete. You may question whether you really need to understand your financial health at such a detailed level. To have the power of control over your finances, you must have the knowledge of where your income is being used.

Although this is a time-consuming exercise, you will likely be surprised by the results. The financial knowledge that you gain will be critical for your ability to take control of your future financial abundance.

Excluded Expenditures

Payments into retirement accounts and donations to your church or other charitable organizations are not included in yearly expenses.

Credit Card Debt

Did you put anything into the expense labeled "Credit Card Interest Payments?"

If so, your first priority is to eliminate this expense. Savings and investments are your sources to pay off credit card debt. Even if it means reducing savings levels below what you find comfortable, use savings, except those held in retirement accounts, to pay off any credit card debt.

If your only available savings are in retirement accounts, get a *home equity credit line*. Do this only when credit card debt is small enough to be considered short-term.

> **Home Equity Credit Line:** A line of credit, secured by a principal residence or second home. The credit line is limited to the amount that the current appraised value exceeds outstanding mortgages on the property.

You must be honest about whether your debt is truly short term, caused by a unique, non-recurring event. If not, your long-term credit card debt must be addressed. If you find that you are unable to find a way to eliminate this debt, seek help from a consumer debt management specialist.

With a home equity credit line, interest rates will typically be lower than credit card interest rates. If you *itemize taxable deductions*, home equity interest may also be deductible.

> **Itemized Deductions:** Items that can be claimed as deductions to your income on Schedule A of federal tax form 1040. The items include mortgage interest, state and local taxes, charitable contributions and medical expenses.

In January, Bill and Mary's dog needed emergency surgery costing $5,000. To pay off this debt, they will need to use Bill's bonus that he will receive in December. If they pay the vet using their credit card, the 16.9 percent annual interest on this

debt will cost $845.

Bill and Mary's house has appreciated since buying it 10 years ago. Last year, their banker suggested that they set up a home equity line of credit, using their home's appreciation as collateral for the credit line. When their home appraised at $150,000 more than their remaining mortgage, the bank agreed to a $75,000 home equity line of credit.

Paying for the dog's surgery with their home equity credit line, instead of their credit card, will provide Bill and Mary with significant savings.

By using their home equity credit line, with an interest rate of 6.9 percent, they will pay only $345 in interest payments. The $345 interest payment is also an itemized deduction on their tax return, reducing the amount of income taxes that they will owe by $100.

Bill and Mary are pleased that they could use their home equity credit line, instead of their credit card, and save a total of $600.

Can you eliminate some "nice to have" expenses?

After paying off your credit card debt and your home equity credit line, look carefully at your other expenditures. Do you have "nice to have" expenditures that can be eliminated?

Every day on her way to work, Joann stops at her favorite coffee shop. With her medium café mocha, she proceeded to the office to start the day.

One day, her frugal co-worker Jim asked her why she didn't just drink the free office coffee.

> Joann responded that her "indulgence" of a daily café mocha was hardly extravagant.
>
> Pulling out his financial calculator, Jim showed Joann what she would have if she saved the $20 per week that she spent on her café mochas.
>
> In 20 years, Joann would have $35,710 if she saved her $20 per week and received only 5 percent interest. If she invested the money and received an 8 percent return, she would have $51,310 in 20 years.
>
> While Joann could not deny that she was "entitled" to her daily café mocha, when she considered the beautiful car she could someday buy with her café mocha savings, she began joining Jim at the company coffee pot.

It is impossible to remove the fear of financial scarcity without excess earnings. Do you have your own "daily café mocha" that you could eliminate to help you achieve financial abundance?

Net Income

Net Income represents funds available for your emergency fund, college funding, retirement savings and charitable giving. Net Income is calculated by adding the contributions that both you and your company make to your company-sponsored retirement plan to the excess earnings amount that you previously calculated.

Allocating your Net Income

Net Income may be used for building an emergency fund, buying a home, funding children's education, retirement savings and giving to philanthropic causes.

Perhaps you wish to use part of your Net Income on a new car, an expensive vacation or some other "indulgence." You earned it and you deserve it!

If you feel this way, go back to your expenditures and add in this "new" expense. By doing this, Net Income will remain for its intended uses. Net Income is never to be used for consumption.

Building Your Emergency Fund

You may be asking, "What is an emergency fund and why do I need one?"

An emergency fund is an "insurance policy" to help you survive a short-term financial set back, such as the loss of your job or a short-term disability. Prematurely using funds that are in a retirement account can have onerous tax consequences, including a 10-percent tax penalty.

Having funds sufficient for six months to one year of your current expenditures will help you survive short-term financial setbacks. Keep your emergency fund in liquid, nonvolatile assets such as money market funds, CDs or short-term bond funds to provide quick access and minimal financial risk.

Buying your first house

Richard and Jane have been married for three years and are preparing to buy their first house. Five years ago, Richard opened a Roth IRA and has been funding it with the maximum annual contribution of $4,000 per year.

Due to tax-free growth, Richard's Roth IRA investments have increased by $12,000, giving him a total of $32,000 in his Roth IRA account.

> Richard and Jane recently learned that they may use $10,000 of this income as well as Richard's $20,000 investment for a down payment on their first home.

Since Richard's Roth IRA has been established for five years, he can withdraw up to $10,000 of income plus the $20,000 that he invested, on a tax-free basis, to buy his first home.

Funding your children's education

Coverdell Education Savings Accounts and Section 529 College Savings Plans are excellent methods of saving taxes while funding your child's education. With both plans, funds grow tax free and can be withdrawn tax free, when used for educational expenses.

Retirement savings

> Jeff's 401(k) plan provides a 100 percent company matching contribution on up to 6 percent of his income. Jeff makes $100,000 per year and contributes $6,000 to his 401(k) annually. Jeff's company provides a matching annual contribution of $6,000.
>
> With an 8 percent annual return over a five year period, Jeff's $30,000 in contributions plus his company's matching $30,000 is worth $73,635.

Contributing the maximum amount that your employer matches lets you take advantage of your employer's matching "free money." Where else could Jeff get a 145-percent return on his investment in just five years?

If you are older than 55, your retirement plan will likely have a *catch-up contribution*. With 401(k) and 403(b) plans there is a $5,000 per year annual "catch-up" provision, that lets you contribute a total of $20,500 (2007) annually.

Catch-Up Contributions: Increased retirement plan contributions that are allowed for employees who are age 50 or over as of the last day of the year.

Philanthropy

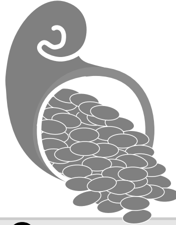
Moving from the fear of scarcity to a life of financial abundance will help you increase the amount that you can contribute to your favorite charitable organizations and deepen your experience of abundant living.

Chapter 1 Summary

1. Determine annual "excess income" by subtracting annual expenditures from annual income. Net Income is your excess income plus retirement plan contributions made by you and/or your employer. Do not include investment returns as income or charitable gifts as expenses.
2. Net Income can be invested for building an emergency fund, buying a first home, your children's education and additional retirement funds.
3. Tax-advantaged plans save you money by lowering the taxes you pay. You receive extra income either up front, through reduced current taxes, or you receive tax-free withdrawals from your investment and returns.

Chapter 1 Abundance Strategies

1. Eliminate credit-card debt. If savings are not available to pay off your credit-card debt, pay it off with a home equity credit line. Home equity loans will have lower interest rates and may provide a deduction on your income taxes.
2. If you do not have adequate excess earnings, consider eliminating some "nice to have" expenses.
3. It is impossible to attain financial abundance without sufficient Net Income.
4. One of the first uses of Net Income is to build an emergency fund that exceeds six months of your current expenditures.
5. Contribute the maximum matching amount that your employer offers in a retirement account. The employer-matching amount is "free money," guaranteeing a good investment return.
6. With a Roth IRA, you can withdraw all of the invested funds and up to $10,000 of investment income to buy your first house, as long as the Roth IRA has been established for at least five years.
7. Considering your financial abundance, as well as your tax savings, decide how much of your Net Income will be used for charitable giving.



Chapter 2

Purchase Educational Expenses at a Discount!

"The hardest thing to understand in the world is the income tax."

–Albert Einstein

Perhaps your child will receive a scholarship or other financial aid to help lower your college expenses. Let's also consider strategies over which you have some control.

Using *tax-advantaged* educational investment plans, you can pay for your child's educational expenses at a "discount" provided by tax savings.

> **Tax Advantaged Investments:** Investments that either provide an immediate tax deduction of the investment amount and/or provide tax-free withdrawals of both principal and interest/growth.

Throughout this guide I will discuss tax-advantaged investments. I only consider an investment tax advantaged when it either:

1. Provides an immediate *tax deduction* of the amount that is invested;
2. Provides tax-free withdrawals

> **Tax Deductions:** Items that directly reduce income for federal tax purposes.

of both principal and interest/growth, when funds are withdrawn.

Tax-advantaged investments always grow on a tax-free basis.

Typically, I will use an 8 percent *annual rate of return* in the investment examples.

Annual Rate of Return: The total amount that an investment increases or decreases on an annual basis.

Historically, the S&P 500 has had an annual return of 11 percent, when dividends are reinvested, and Treasury bonds have returned over 5 percent. By assuming that the investments shown in my examples are evenly divided between equity (stock market) investments and fixed income (bonds and bond funds), an 8 percent annual return appears reasonable.

Let's look at two tax-advantaged educational savings plans, designed to provide you with discounted educational expenses. Assuming the funds are used for qualified educational expenses, withdrawals from these plans are made on a tax-free basis.

Never paying taxes on the income and growth of these funds provides a significant "discount" for your educational expenses.

Coverdell Education Savings Account

With a Coverdell Education Savings Account (ESA), annual, nondeductible contributions of up to $2,000 may be made for each of your children younger than 18 years of age. With three children all under 18, you may contribute a maximum of $6,000 annually to the Coverdell ESAs.

When Coverdell ESAs are used for qualified educational expenses, withdrawals are tax free. Appreciation in the value of the funds escapes taxation. Coverdell ESAs can be used for

tuition, fees, books, supplies or room and board.

Robert and Cindy have three children. Wanting to give their children every possible educational advantage, they plan to send each child to a local private school during their last three years in high school.

When each child was born, Robert and Cindy set up a Coverdell ESA for that child and contributed $2,000 per year for fifteen years. When each child reaches age 15, the $30,000 invested will have grown to $54,300, assuming an 8 percent annual rate of return.

Robert and Cindy's combined federal and state income tax brackets are 33 percent. Withdrawing the $54,300 to pay for educational expenses is tax free.

If the $24,300 growth had been taxed at ordinary tax rates, they would have owed over $8,000 in taxes. For their three children, they will receive a $24,000 educational "discount" by using a Coverdell ESA.

Robert and Cindy's middle son, George, decides he wants to stay in the public schools and does not want to go to college. Robert and Cindy spend some of George's Coverdell ESA funds on computer equipment and tutoring for George, but more than $50,000 remains in his ESA when George turns 18.

Clara, their youngest daughter, has one more year of high school and plans to attend Stanford. Robert and Cindy's financial planner tells them that they may transfer a child's unused Coverdell ESA funds to another child, as long as both are under age 30. They transfer George's remaining balance to Clara, allowing her to use these funds for her

college expenses.

If the Coverdell ESA funds had remained in George's name and were not used for his educational expenses, any funds remaining in the ESA must be distributed to him when he is age 30. George would have to pay ordinary income taxes on all Coverdell ESA earnings plus a 10 percent tax penalty.

Since Robert and Cindy control the naming of each Coverdell ESA beneficiary, the funds can be transferred into another child's ESA before George turns 30.

Tax-free distributions can be used to pay expenses for college, graduate school or even kindergarten through 12th grade (K–12) for public or private schools. Other allowed education-related expenses include tutoring, computer equipment, room, board, uniforms and other school-related expenses.

There are *Adjusted Gross Income (AGI)* ceilings for funding a Coverdell ESA. If you file a joint tax return, the AGI limit amount for funding a Coverdell Education Savings Account is $190,000. As a single tax payer, the AGI limit is $95,000.

Adjusted Gross Income (AGI): A line on your Federal Income tax 1040 form which represents gross income less allowable deductions, such as individual retirement plans, HSA contributions, alimony payments, self-employment tax and student loan interest.

Section 529 College Savings Plan

Another educational savings vehicle is the qualified state tuition program, commonly called a Section 529 College Savings Plan. Like a Coverdell ESA, all funds withdrawn to pay for educational expenses are tax free.

Unlike a Coverdell ESA, funds can be used only for higher education expenses of college and graduate school. There are no federal limitations on the amount that you can contribute to a Section 529 College Savings Plan.

Contributions to a Section 529 College Savings Plan are treated as gifts to the person for whom the plan is established. An annual gift of up to $12,000, or $24,000, if your spouse also agrees to the gift, may be made under the annual federal *gift tax exclusion*.

A special feature of a Section 529 College Savings Plan is the ability to elect to make a gift of up to five times the annual federal gift tax exclusion amount, without triggering any gift taxes. In a single year, you and your spouse could each give $60,000 to each of your children's Section 529 College Savings Plans.

Gift Tax Exclusion: A specified amount that can be given annually to any individual without the gift being subject to the federal gift tax. This annual amount can be given to as many people as you desire.

This contribution is treated as if it was made over a five-year period. No further contributions to that Section 529 College Savings Plan can be made for five years.

Jerry and Gina have a 10-year-old daughter named Liz. Liz is very intelligent and has a great desire to attend an Ivy League college. Jerry's company has had a very profitable year. His year-end bonus will provide $100,000, after taxes.

Jerry and Gina decide to use the $100,000 bonus to fund a Section 529 College Savings Plan for Liz. Receiving an 8 percent annual return on their investment, when Liz turns 18, Jerry and Gina will have approximately $185,000 that can be withdrawn, tax free, to pay for her educational expenses.

With the continued growth of the funds in the Section 529 College Saving Plan, by the time Liz finishes Yale, the plan will have provided over $205,000 in college funding.

Jerry and Gina live in a state with high income taxes. Their combined federal and state income tax brackets are 40 percent. Since no taxes are paid on the $105,000 of income withdrawn from the Section 529 College Saving Plan, Jerry and Gina will save $42,000 in income taxes.

They received a $42,000 ”educational discount”, based on the amount of income taxes that they saved by using a Section 529 College Saving Plan.

Neither you nor your child can have direct "control" of the plan's contributions or earnings, as you can in a self-directed IRA.

Most Section 529 College Savings Plans have a limited number of investment options available for you to choose from, often including a selection of mutual funds. You may change the investment options once every twelve months.

You may roll over or transfer the account to a different state's plan once every twelve months. You may change the account beneficiary to another qualifying family member at any time. You may also assign a different family member as the plan's beneficiary at any time.

Phil and Norma funded a Section 529 College Savings Plan with $20,000 when their son William was born. Their funds have had an 8 percent annual return. When William turned 18, the $20,000 had grown to $79,900.

Wishing to stay close to home, William majored in computer science at his state university. His total college expenses were less than $15,000 per year.

When William graduated, the Section 529 College Savings Plan had over $35,000 in remaining funds.

Phil was languishing in a mid-management position and felt that his career could benefit from an Executive MBA program offered at the local university. When William graduated, Phil was made the plan beneficiary. Phil could then use the remaining funds in the Section 529 College Savings Plan for his Executive MBA.

The $20,000 that Phil and Norma invested in the Section 529 College Savings Plan grew to over $95,000 before it was completely consumed. It paid for William's education and for Phil's Executive MBA.

Since Phil and Norma have combined federal and state income tax brackets of 33 percent, the $75,000 of untaxed income from the Section 529 College Savings Plan provided them with an educational "discount" of $24,750, over 40 percent of the total cost of William's college education.

Distributions from a Section 529 College Savings Plan can be used for qualified higher education expenses. These expenses include tuition, books, fees, equipment, special needs services and/or room and board costs for students who are taking at least a half-time course load.

Section 529 College Saving Plans have severe tax consequences if you do not use the funds for qualified higher education expenses. When this occurs, all account income is treated as *ordinary income* and a 10 percent tax penalty payment is

Ordinary Income: All income that is not capital gain income.

applied to account income.

The 10 percent penalty will not apply if you terminate the account due to the death or disability of the beneficiary or if the funds are not needed for college because the beneficiary has received a scholarship.

To avoid taxation consequences, you may roll over any unused amounts into another family member's Section 529 College Saving Plan or change the beneficiary designation on the plan to a different family member. The person who funds the Section 529 College Saving Plan controls the choice of plan beneficiary.

An excellent web site that provides additional information and comparisons between different Section 529 plans is www.savingforcollege.com.

Series EE Bonds and Series I Bonds

Series EE U.S. Savings bonds offer another method of getting an educational "discount" through tax savings on investment income. Interest on Series EE U.S. savings bonds is typically payable only upon bond redemption. This allows your investment in Series EE U.S. savings bonds to defer taxes until redemption.

Series EE bonds can be totally tax free, if you apply the proceeds of EE bond redemption directly to qualified educational expenses for yourself, your spouse or a dependent. This same tax exclusion applies to the Series I savings bonds.

The tax exclusion is subject to Adjusted Gross Income (AGI) phase-out rules. An *AGI phase-out* can apply when your income

AGI Phase-Out: Based on your AGI (or in some cases your MAGI), various tax benefits, including personal exemptions and itemized tax deductions, are reduced when your AGI reaches a specified lower limit. At the upper (phase-out) limit, the tax benefit is completely eliminated.

exceeds a specified amount.

Between the two phase-out amounts, the amount of tax exclusion is reduced from 100 percent to 0 percent. When filing a joint tax return, Series EE bond income is partially taxed when your AGI exceeds $98,400 and is 100 percent taxable when your AGI exceeds $128,400 (2007).

Your tax savings are an educational "discount" provided by your generous Uncle Sam. Maximize your tax savings discount by funding these plans as early as possible.

Depending upon AGI, all three approaches may be simultaneously used to provide the maximum possible discount.

Hope Credit

If you, or any dependent claimed on your tax return, is in the first two years of college, a Hope Credit of up to $1,650 off the income taxes that you owe may be available.

To claim a Hope Credit, the student must meet the all of the following:

1. Be enrolled in the first or second year of post-secondary education,
2. Be enrolled in a program that leads to a degree, certificate or other educational credential,
3. Be taking at least half of the normal full-time course load, and
4. Have no felony convictions for drug possession or distribution.

Assuming the student meets all of the above criteria, you may use the Hope Credit of 100 percent of the first $1,100 paid for tuition and fees and 50 percent of the next $1,100, for a total of $1,650. This is a *tax credit*,

Tax Credit: Items that directly reduce income taxes owed. These are more valuable than deductions, since they reduce the amount of taxes you pay on a dollar-for-dollar basis.

deducted from the amount of tax owed.

If you have more than one student who qualifies for a Hope Credit in the same tax year, you may claim a Hope Credit for each student. The Hope Credit has a *Modified Adjusted Gross Income* (MAGI) "phase-out" of between $47,000 and $57,000 for single taxpayers and $94,000 and $114,000 for joint tax filers (2007).

Modified Adjusted Gross Income (MAGI): Adjusted Gross Income (AGI) increased by items such as tax-free foreign earned income. For most people, MAGI is the same as AGI.

Modified Adjusted Gross Income (MAGI) is usually the same as Adjusted Gross Income (AGI). If you have earned foreign income, your MAGI is your AGI, increased by the amount of foreign income earned.

Lifetime Learning Credit

Another tax credit that may be deducted from the taxes that you owe is the Lifetime Learning Credit. You may claim this credit for yourself or a dependent, as long as the student is taking one or more courses at an eligible educational institution. The courses can either be for a post-secondary degree program or be taken to acquire or improve job skills.

The Lifetime Learning Credit is limited to 20 percent of all of your family's qualified tuition and fees, with a $10,000 family limit per year. If two children are in college and a parent is taking courses to improve job skills, the yearly tuition and fees of all three can be combined.

If the combined tuition and fees is below $10,000, 20 percent of this total may be taken as a tax credit. If the tuition and fees are $10,000 or more, $2,000 may be taken as a tax credit.

The maximum Lifetime Learning Credit that you may take in a single tax year is $2,000. There is no limit to the

number of years that you may take these credits.

The same MAGI "phase-out" limits apply to the Lifetime Learning Credit as the Hope Credit.

If you are eligible for both the Hope Credit and the Lifetime Learning Credit in the same year, you can use only one of the credits. If your eligible Lifetime Learning Expenses are greater than $8,250, you will want to use the Lifetime Learning Credit, as it will exceed the maximum $1,650 Hope credit available.

Chapter 2 Summary

1. Tax-advantaged savings vehicles provide significantly higher *after-tax returns* than non-tax-advantaged savings.

2. Investments in both Coverdell Education Savings Accounts and Section 529 College Savings Plans allow for funds to grow tax free. If the funds are used for qualified educational expenses, all withdrawals from these accounts are tax free.

> **After-Tax Return:** The total amount earned on an investment, reduced by any taxes paid on the earnings. For example: If a taxable bond pays 6 percent interest and you must pay 33 percent of the interest earned in federal and state income taxes, your after tax return is 4 percent.

3. Up to $2,000 per child per year may be invested in a Coverdell Education Savings Account. These funds can be used for a wide variety of educational expenses, including K-12 educational expenses.

4. In a single year, a couple may put up to $120,000 into a Section 529 College Savings Plan. These funds can only be used for higher education expenses, but they may be transferred from one family beneficiary to another family beneficiary at any time.

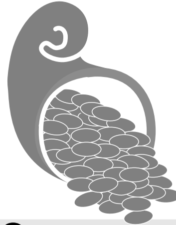
5. Interest on Series EE bonds and Series I bonds is typically paid only upon bond redemption. These government bonds are tax deferred and may be totally tax free, when the proceeds are used for qualified educational expenses.

6. If you and/or a dependent are in the first two years of a post-secondary degree program, you may be eligible for a Hope Credit of up to a $1,650 tax credit for tuition and fees paid.

7. If you and/or your dependents are taking courses for a degree or to improve your job skills, 20 percent of the tuition and fees that you pay may be eligible for the Lifetime Learning Credit, providing a tax credit of up to $2,000 in a single tax year.
8. You may use either the Hope Credit or the Lifetime Learning Credit in a single tax year, but not both. Both are also subject to MAGI phase-outs.

CHAPTER 2 ABUNDANCE STRATEGIES

1. Use Coverdell ESA accounts to fund precollege educational expenses and Section 529 College Savings Plans to fund expenses for higher education.
2. With a 529 College Savings Plan, fund the maximum that you can afford as early as possible. If your spouse agrees, you may fund up to $120,000 in one year, with no further funding for five years. Funds grow on a tax-free basis and are totally tax free when withdrawn for higher educational purposes.
3. Have grandparents fund a 529 College Savings Plan. The account owner can change the account beneficiary to another qualifying family member at any time. This gives the account owner complete control over who will be able to access the educational funds.
4. Series EE and Series I Government Savings Bonds are a tax-deferred method of saving. Income tax on these bonds is deferred until they are sold. Use the proceeds for educational expenses and pay no taxes on the income from these bonds, if you are under the Adjusted Gross Income "phase-out" limits.
5. If both the Hope and Lifetime Learning Credits are available, you will typically benefit from choosing the Hope Credit, unless your family's total tuition and fees exceed $8,250.



CHAPTER 3

Let Uncle Sam Subsidize your Retirement

"When a man retires, his wife gets twice the husband but only half the income."
–Chi Chi Rodriguez

Having adequate funds for your retirement years is crucial to living an abundant life. Thanks to our tax code, there are several ways in which you can let Uncle Sam help subsidize your retirement savings.

Individual retirement accounts and company-sponsored retirement accounts will maximize the funds that you will have available to live abundantly throughout your retirement.

Individual Retirement Accounts

With a traditional IRA, you may receive an immediate tax deduction of the amount used to fund your IRA. When you withdraw IRA funds, you pay ordinary income taxes on your withdrawals.

A Roth IRA deposit receives no immediate income tax benefits. However, "qualified" withdrawals from a Roth IRA are completely tax free.

With both a traditional IRA and a Roth IRA, all funds grow on a tax-free basis from the time they are deposited until the time they are withdrawn.

Traditional IRA

There are two requirements to making an IRA contribution:

1. You must be age 70 ½ or younger.
2. You or your spouse must have *earned income*, which includes wages, tips, self-employment income, alimony and divorce maintenance payments.

Earned Income: All compensation received for performing personal services.

Your maximum annual IRA contribution is $4,000 ($5,000 if you are between 50 and 70 ½ years of age). If your annual earned income is less than $4,000, your maximum contribution is the amount that you earned.

In 2008, the maximum IRA contribution amount rises to $5,000 ($6,000 if you are 50 years old or older). In 2009 and beyond the maximum amount that you can contribute to an IRA will be adjusted for inflation.

Regardless of your income, your entire IRA contribution is tax deductible if you are not covered by a company retirement plan.

If you are covered by a company retirement plan, the tax deductibility of your IRA contribution is phased out when your Modified Adjusted Gross Income (MAGI) is between $83,000 and $103,000 (2007) for joint tax filers and between $52,000 and $62,000 for single taxpayers.

Modified Adjusted Gross Income (MAGI) is typically the same as Adjusted Gross Income (AGI). If you have earned

foreign income, your MAGI is your AGI, increased by the amount of foreign income earned.

If your spouse is an active participant in a company-sponsored retirement plan but you are not, you may deduct your IRA contributions, even if you have no income!

> Olaf and Anita are both 51 years of age. Olaf, a manager in a high-tech company, is paid $140,000 per year and has a 401(k) retirement plan with his company. Anita volunteers at the local food bank and is taking courses at the local university.
>
> Although Anita has no income and Olaf is covered by a company retirement plan, Anita may make a fully deductible IRA contribution of $5,000 in 2007. The only requirement is that she and Olaf file a joint tax return.
>
> Anita's tax-deductible contribution is considered a Spousal IRA. As long as Olaf and Anita's combined earned income is at least equal to their IRA contributions, Anita may make a tax-deductible contribution of the maximum allowed amount of $5,000 (2007), since she is between the ages of 50 and 70 1/2.

The Modified Adjusted Gross Income (MAGI) of your joint return must be below $156,000 (2007) for a Spousal IRA to be fully deductible. If your MAGI is between $156,000 and $166,000, the deductible amount is reduced, and it is nondeductible when MAGI is over $166,000. This process is called a MAGI "phase-out."

If you choose to make a nondeductible contribution to your IRA, file IRS Form 8606 to report the nondeductible

contributions and keep this form until retirement, so you will not pay taxes twice on your nondeductible contributions.

Roth IRA

As with a traditional IRA, Roth IRA contributions have two requirements:

1. In 2007, your Adjusted Gross Income (AGI) must be under $99,000 if you are single or under $156,000 if you are married and filing taxes jointly.
2. You or your spouse must have earned income, which includes wages, tips, self-employment income, alimony and divorce maintenance payments.

Your contributions to a Roth IRA are limited to the lesser of $4,000 per year ($5,000 if you are over age 50) or your annual compensation. If you make any deductible IRA contributions during the year, your maximum Roth contribution amount will be further reduced by the amount contributed to your IRA.

Contributions to a Roth IRA are never deductible and provide no immediate tax savings. However, you are allowed to make Roth IRA contributions after you have reached age 70 1/2.

Since your contributions to a Roth IRA have already had taxes paid on them, you may withdraw your contributions at any time, without any income tax or penalty. Withdrawals from your Roth IRA are treated as though the distribution is taken first from your contributions. The full amount contributed to your Roth IRA can be withdrawn, with no tax consequences.

Phillipe and Nicole are ages 73 and 71 respectively. They are both in good health and hope to live many more years. Phillipe serves as a director on a company board and is paid $15,000 annually for his services.

With Social Security payments, Phillipe's company compensation and investments, their annual income is $130,000. This amount is more than enough for them to live abundantly.

When Phillipe and Nicole die, their son Michel will inherit their remaining estate. With advice from their estate-planning attorney, they decide to each contribute $5,000 to a Roth IRA, with their son as the beneficiary.

When they die, Michel will be able to roll over their Roth IRAs into an inherited Roth IRA. With an inherited Roth IRA, Michel will only be required to take annual distributions that are based on IRS supplied tables of his life expectancy. The remaining inherited Roth IRA funds can continue to grow tax free throughout Michel's lifetime.

Qualified distributions of Roth IRA earnings are tax free. As long as a Roth IRA has been in existence for at least five tax years, a qualified distribution must meet only one of the following requirements:

> **Qualified Distributions:** Retirement plan distributions that meet the specified requirements of the plan so as to avoid taxation and/or penalties.

1. You must be at least 59 1/2 years of age.
2. Your Roth IRA funds are paid to a beneficiary upon your death.
3. You have become disabled.
4. You are a first-time homebuyer and are withdrawing no

more than $10,000 in Roth IRA earnings. A first-time homebuyer is defined as anyone who has not owned a home for the prior two years.

One of the above requirements must be met, otherwise distributions are treated as though they were first taken from nontaxable contributions and then taken from taxable earnings. Because of this, *nonqualified distributions* are only taxable when the total distributions from your Roth IRA exceed your total contributions.

With nonqualified distributions, the Roth earnings are taxed as ordinary income and receive a 10 percent tax penalty.

Nonqualified Distributions: Withdrawals from a retirement account that do not meet the withdrawal requirements of the plan. These withdrawals will often receive taxation and penalty payments that would not be imposed on a "qualified withdrawal."

Converting IRA Assets

Deductible IRA assets can be converted to a Roth IRA. When you convert IRA assets to a Roth IRA, ordinary income taxes are due on the converted assets in the year that you make the conversion. The Roth IRA conversion deadline for each year is December 31, not April 15 of the following year.

To convert an IRA, you must have a modified adjusted gross income (MAGI) of $100,000 or less. This does not include the amount that you convert. Beginning in 2010, the $100,000 MAGI limit will no longer apply.

Last year, Hoshi and Niki sold their retail store to a large chain. They have decided to take a year off and travel around the world.

When they return home in early December, they realize that their annual $45,000 in *Schedule A*

itemized tax deductions for their home mortgage, medical expenses, charitable contributions, and property taxes will be "wasted," since they have no income to "offset" these deductions.

> **Schedule A:** The schedule on tax form 1040 for itemized deductions. If Schedule A deductions exceed the "standard deduction," you may deduct the Schedule A amount.

Researching this concern, Hoshi finds that he and Niki can convert their IRA assets to a Roth IRA. The taxes that they will pay on a $100,000 conversion are less than 7 percent ($7,000) of the amount transferred. The conversion tax rate is a much lower tax rate than they will have to pay in retirement.

The $100,000 converted to a Roth IRA will grow tax free for the rest of their lives. Hoshi and Niki can make tax-free withdrawals of these funds in retirement or pass them on for their children to use tax free, if they do not need them.

Thanks to their "rich uncle" (Uncle Sam), Hoshi and Niki were able to travel around the world and still save thousands of dollars in future taxes. If you itemize your income tax deductions and have a low-income year, consider a Roth conversion to keep from "wasting" your Schedule A tax deductions.

Always hold Roth IRA conversion funds for at least five tax years before making a withdrawal. If you withdraw converted Roth IRA funds before the five year holding period requirement is met, all of the funds withdrawn will be subject to a 10 percent tax penalty.

You cannot directly convert qualified retirement plan assets, such as a 401(k) plan, to a Roth IRA. However, you can roll over your 401(k) plan into an IRA. The *rollover* IRA can

then be converted to a Roth IRA.

> **Rollover:** A tax-free reinvestment of a distribution from a qualified retirement plan into an IRA or other qualified plan within 60 days.

A Roth IRA does not provide the immediate tax reduction of a traditional IRA. However, your ability to withdraw Roth IRA funds tax free and your ability to pass these tax-free funds to your children or grandchildren, make the Roth IRA an investment worth careful consideration.

Company-Sponsored Retirement Plans

Only the most common *defined contribution plans* are explained below. These include 401(k) and 403(b) plans for employees and SEP IRA plans and SIMPLE IRA plans for the self-employed and the small business owner.

> **Defined Contribution Plan:** A retirement plan providing for an individual account for each participant and for benefits based solely on the amount contributed to the account, plus income, gains, expenses and losses allocated to the account.

If you have a *defined benefit pension plan* or any other type of defined contribution plan, your plan administrator can provide complete information on the benefits that will be available to you upon retirement.

> **Defined Benefit Pension Plan:** A specific pension benefit, determined by a formula that can incorporate the employee's pay, years of employment, retirement age and other factors.

401(k) Plan

With a 401(k) plan, you make an *elective contribution* in which your employer defers part of your salary to the plan. For tax purposes, the deferral is considered a contribution from your employer. Making this elective contribution lowers your taxable income by the

> **Elective Contribution:** The amount of salary that you “elect” to have deferred and put into the account with a defined contribution retirement plan.

amount contributed.

Often, your employer will match a percentage of the amount that you contribute. Employer matching contributions are often between four to six percent of your salary.

Maria is the human resources director of an electrical supply manufacturer, with a salary of $100,000 per year. Offering a 401(k) plan, her employer matches employees' contributions of up to 6 percent of their salary.

Maria has "elected" to have her employer defer 6 percent of her salary or $6,000, lowering her taxable income to $94,000. Maria's company will match her $6,000 401(k) contribution to provide a total of $12,000 for Maria to invest.

As a single taxpayer, Maria is in the 28 percent income tax bracket, with a 5 percent state income tax. Deferring $6,000 will save Maria $2,000 in state and federal taxes, giving her an after-tax cost of only $4,000 for her $6,000 contribution.

With her employer's matching contribution, Maria will have $12,000 to invest at an after-tax cost of $4,000. Thanks to a generous employer and Uncle Sam's tax subsidy, Maria will get an immediate 200 percent return on her investment

Maria's $6,000 contribution is immediately available to her or "vested" in her 401(k) account. Her employer has chosen a vesting schedule of 20 percent per year, starting in the second year of employment.

With this *vesting plan*, in her second year of employment Maria is 20 percent vested, 40

Vesting Plan: The process by which employees receive complete ownership of employer contributions made to the employee's qualified retirement plan account.

> percent vested in her third year, 60 percent in her fourth year, 80 percent in her fifth year and 100 percent vested when she has been employed for six years.
>
> When you become "vested," the vested funds are yours to do with as you please. Your employer no longer has any control over "vested" funds.
>
> Since Maria has been at her employer for three years, she is 40 percent vested in her employer's contribution. Since her employer has matched $18,000 of contributions over the past three years, $7,200 is now vested. If Maria leaves tomorrow, she may keep $7,200 of her employer's contribution.
>
> When Maria has been with her employer for six years, all of her employer's past and future contributions will be completely vested and available to her.

Annual elective contributions to a 401(k) plan are limited to $15,500 (2007). If you are at least age 50, you may make an additional $5,000 "catch-up" contribution for a total annual deferral of $20,500.

Annual employer matching contributions are limited to a maximum of 25 percent of your total compensation.

The maximum amount of employee and employer combined contributions is the lesser of 100 percent of your total compensation or $45,000 (2007). If you are at least 50 years old, with the $5,000 "catch-up" contribution, your maximum combined annual contribution is $50,000.

Roth 401(k)

Some 401(k) plans include a Roth 401(k) contribution program. With this, you may elect to have all or a portion of

your annual contributions treated as Roth contributions. Designated Roth 401(k) contributions are included in your gross income. Roth 401(k) contributions are treated as wages, subject to all applicable withholding requirements.

The annual dollar contribution limitation to a Roth 401(k) is $15,500 or $20,500 if you are age 50 or older. If you make any tax-deductible 401(k) contributions during the year, your maximum Roth 401(k) contribution amount will be further reduced by the amount you put into your tax-deductible 401(k) account.

Maria, now age 51, plans to retire when she is 60 years old. Her annual salary is $150,000. Her employer continues to offer a 6 percent 401(k) matching contribution.

Maria elects to have $9,000 of her salary deferred. The after-tax cost for her $9,000 contribution is $6,000. Her employer's matching $9,000 gives her $18,000 to invest in her 401(k).

Thanks to her good investment returns, Maria has over $600,000 in her 401(k).

While wishing to save more, Maria is concerned about paying high ordinary income taxes on her 401(k) withdrawals during her retirement years. She therefore decides to put $11,500 of her after-tax income into a Roth 401(k), from which she can make tax-free withdrawals when she retires.

Maria's total investment in her 401(k) and her Roth 401(k) is $20,500, the maximum allowed in 2007. Including her employer's matching contribution, Maria has $29,500 invested for her retirement this year.

While your employer cannot make matching contributions into a Roth 401(k) account, contributions that match your Roth 401(k) contributions can be made into your tax-deferred 401(k) plan account. In Maria's case, even if she put $20,500 into her Roth 401(k), her employer could match her contribution and put $9,000 into her 401(k).

Qualified distributions from a Roth 401(k) may be made only because of:

1. Death
2. Disability
3. Termination of employment
4. Attainment of age 59 1/2
5. Hardship.

Assuming that you have had your Roth 401(k) account for at least five calendar years, all qualified distributions are tax free.

Roth 401(k) plans are subject to the same age 70 1/2 minimum required distribution rules that apply to other retirement plans. To avoid this requirement, roll over your Roth 401(k) account into an individual Roth IRA account upon leaving your company. By doing so, you will no longer be subject to the age 70 1/2 minimum required distribution rules.

403(b) Plan

Available to employees of certain charitable, religious, educational and other tax-exempt organizations, the 403(b) plan is very similar to a 401(k) plan. Salary reduction rules, employer matching rules and vesting requirements are identical to a 401(k) plan.

With a 403(b) plan, employers must include all employees who have reached age 21 and who have completed at least one or two years of service, depending on the vesting schedule chosen for the plan.

Your elective contributions are limited to $15,500 (2007) or 100 percent of your compensation, whichever is less. As with a 401(k) plan, if you are at least age 50, you may contribute up to $20,500 by using the additional $5,000 "catch-up” contribution.

The maximum annual additions to your 403(b) plan account, including all employer matching contributions, are limited to a maximum of 100 percent of your total compensation or $45,000 (2007), whichever is less. If you are age 50 or older, the maximum combined contribution that may be allocated to your 403(b) account is $50,000.

Some 403(b) plans have a “special catch-up provision” that allows increased contribution limits. If you have been with the same qualified institution for at least 15 years, you may defer an additional “catch-up” of up to $3,000 per year. This “catch-up” deferral is limited to a lifetime maximum “catch-up” of $15,000.

The 403(b) plan “special catch-up provision” is in addition to the age 50 or older “catch-up” contribution. With this provision, you may contribute up to $23,500 annually for up to five years. If you have a 403(b) plan, check with your plan administrator to see if this “special catch-up provision” applies to your plan.

SEP IRA

If you are self-employed, being both employer and employee, the easiest retirement plan is a SEP IRA. Your annual contribution to a SEP IRA is limited to the lesser of 25 percent of your compensation or $45,000 (2007).

Contributions to the plan are deductible for the employer and excluded from the employee’s income.

Jim, a self-employed business consultant, has adopted a SEP IRA plan. As he is approaching retirement, Jim wishes to put the maximum amount possible of his $150,000 W-2 salary into his SEP IRA.

He elects to put $37,500 (25 percent of $150,000) into his SEP IRA. Since Jim's combined federal and state income marginal tax bracket is 35 percent, his after-tax cost of the $37,500 investment is only $24,375. Thanks to his tax savings, Jim receives an immediate after-tax return of over 50 percent on his SEP IRA investment.

SEP IRA accounts are always fully vested and belong to the account holder. All employees who are age 21 or over and who have been employed for at least three or more of the five preceding years must be included in the plan.

Requiring no tax reporting, other than filling out an "adoption agreement" to establish the plan, the SEP IRA is an ideal retirement plan for the self-employed.

Savings Incentive Match Plan for Employees (SIMPLE) IRA

Only employers with 100 or fewer employees are eligible to adopt a SIMPLE IRA plan. If you own a small business and wish to offer your employees a retirement plan, the SIMPLE IRA is often your best option.

Employees who receive compensation of $5,000 or more during any two prior years and who can expect to make at least that amount in the current year must be covered under a SIMPLE IRA. There are no age restrictions with a SIMPLE IRA plan.

Contributions made by the employee and the employer are both immediately vested (owned) by the employee. Employee contributions are limited to $10,500 (2007). If you are at least age 50, you may make an additional "catch-up" contribution of up to $2,500, for a maximum yearly employee contribution of $13,000.

As an employer, there are two methods of contributing to a SIMPLE IRA retirement plan. You can match your employee's contribution of up to 3 percent of annual salary or you can contribute 2 percent of each eligible employee's annual salary, regardless of whether or not the employee contributes.

All employer and employee contributions are excluded from income and all earnings in a SIMPLE IRA grow tax free until withdrawal.

Carlos, age 52, owns a small construction company with three full-time employees. These employees have been with Carlos since he started his business four years ago. Although he employs other workers during his peak building season, they are never with him for more than a few months.

Wanting to offer a retirement plan, Carlos has decided upon a SIMPLE IRA, using the 3 percent employee matching contribution approach.

Carlos' annual salary is $150,000. His three employees are annually paid $50,000, $40,000 and $30,000. If all employees participate in the SIMPLE IRA plan, Carlos' company will contribute $4,500 to Carlos' account and $3,600 to his three employees' accounts.

Since Carlos is over age 50, his "employee" contribution to his SIMPLE IRA is $13,000.

Including his $4,500 "company matching" contribution, Carlos is able to put $17,500 annually into his SIMPLE IRA.

As the company owner, he can deduct $13,000 from his personal income taxes and an additional $8,100 from his company's income taxes.

With a SIMPLE IRA, there are no limits on the amount of compensation that can be considered for each participant, when the employer uses the 3 percent matching contribution approach. When an employer's contribution is based on the matching formula, the employer's 3-percent match could reach $10,500 for any employee earning $350,000 or more per year.

There is a $225,000 limitation on compensation if the employer uses a flat 2 percent nonelective contribution. With the flat 2 percent contribution approach, the maximum employer contribution would be $4,500.

SIMPLE 401(k) Plan

The SIMPLE 401(k) plan is a SIMPLE plan that can be adopted as part of a 401(k) plan. Since this plan does not have to satisfy the nondiscrimination tests or the top-heavy rules applicable to most 401(k) plans, it can be very attractive to a small business owner.

A SIMPLE 401(k) plan has the same requirements and provisions as the SIMPLE IRA plan regarding eligibility, maximum contribution, deductibility, vesting, etc.

The only difference is that with a SIMPLE 401(k) plan, the $225,000 compensation limitation applies, regardless of whether the employer provides the 3 percent matching or the 2 percent nonelective contribution. Because of this, the maximum 3 percent matching company contribution is $6,750 in the SIMPLE 401(k) plan.

If you own a small business, you may want to consider the benefits of either a SIMPLE IRA or a SIMPLE 401(k), especially if your employees make considerably less than you.

CHAPTER 3 SUMMARY

1. Individual Retirement Accounts (IRAs) allow up to $4,000 annually, or $5,000 if at least age 50, to be contributed and deducted from income taxes. IRA funds grow tax free until they are withdrawn. Mandatory withdrawal must begin at age 70 ½, with all withdrawals taxed as ordinary income.
2. Your Spouse can invest $4,000, or $5,000 if age 50 or older, into their own IRA, even if they have no earned income. Your combined earned income must exceed your combined IRA contributions. If you are in a retirement plan, the Modified Adjusted Gross Income (MAGI) for your joint tax return must be under $156,000 (in 2007) for your spouse's IRA contribution to be completely deductible.
3. Roth IRAs are an alternative investment to traditional IRAs. The same IRA investment limits apply to Roth IRAs. The Roth IRA investment limit is reduced by any deductible IRA contributions that you make.
4. Roth IRA investments are not tax deductible, but grow on a tax-free basis. Qualified distributions from Roth IRA accounts are tax free. Roth IRA accounts have no mandatory age 70 ½ withdrawal requirements and can be ideal accounts to pass on to your younger heirs.
5. The 401(k) and 403(b) are similar retirement plans allowing up to $15,500 per year ($20,500 per year at

age 50) to be saved in a tax-deferred account. All plan contributions are not included in taxable income. Mandatory withdrawal must begin at age 70 1/2. Withdrawals are taxed as ordinary income.

6. Companies often match some portion of your 401(k) or 403(b) contributions. This can multiply your rate of return from these plans. Upon leaving your employer, plan funds can be rolled over into an IRA.
7. Some 401(k) plans have a Roth 401(k) plan, allowing you to invest after-tax funds that grow tax free and can be withdrawn tax free. The 401(k) plan funding limits apply to the Roth 401(k) plan. The Roth 401(k) investment limit is reduced by any deductible 401(k) plan contributions.
8. Roth 401(k) plans require mandatory withdrawal beginning at age 70 1/2. However, a Roth 401(k) account can be rolled over into a Roth IRA account to eliminate this requirement
9. If you are self-employed, a SEP IRA is an ideal retirement plan. You may contribute up to the lesser of 25 percent of your compensation or $45,000 (2007). Contributions to a SEP IRA are deductible for your employer and are excluded from your income. All earnings on the contributions grow tax free until they are withdrawn. Mandatory withdrawals must begin at age 70 1/2, with all withdrawals taxed as ordinary income.
10. If you are the owner of a small business, with fewer than 100 employees, consider a Savings Incentive Match Plan for Employees (SIMPLE) IRA. The company may either match employee contributions of up to 3 percent of annual salary or it can make a flat contribution of 2 percent of each employee's salary, regardless of whether or not the employee contributes.

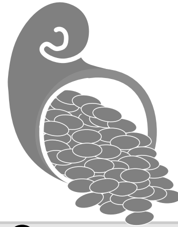
The maximum employee contribution is $10,500 (in 2007) or $13,000 for age 50 or older employees.

11. The SIMPLE 401(k) plan does not have to satisfy the nondiscrimination tests and top-heavy rules applicable to 401(k) plans. Contribution amounts and limits are the same as to the SIMPLE IRA, except that a $225,000 compensation limit applies to the 3 percent matching company contribution.

CHAPTER 3 ABUNDANCE STRATEGIES

1. If you file a joint tax return and your spouse has little or no earned income, your spouse should put $4,000 ($5,000 if age 50 or more) into an IRA. If you are in a company retirement plan, your joint return MAGI must be less than $156,000 for the "Spousal IRA" to be fully deductible.
2. If you are not 59 1/2 years old and must withdraw funds from one of your tax-deferred accounts, withdraw funds from your Roth IRA. All of the funds that you invested in a Roth IRA may be withdrawn tax free. Only funds that represent your Roth IRA earnings' growth are taxable, and these come out of your Roth IRA last.
3. If you have little income during the year, but you have large itemized tax deductions for your home mortgage, property taxes, charitable donations, etc., convert some of your IRA holdings to a Roth IRA. Your itemized deductions may allow you to convert a significant amount of your IRA to a Roth IRA and pay little or no tax on the converted amount.

4. If you have a 401(k) plan or a 403(b) plan and your employer provides matching contributions, contribute the maximum amount that your employer will match. The matching amount provides a guaranteed investment return. If your employer provides 100 percent matching, you receive an immediate 100 percent return on your contribution and an even greater return on an after-tax basis.
5. If you participate in a Roth 401(k) plan, be sure to roll this account over to a Roth IRA when you leave your employer. By doing this, you avoid the age 70½ required distribution rules of a Roth 401(k) plan.
6. When you leave your employer, it is often wise to roll over your 401(K) plan or your 403(b) plan into an IRA. This will not only provide you with more investment control, it will also give you the option of converting the IRA funds into a Roth IRA.
7. If you are self-employed, the best retirement plan is often a SEP IRA. With a SEP IRA, you may reduce your taxable income by the lesser of 25 percent of compensation or $45,000, investing this amount for your retirement.
8. If you own a small company with fewer than 100 employees, consider a SIMPLE IRA or SIMPLE 401(K) plan. The 3 percent match approach allows you to put up to $10,500 ($13,000 if you are at least age 50) plus an additional 3 percent of your salary into your SIMPLE account. This is especially effective when you earn considerably more than your employees.



CHAPTER 4

Cut Your Health Insurance Costs in Half

"The greatest Wealth is Health."
–Virgil

A Health Savings Account (HSA) is a tax-advantaged savings account that must be combined with a qualifying high-deductible health insurance plan (HDHP).

Since you are able to purchase medical expenses with income that is never taxed, all of your medical services are purchased at a discount, equal to your combined federal and states tax brackets. With a 28 percent federal tax bracket and a 5 percent state tax, you are buying all of your medical services at a 33 percent discount!

The Health Savings Account (HSA) is the only savings account that combines both tax-advantaged features.

Like IRAs, HSAs receive an immediate tax deduction of the amount used to fund the HSA. As with all tax-advantaged investments, your HSA grows tax-free. When funds are withdrawn for health care, all withdrawals are tax-free, similar to a Roth IRA.

Available through most health insurance companies, qualified HDHPs must be partnered with an HSA. HDHP plans have deductibles between $1,100 and $5,250 for singles and between $2,200 and $10,500 for families. Once the HDHP insurance policy becomes effective, you are allowed to fund an HSA account.

HSAs allow you to avoid federal income tax on annual HSA deposits of up to $2,850 for singles or $5,650 for families. If over age 55, you may contribute an additional $800 (2007) to the HSA. HSA deposits must be made by the time income taxes are filed for the year or April 15 of the following year at the latest.

Chris' company changed to a high-deductible health insurance plan (HDHP) in January. His company pays all of the insurance premiums, but Chris must now pay a $2,500 family deductible. He has no co-pay and all medical costs are covered at 90 percent, once the family deductible is met.

To pay for deductibles and other medical costs, Chris deposits $5,650 into an HSA account. Chris' combined federal and state income tax brackets are 34 percent. With his income tax savings of $1,921 from the HSA deposit, his after-tax cost of the $5,650 HSA investment is only $3,729.

Chris is now able to purchase $5,650 of medical services at an after-tax cost of only $3,729. On an after-tax basis, Chris is receiving a 34-percent "discount" on all medical services purchased with HSA funds.

By subtracting his $1,921 in tax savings from his $2,500 deductible, Chris' actual "out-of-pocket" expense for the $2,500 deductible is only $579.

Having a previous insurance policy with a $500 individual deductible and a $1,000 family deductible, Chris can already see the advantage of his HDHP/HSA policy.

If Chris' family requires only $500 in health care costs, Chris has saved $1,421 in income taxes. He also has the $5,150 remaining in his HSA to grow tax free.

Assuming that Chris' family requires $3,000 in medical expenses, the $2,500 deductible cost of his HDHP, reduced by his HSA tax savings of $1,921, leaves him an after-tax deductible cost of $579. Once his family's deductible is met, the additional $500 in medical costs are covered at 90%, for an out-of-pocket cost of $50.

With his HDHP/HSA Chris' $3,000 in medical expenses have an after-tax cost of $629. Plus, after paying $3,000 in medical expenses, Chris will still have $2,650 in his HSA to grow tax-free.

With Chris' previous health plan, the after-tax deductible costs would have been $1,000. His policy also required "co-pays" of $20 for each doctor's visit. His family's six trips to see their doctors would have cost $120.

Chris' previous policy also covered 90% of all medical costs after the deductible was met. For the $2,000 in medical costs, after the $1,000 deductible, he would have been required to pay $200. With his previous "low deductible" insurance policy, Chris would have had after-tax costs of $1,320 to pay for $3,000 in medical expenses.

Even with $3,000 in medical costs, the after-tax cost of his previous plan would have been $1,320 while his HSA/HDHP plan after-tax costs are only $629. With the HSA/HDHP plan, Chris will save $691 and have $2,650 in remaining HSA funds, to

grow and use for future medical expenses on a tax-free basis.

If you have no earned income and do not itemize deductions, you are still allowed to fully deduct HSA deposits.

If your employer makes the HSA contribution, this contribution is excluded from your income and is not subject to any income tax or *Federal Insurance Contributions Act* (FICA) tax. Regardless of who makes the contribution, you will reduce your income taxes significantly.

Federal Insurance Contributions Act (FICA): An employment tax imposed equally on employees and employers. It funds federal programs for retirees, the disabled and children of deceased workers. The FICA tax funds Social Security and Medicare.

An HSA account can be used to cover costs that would not normally be covered by a health insurance policy. Some of the medical expenses for which an HSA can be used include:

1. Dental expenses
2. Mental health care
3. Physical therapy
4. Alternative medicine treatments
5. Transportation and lodging expenses when related to health care
6. Charges incurred as part of a preventive health program
7. Non-prescription medications
8. Special fees incurred by handicapped individuals
9. Maternity expenses
10. Insurance premiums to pay for qualified long-term care

Your HSA account can be used to pay medical expenses for a spouse or any dependent family member, even if that person is not covered by the insurance policy.

Half-Priced Health Insurance!

HDHP health insurance costs less than a typical lower-deductible health plan. Premium savings often amount to between 25 and 40 percent.

Pierre is self-employed, with a net income of $150,000 per year. He is in the 28 percent Federal and 5 percent state income tax brackets. Presently, his family health insurance costs are $800 per month.

Pierre has found a $3,000 family deductible HDHP insurance policy, with 90 percent of all in-network expenses paid after reaching the family deductible. The HDHP insurance premium is $560 per month, a 30-percent savings off his current policy. For the year, his premium savings are $2,880.

Pierre buys the HDHP policy and deposits the maximum contribution of $5,650 into an HSA. With a federal and state combined income tax bracket of 33 percent, the $5,650 contribution provides Pierre with a tax savings of $1,865.

Pierre and his wife Marie are healthy and require little health care. Pierre estimates tax savings of $100 per year on the tax-free growth of his HSA.

Pierre's combined health insurance savings are $4,845 ($2,880 + $1,865 + $100). Since his previous health insurance cost $9,600 annually, the after-tax cost savings on the HDHP/HSA of $4,845 has cut his health insurance costs in half!

Free Health Care in Retirement!

Medicare will not cover many medical expenses in your lower-income retirement years. The Employee Benefit Research Institute estimates that medical expenses could be $164,000 for a 65-year-old who lives the average life span of 20 more years.

With proper planning, your retirement medical costs could be reduced to $0.

If it is possible, pay your medical care costs without using the funds contributed to your HSA during your higher-income working years. During these years, your HSA funds will grow tax free and they will be tax free when withdrawn for medical expenses. This tax-free growth can reduce or even eliminate healthcare costs during your retirement years.

Mario and Annette are age 45. As self-employed web site designers, with a growing client base, their combined annual income is $180,000. While they feel financially secure, they know that, except for Social Security, they must be financially self-sufficient when they retire in 20 years.

After considering various health-care plans, Annette and Mario decide upon a HDHP/HSA medical plan. They are attracted by its ability to immediately reduce their insurance payments and to get a $5,650 annual tax deduction.

Understanding the advantage of tax-free growth, they decide to pay their current medical expenses without using the funds deposited in their HSA.

Using a family HDHP/HSA medical plan, they deposit $5,650 into their HSAs until age 55

and deposit $7,250 (using the $800 per person "catch-up" provision) from age 55 until they retire at age 65. Assuming an 8-percent annual return, Mario and Annette will have $281,700 in their HSA at age 65.

Once enrolled in Medicare, Annette and Mario can use their HSA funds to pay for Medicare premiums, deductibles, co-pays and co-insurance under any part of Medicare. They can also use these funds for long-term care insurance and other medical related expenses that are not covered by Medicare.

The one medical expense that their HSA funds cannot be used for is the purchase of a Medicare "supplemental insurance" or "Medigap" policy

By planning for their future, Mario and Annette feel confident that their HSA funds will be sufficient to pay 100 percent of their medical expenses throughout their retirement years.

If your employer does not provide health insurance, consider an HSA, matched with an HDHP. On an after-tax basis you may be able to cut your health care insurance cost in half with the HDHP/HSA approach. An HSA will also provide you with more control over your future health care expenses upon retirement.

CHAPTER 4 SUMMARY

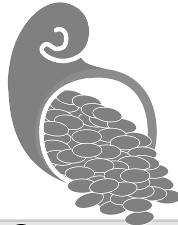
1. A Health Savings Account (HSA) is a tax-advantaged savings account that must be combined with a qualifying high-deductible health insurance plan (HDHP). Using *pretax funds* to pay for medical expenses allows you to buy medical services at a "discount," equal to your combined federal and state income tax rates.

> **Pretax Funds:** Funds upon which you are not required to pay income taxes. When you are able to purchase services with untaxed funds, the services are effectively purchased at a discount that is equal to your combined federal and state income tax rates.

2. The HSA is the only savings account that combines both features of a tax-advantaged savings account. An immediate tax deduction of the amount deposited into the HSA is combined with tax-free withdrawals for medical expenses.
3. HSAs allow you to avoid federal income tax on annual deposits of up to $2,850 for singles or $5,650 for families. If over age 55, an additional $800 (2007) per person can be contributed to your HSA. Deposits must be made by the time income taxes are filed or April 15 at the latest.
4. The HSA account can be used to pay medical expenses for your spouse or any dependent, even if that person is not covered under the insurance policy. You can also use your HSA account to cover medical costs that are not normally covered by a health insurance policy.
5. Combining reduced insurance costs, tax savings of your HSA deposit and the tax-free growth of your deposits, the HDHP/HSA insurance approach can cut your health insurance costs in half!

CHAPTER 4 ABUNDANCE STRATEGIES

1. If you have a HSA/HDHP, always contribute the maximum amount, $2,850 for singles or $5,650 for families. If over age 55, you and your spouse can each contribute an additional $800 (2007) to your HSA.
2. If you must use your HSA for immediate health care costs, you are using pretax funds to pay for your medical expenses. Using pretax funds allows the purchase of medical services at a "discount," equal to your combined federal and state income tax brackets.
3. If possible, save your HSA funds until your retirement years. Even though Medicare covers some of your costs, health-care costs during retirement are often substantial, averaging $164,000 per person. Having the financial security of funds in your HSA will help you maintain your feeling of financial abundance throughout your retirement years.



CHAPTER 5

Generous Giving with Uncle Sam's Support

"If you haven't got any charity in your heart, you have the worst kind of heart trouble."

–Bob Hope

Your abundance can have many uses. Let's explore techniques to maximize charitable giving with the help of Uncle Sam.

Qualified Charitable Deductions

From an IRS perspective, a contribution to a qualified charitable organization is tax deductible, based on the amount that the contribution exceeds the value of any benefits that you receive from the organization.

Meredith is a volunteer at the local food bank. This year, she is organizing a fundraiser that includes a benefit dinner and a silent auction.

Before the big event, she traveled 500 miles in

her personal car to ask local restaurants to prepare and donate food and wine for the dinner. She has also visited several businesses and artisans to get donations for the silent auction. At tax time, Meredith can deduct 14 cents per mile or $70 for her nonreimbursed commuting expenses for volunteer work.

Even though the food and wine is donated, Meredith estimates that the value of the meal is $40 per person. Tickets for the benefit dinner are priced at $100 per ticket. When Meredith and her husband Joe buy two tickets, they will be able to deduct $120 at tax time.

At the fundraiser, Meredith has a winning bid of $500 on a donated piece of art that the artist valued at $200. Even though the food bank will receive the full $500, Meredith's charitable tax deduction will be limited to $300, the difference between what she paid for the art and its *fair market value* (FMV).

Fair market value (FMV): The price a willing buyer will pay a willing seller, when neither party is required to buy or sell the item or service.

Meredith has the food bank send her written confirmation of all three items (mileage, benefit dinner and donated art work). She knows that, beginning in 2007, she must have written confirmation for any charitable expenses, even when the expenses are under $250.

Nondeductible items include donations to specific individuals, regardless of how needy they may be. While you may make donations (gifts) to individuals for up to $12,000, without paying any gift tax on your gift, you may only claim a charitable deduction when your gift is to a qualified charitable organization.

You may not deduct the value of your volunteer work, the

value of blood that you donate to the Red Cross or the rental value of property that you allow a charity to use at no charge.

If you decide to donate a week's use of a vacation rental property to a charitable event, you may be in for a double surprise from the IRS. Not only is the value of the week's rental not considered a deductible charitable gift, the donated week will be considered "personal use" of the rental property. If personal use of your rental property exceeds the greater of 14 days or 10% of the number of days it is rented, for tax purposes the property is treated as a residence rather than a rental property.

Donations to nonprofit organizations that are not qualified charities are also not tax deductible. If you are in doubt about whether a nonprofit organization is a qualified charitable organization, contact the organization and ask them if they are an IRS-qualified charitable organization.

Cash Donations

The simplest gift is the gift of cash. Prior to 2007, you were only required to have a written receipt from a charity when your cash donation was $250 or more. Now, you must have a cancelled check or other bank record or a receipt from the charity for any cash donation.

If you have previously put cash in your church's collection plate and kept a log of the weekly amount, this approach will no longer qualify for an income tax deduction. You must either have a bank record of each cash transaction or receive confirmation of your gifted amount from the charity.

A written receipt from the charity is required for all gifts of $250 and higher. Your receipt must include the charity's name, the date of the contribution, the amount of the contribution and a statement that you received nothing of value in return for the contribution. If you did receive something from the

charity, the receipt must also include the fair market value (FMV) of what you received.

Depreciated Property

For depreciated property such as clothing, furniture and household items, you may deduct the price you would pay for a comparable item at a thrift store. All of these items must be in at least "good" condition.

Keep a detailed list of all items that you donate, their condition and your estimated value for each item. Get a written receipt from the charity for the goods donated.

Luke owns a 1995 Honda and a 1983 Ford with Blue Book values of $3,800 and $450 respectively. With his new wife's encouragement, he has decided to donate these vehicles to a local charity. The charity sells the Honda for $3,500 and the Ford for $300.

Luke may only deduct $3,500 for the Honda, the amount that the charity received for the vehicle. However, since the Ford is worth less than $500, he may deduct the Blue Book value of $450, even though the charity only received $300.

Appreciated Capital Property

The easiest appreciated property to donate is publicly traded stock. For long-term capital gain stock, held for more than one year, you may deduct the stock's full value. A major advantage of contributing

Capital Property: Property that is subject to capital gain/loss treatment. This includes most of your assets, except for certain business assets or items that you have personally created.

long-term stock holdings is avoiding the requirement to pay capital gains taxes on the donated stock.

Long-term real estate and non-publicly traded securities are treated the same as publicly traded stock, but they also require a qualified appraisal of their value. Fees paid to an appraiser may be deductible as a miscellaneous itemized deduction, but cannot be included in the charitable deduction.

Never gift short-term capital gains property. Short-term capital property is any property, subject to capital gain/loss tax treatment, that has been owned for one year or less. Your charitable deduction for short-term capital gain property is limited to the price paid for the property and not its current appreciated value.

Do not gift any capital property that has depreciated. Always sell it first and donate the proceeds from the sale. By doing this, you receive a capital loss at the time of sale, helping to reduce your income taxes.

Appreciated Tangible Property

Works of art, jewelry, rare coins, collectibles and antique cars are considered *tangible property*. For tangible property that has increased in value since you bought it, the deductible amount is dependent upon how the property is used by the charity.

Tangible Property: Items such as machinery, computers and automobiles, that can be moved and are depreciated over a five- to seven-year time period.

In 1986, Terry bought a 1967 Ford Mustang GT 500 for $10,000. He has kept this car in excellent condition and has shown it at many car shows around the country. The Mustang was

> recently appraised for $100,000.
>
> Cars & Kids is a qualified charitable organization that raises funds to help needy children by having antique car shows throughout the country. Terry donated the Mustang to Cars & Kids with the understanding that it would be included in the travelling antique car show exhibit.
>
> Since his car will be included in the travelling exhibit, and exhibiting antique cars is part of the charity's primary tax-exempt purpose, Terry may deduct $100,000 from his taxes this year. If Terry had donated his Mustang, and Cars & Kids had sold it to raise funds to buy other, more exotic cars, Terry would only have been allowed a deduction of his original $10,000 cost.

When used by the charity for its primary tax-exempt purpose, the donated property's full value is deductible, as long as you have a qualified appraisal. If this is not the case, the deduction is limited to what you paid for the property.

Reversionary and Retained Interests

When donating property, make sure you retain no control whatsoever over the property. If there is even a remote possibility that the property might come back to you or that you still have power over the property, the IRS will disallow the charitable deduction.

Any *retained interest* in donated property can cause forfeiture of your charitable deduction. For example, suppose that you wish to keep voting rights in donated stock of your small, non-publicly traded company. Even if the charity will receive all of the dividends and is allowed to sell the stock back to the

> **Retained Interest:** When the gift giver or trust grantor keeps any control over the gift or trust.

company, your retained voting rights interest will keep the gift from being tax deductible.

Deduction Ceilings

There are deduction ceilings on charitable donations. This means that in any tax year, your maximum annual charitable deductions can be limited to 50 percent, 30 percent or 20 percent of your Adjusted Gross Income (AGI). The deduction ceiling depends upon the type of charitable organization to which your gift goes and the type of property that you donate.

Most charitable organizations are considered "50 percent organizations."

Included among "30 percent organizations" are veteran's organizations, fraternal societies, nonprofit cemeteries and private, non-operating foundations that do not pay out enough to charities each year to meet the requirements established for "50 percent organization" status.

The type of property that is donated also affects the AGI ceilings.

If the donated property is cash, ordinary income property, short-term capital property or property that has depreciated in value since its purchase, this property will maintain a 50 percent ceiling for "50 percent organizations" and a 30 percent ceiling for "30 percent organizations." This treatment also applies to all nonreimbursed expenses incurred while doing volunteer work.

Appreciated property, including publicly traded stock, in which you use the market value of the property as your donation amount, has a reduced ceiling. This type of property will have a 30 percent AGI ceiling if donated to a "50 percent organization" and a 20 percent AGI ceiling if donated it to a "30 percent organization."

If you chose to deduct the price you paid for the appreciated property, instead of its current value, the full 50 percent and 30 percent ceilings apply.

If you exceed the allowable ceiling in any year, excess contributions can be carried forward for up to five years.

Charitable Giving Strategies

Our federal tax code treats charitable giving very favorably. Even if you are subject to the *Alternative Minimum Tax* (AMT), your charitable contributions are deductible. This favorable tax treatment lets Uncle Sam subsidize your charitable gifts.

Alternative Minimum Tax: A parallel tax to the regular federal income tax, with different rates and definitions of income and deductions. This tax applies when certain tax benefits reduce your regular income tax below a specified level.

When making a charitable contribution you typically may write a check to the charitable organization. If you itemize deductions on your income taxes, the amount of the check can be deducted from your taxable income.

If you are single, with taxable income exceeding $77,100, you are in the 28 percent federal income tax bracket. When you give $10,000 to charitable organizations, you can deduct $10,000 from your taxable income, providing federal income tax savings of $2,800. With a state income tax of 5 percent, your charitable contributions will lower your state income tax by $500, for total tax savings of $3,300.

Your after-tax cost of contributing $10,000 is only $6,700.

To further increase the amount that you can give without increasing out-of-pocket costs, consider giving appreciated long-term capital property such as stocks or real estate.

Rehana feels very blessed with her financial abundance. Her church is having a capital campaign to which Rehana has pledged $10,000. Having a combined federal and state tax rate of 33 percent, Rehana's $10,000 cash donation would reduce the amount of taxes she owes by $3,300.

Two years ago, Rehana bought 100 shares of a publicly traded stock for $40 a share. Her stock is now worth $100 a share. If Rehana sold her stock, she would receive the $10,000 she has pledged to her church. However, she would also be required to pay a long-term capital gains tax of $900.

With her financial planner's advice, Rehana donates the appreciated stock directly to her church. By doing this, she avoids paying $900 in capital gains tax and still reduces her taxes by $3,300 for her $10,000 charitable contribution. By giving appreciated stock, Rehana's $10,000 gift costs her only $5,800, with Uncle Sam providing the remaining $4,200.

Donor Advised Funds

The easiest way to give appreciated publicly traded stock to a charitable organization is through a *Donor Advised Fund*– and you don't have to be rich to create one!

> **Donor Advised Fund**: An easy-to-establish charitable giving vehicle, set up under the tax umbrella of a public charity, that offers a low-cost, flexible alternative to direct giving or creating a private foundation.

The logistics of giving stock directly to a charity are cumbersome. Transferring stock certificates can take time and may require personal interaction with both your broker and the organization that your charity uses for the transfer of stock. If you don't want to give a large amount of

stock to any one charity, you must divide your shares of stock into smaller lots for each charity.

To overcome the problems of directly giving appreciated stock, you can create a Donor Advised Fund. These are qualified, private, *nonoperating foundations* that pool their donations and allow donors to select qualified charities for gifts.

Nonoperating Foundation: Usually incorporated as a nonprofit corporation or organized as a charitable trust, whose primary purpose is to make grants to charitable organizations

Feeling grateful for their financial abundance, Roberta and Juan are planning to contribute $10,000 at year-end. They will give $3,000 to their church and $7,000 to ten local charities that support the sick and needy in their town.

Roberta and Juan have a brokerage account at Fidelity that contains several appreciated stocks. Juan is aware that he can save taxes by giving appreciated stock, but the time required to give stock to eleven different organizations is too burdensome.

While reviewing his Fidelity account, Juan sees a link to Fidelity's informative website, www.charitablegiving.org. When he clicks on this link, he discovers that he can easily create a "Charitable Giving Account." On December 15, Juan makes an electronic transfer from his brokerage account to his Charitable Giving Account of 200 shares of a stock worth $55 a share, purchased three years ago for $15 a share.

Roberta and Juan receive a charitable deduction of $11,000, the fair market value (FMV) of their transferred stock. They also avoid paying

> $1,200 in capital gains taxes on their appreciated stock.
>
> Using the Fidelity website, they provide donations to their church and the other charitable organizations by recommending grants to each charitable organization. After giving $10,000, the $1,000 remaining in their charitable giving account can be invested in various mutual funds or money market funds. These funds may grow until they are used for future charitable giving.
>
> Each year, Roberta and Juan can choose the most appreciated stock(s) to transfer, and transfer the number of shares that will provide them their optimal charitable deduction. If they do not want to directly grant the full amount to their favorite charities, they can invest the remaining funds to provide them with even more charitable gift funds in the future.

Donor Advised Funds are simple to establish. Fidelity, Schwab, Vanguard and other brokerage firms offer these accounts. You may deduct more in a given year than you actually grant to your chosen charitable organizations, with any excess available for future charitable gifts.

Donor Advised Funds are similar to having your own charitable foundation, without the overhead and legal expenses required to establish a foundation. It's very easy to do.

Charitable Gift Annuity

If you are at least 50 years of age and wish to make a substantial gift to a charitable organization, consider a Charitable Gift Annuity, in which the charitable organization agrees to pay you and/or your spouse a fixed payment (annuity) for the remainder of your lifetime(s). After the death

of the last annuitant, the designated charitable organization receives any assets that remain.

A Charitable Gift Annuity provides the following tax benefits:

1. Upon setting up the annuity, you receive an immediate charitable income tax deduction for the value of the *remainder interest* of your gift. This is the calculated amount of your gift that will remain after you pass on.

Remainder Interest: The amount in a remainder trust that is left upon the conclusion of the income period.

2. Quarterly or annually, you receive tax-favored income, with a portion of each payment being tax free, since it is considered a return of your principal.
3. The asset(s) contributed are removed from your estate and will not be subjected to any potential estate tax.

IRS tables determine the amount of income that you will receive from the Charitable Gift Annuity, based on your age at the time you create it. Rates of return on the value of the donated property are competitive with commercial immediate annuities on a pre-tax basis.

On an after-tax basis, the Charitable Gift Annuity will often provide a higher payment than a commercial annuity plus provide a significant gift to your favorite charity.

The following are *immediate annuity* rates available, based on one or two lives:

Immediate Annuity: An insurance contract, guaranteeing that the policy issuer will make a series of payments in exchange for a sum of money. These payments may be either level (fixed) or periodically increasing payments for a fixed term of years or until the end of one or two lives.

ONE LIFE		**TWO LIVES**	
AGE	**RATE**	**AGES**	**RATE**
50	5.3%	55/50	5.1%
55	5.5%	60/55	5.3%
60	5.7%	65/60	5.5%
65	6.0%	70/65	5.7%
70	6.5%	75/70	6.1%
75	7.1%	80/75	6.6%
80	8.0%	85/80	7.3%
85	9.5%	90/85	8.4%
90	11.3%	95/90	10.1%

Funding a Charitable Gift Annuity with a cash gift will provide an immediate tax deduction on the remainder value of the gift. For greater tax savings, fund the Charitable Gift Annuity with appreciated long-term stock. With this approach, you will no longer be required to pay capital gains taxes of 15 percent on your stock's appreciated value.

Your tax savings include both the remainder value tax deduction on the total value of your stock as well as a 15 percent tax reduction on the amount that your stock has appreciated.

You may choose to delay your Charitable Gift Annuity payments for at least one year. By delaying payments, you are setting up a Deferred Charitable Gift Annuity. While the annuity payments are delayed, the tax deduction will be available in the year that the annuity is established.

William, age 50, has had a successful career as a business executive and would like to make a substantial gift to the university he attended.

Having no close relatives, William decides on a Deferred Charitable Gift Annuity. This provides an immediate charitable deduction to lower his current income taxes and, when he retires at age 65, he will receive income for the rest of his life.

By setting up his annuity to begin payments at age 65, William's gift of $500,000 in long-term appreciated stock will receive an immediate charitable income tax deduction of approximately $248,000. Since William has a combined marginal tax bracket of 38 percent (33 percent federal and 5 percent state), this deduction will save him $94,240 in taxes.

William's appreciated stock has a cost/basis of $200,000. He will not be required to pay 15 percent tax on the $300,000 capital gain, saving an additional $45,000 in taxes. Combining both his charitable and capital gains tax savings provides a total tax reduction of $139,240. William is pleased that Uncle Sam is contributing 28 percent of his $500,000 gift.

With an Adjusted Gross Income (AGI) of $200,000, the 30 percent deduction ceiling on his charitable remainder gift limits William to deducting $60,000 per year. Since the excess deductions can be carried forward for up to five years, William may deduct $60,000 for four years and $8,000 in the fifth year.

When William turns 65, his Charitable Gift Annuity will pay him $64,500 per year for the rest of his life. Since approximately 12 percent of this income is the return of William's original principal, 12 percent of his income is tax-free.

Comparing the $360,760 after-tax cost of his annuity with a commercially available single payment *deferred annuity*, William finds that the commercial annuity would pay him $66,000

annually when he turns 65. On an after-tax basis, the Charitable Gift Annuity will pay him almost the same amount, with William providing a substantial gift to his alma mater when he dies.

Deferred Annuity: An insurance contract that is primarily a vehicle for accumulating tax-deferred savings, with a view to eventually distributing the savings as either an immediate annuity or as a lump-sum payment.

With a Deferred Charitable Gift Annuity you can use the tax benefit from the charitable deduction in your high-income years. Deferring annuity payments until retirement allows you to receive fixed annuity payments in your lower income retirement years. This is similar to a fixed-income pension plan, with a portion of the annuity income being tax free.

Retained Life Estate

If you have greatly appreciated real estate that you would like to remove from your taxable estate, but wish to continue to use, consider a Retained Life Estate.

Jasmine and Bob built their home in Chapel Hill when their son Julio was born. In 1975 it cost them $45,000 to build their house, which was recently appraised at $400,000. When Bob passed away last year, Jasmine decided that she wanted to stay in Chapel Hill and live the rest of her life in her home that is filled with many wonderful memories.

Jasmine and Bob met at Duke University and she would like to leave a substantial gift to the university. Jasmine is financially secure, with assets of approximately $2,000,000, excluding her home. Her CPA has suggested that she consider a Retained Life Estate.

> Julio moved to California in 1999 and has no interest in ever returning to North Carolina. By setting up a Retained Life Estate, Jasmine will be able to remain in her house for the rest of her life and receive a substantial charitable tax deduction. The tax savings will help her pay for the maintenance, insurance and taxes on her home.
>
> When Jasmine dies, the house will go to the Duke foundation to be sold. Julio will not be burdened with selling the house or with paying estate taxes on the value of the home.

Your "residence" may be a vacation home or a farm. A Retained Life Estate generates a current charitable deduction equal to the value of the property less the *present value* of the retained life estate. Upon agreement termination, the charity may use or sell the property.

Present Value: The amount that funds, to be received in the future, are worth today, assuming a specified rate of return.

Charitable Remainder Trust

A Charitable Remainder Trust is an *irrevocable trust*, created to provide income to one or more beneficiaries for a specified time. At the end of the specified term, the trust terminates and the remaining assets go to the named charity.

Irrevocable Trust: A trust that cannot be modified or terminated by the grantor without the permission of the beneficiary of the trust.

Beneficiaries of the trust may be any person(s) whom you choose, including you and/or your spouse. Beneficiaries may receive income for their lives or for a specified term of years.

Charitable Remainder Trusts are tax exempt. The trust pays no income taxes, even if it has retained income. The beneficiary is taxed on all income received.

Charitable Remainder Annuity Trust

With a Charitable Remainder Annuity Trust (CRAT) you may select the amount of annual income that you receive. As with a Charitable Gift Annuity, you have the security of a fixed income for a fixed period of time of up to 20 years or until the death of the last beneficiary. With a Charitable Remainder Annuity Trust, you must fund the trust entirely at one time.

Raul purchased an apartment building in 1977 for $50,000. For the past 30 years, he and his wife Janet have received income from the apartment building. Raul and Janet have recently turned 65 and would like to sell the apartment building so they can begin traveling more often.

The apartment building is now worth $1,000,000. Raul has invested $200,000 in *capital improvements* and the building is fully depreciated. With his accountant, Raul discovers that if he sells the apartment building, he will pay $175,000 in federal income taxes. Knowing that Raul and Janet are major supporters of their local homeless shelter, their accountant suggests that they consider a CRAT.

Capital Improvements: Funds used to improve a capital asset, such as an apartment building, that are not deductible in the current year and that are added to the basis of the asset.

Upon talking to his lawyer, Raul finds that they can donate the apartment building to the CRAT and receive up to $64,200 per year in annuity payments for the rest of both his and Janet's lives. He also discovers, that they will receive an immediate $200,000 charitable tax deduction, saving them $66,000 in income taxes.

Combining the charitable tax savings with the

$175,000 capital gains tax savings provides a total tax reduction of $241,000. The after-tax "cost" of their $1,000,000 apartment building gift is only $759,000.

Comparing what his after-tax cost of $759,000 will buy with a commercially available *single payment annuity*, Raul discovers that the commercial annuity will pay him and Janet only $50,420 annually for the rest of their lives. By contributing their apartment building to a CRAT, they can receive $13,780 more annually than they could with a commercial single payment annuity and they leave a substantial gift to their local homeless shelter.

Single Payment Annuity: Often called a life annuity, this will provide a series of future payments for a specified purchase price. Annuity payments continue until the death of the annuitant or the death of the second of two annuitants in a joint and survivor annuity.

When you set up a CRAT, you receive a charitable deduction for the remainder interest of the trust. Using IRS tables, your remainder interest is calculated based upon the term of the trust, current interest rates and the rate chosen for annual payments. This complicated calculation should be left to the legal professional that helps you set up the Charitable Remainder Annuity Trust

Charitable Remainder Unitrust

With a Charitable Remainder Unitrust (CRUT), you decide what percentage of the value of the trust is to be paid to the income beneficiary each year. The CRUT must pay out at least 5% of its remaining value on a yearly basis. The number of years that the trust exists must be set so that the calculated remainder interest amount that will go to the designated charity is at least 10 percent of the total amount contributed.

The remainder interest that the charitable organization receives is the charitable deduction amount. The higher the annual pay-out to the beneficiary, the lower your charitable deduction. You may make additional contributions to a unitrust and you may modify the investment strategy to meet your changing financial needs.

Wealth Replacement Trust:

With a Charitable Remainder Trust, the trust's assets will eventually pass to one or more charities, instead of to your heirs. By receiving an immediate charitable deduction for the remainder value of the trust assets, a CRAT or CRUT provides a significant tax reduction. Purchasing life insurance with the tax savings can replace this "lost wealth" for your heirs.

George, age 60, is grateful that he has two grown sons who are married and financially independent. Before his wife Soo died, they were very active in their church. George would like to leave a substantial gift to his church's benevolence fund when he dies, but would also like to leave an inheritance for his sons.

Over the past 20 years, George has, among other assets, built a stock portfolio worth $1,000,000 with a cost/basis of $500,000. He is concerned about the stock market but does not want to pay the $75,000 in capital gains taxes required to liquidate his portfolio.

Talking to his financial planner, George learns how he can accomplish all of his goals through a Wealth Replacement Trust. George funds a Deferred Gift Annuity with his church, using his

$1,000,000 stock portfolio and receives an immediate charitable deduction of $439,000. At age 65, George will also begin receiving annual payments of $77,000 from his deferred gift annuity.

Having a combined federal and state income tax bracket of 33 percent, his charitable deduction will save him $144,870 in taxes. By funding his deferred gift annuity with appreciated stock, George also saves $75,000 in capital gains taxes for a total tax savings of $219,870.

With his lawyer's help, George establishes an *Irrevocable Life Insurance Trust* (ILIT). Using George's income tax savings, the trustee of the ILIT purchases a $1,000,000 life insurance policy on George with his sons as the co-beneficiaries.

Irrevocable Life Insurance Trust (ILIT): A trust that cannot be modified or terminated by the grantor without the permission of the beneficiary of the trust and contains a life insurance policy.

By setting up the Irrevocable Life Insurance Trust, George has "replaced" the $1,000,000 stock portfolio with a life insurance policy that will provide his sons that amount upon his death. He is also assured that his church will receive a significant gift for its benevolence fund upon his death. Plus, George will receive an annual annuity payment of $77,000 for the rest of his life

The Irrevocable Life Insurance Trust (ILIT) is a Wealth Replacement Trust. Your children receive a guaranteed amount of inheritance upon your death. You and your spouse receive lifetime income and leave a significant gift to one or more of your favorite charities.

Charitable Lead Trusts

With a Charitable Lead Trust, the income from an asset goes to a charitable organization for a period of time. At the end of the specified period of years or for a period measured by a named person's lifetime, the remainder of the trust will go to you or to some other beneficiary such as your children or grandchildren.

With a Non-Grantor Charitable Lead Trust, you pass assets to your child, grandchild or other beneficiary at greatly reduced federal gift and estate taxes or possibly completely free of estate taxes.

Charitable Lead Trusts are mainly used in the non-grantor form to remove assets from your estate with reduced gift and estate taxes. Talk to you legal and financial advisors to see if they might apply to you.

Charitable Gifts of Life Insurance

Giving a paid-up life insurance policy that is no longer needed can be beneficial.

Randy has a $100,000 paid-up whole life insurance policy that he purchased twenty-five years ago, when his son Thomas was born. Randy is the owner of the policy and Thomas was the beneficiary. After Thomas was killed in an automobile accident last year, Randy has become an active supporter of Mothers Against Drunk Drivers (MADD).

As Randy is divorced, he no longer requires a paid-up life insurance policy. Randy has decided to gift his life insurance policy to MADD. He makes MADD both the owner and beneficiary of the insurance policy.

Randy’s gift receives an income tax charitable deduction for the cost of replacing the policy at his present age and physical condition. The policy is now completely removed from Randy’s estate and he receives a substantial tax reduction in the year in which the gift is completed.

If Randy had gifted a life insurance policy that was not fully paid up, his income tax charitable deduction would have been the policy's cash surrender value. If he then continued to pay premiums on the policy, he would receive a charitable deduction in the amount of the premiums paid each year.

State laws regulate life insurance policies. Some state laws affect the deductibility of life insurance policies as charitable gifts for federal income tax purposes. Be sure to consult your legal and tax advisors before completing a gift of life insurance to a charity.

Chapter 5 Summary

1. A gift to a qualified charitable organization is a tax-deductible contribution, equal to the amount that the contribution exceeds the value of any benefits that you receive from the charity.
2. You can deduct the fair market value (FMV) of the following types of gifts: cash; depreciated property such as clothing, furniture and household items; publicly traded stock that you have held for over one year; real estate and non-publicly traded securities that have been appraised and held for over one year; appreciated tangible personal property used in the charity's tax exempt purpose; life insurance policies if the charity is the irrevocable beneficiary of the policy.
3. With short-term capital property your charitable deduction is limited to the lesser of your cost/basis or its current value.
4. Annual contributions are limited to 50 percent, 30 percent or 20 percent of your Adjusted Gross Income (AGI), depending upon the type of charitable organization and the type of property that you donate. Most charities are "50 percent organizations." If you deduct the fair market value (FMV) of appreciated property, the deduction limit will be reduced to 30 percent for "50 percent organizations" and 20 percent for "30 percent organizations." With cash and most other property, the AGI ceiling is not reduced.
5. If the AGI contribution ceiling is exceeded, excess contributions can be carried forward up to five years, to reduce future income taxes.
6. Giving long-term appreciated stock receives a tax deduction for the stock's current value, plus you pay no

capital gains tax on the stock.

7. With a Donor Advised Fund, you deposit appreciated stock and select qualified charities to receive cash gifts from the fund. Donor Advised Funds are similar to having a charitable foundation without the overhead and legal expenses.
8. With a Charitable Gift Annuity, the charity pays you and/or your spouse a fixed payment for the remainder of your lifetime(s). The charity receives any remaining assets after the passing of the last beneficiary. Tax benefits include an immediate charitable deduction of the remainder interest, partially tax-free annuity payments and the removal of the contributed assets from your estate.
9. A Retained Life Estate gives you and your spouse the right to live in your home or farm for your lifetime(s), a term of years or both. The home or farm is deeded irrevocably to the charitable organization. This generates a current charitable deduction equal to the value of the property, less the present value of your retained life estate, and removes the property from your estate.
10. A Charitable Remainder Annuity Trust (CRAT) pays you and/or your spouse a fixed payment for up to 20 years or until the death of the last beneficiary. At trust termination, the charity receives the remaining assets. You receive a charitable deduction for the present value of the remainder interest.
11. In a Charitable Remainder Unitrust (CRUT), the income beneficiary annually receives at least 5 percent of the trust's principal value. Your charitable deduction is the trust remainder interest, based on the pay out amount and the time period that the trust will

exist. The higher the pay out amount, the lower your charitable tax deduction

12. To replace assets that are donated in a CRAT or CRUT, a Wealth Replacement Trust purchases life insurance, using tax savings from a Charitable Remainder Trust. Putting life insurance into an Irrevocable Life Insurance Trust (ILIT), you have removed the assets used to fund the Charitable Remainder Trust from your estate and "replaced" them with proceeds from a life insurance policy. The insurance proceeds go to your children or grandchildren and are not included in your taxable estate.
13. With a Charitable Lead Trust, the charitable organization receives income for a period of time, with the principal passed back to you or to another beneficiary. The trust may be either a Charitable Lead Unitrust or a Charitable Lead Annuity Trust.
14. An unneeded life insurance policy is a charitable giving opportunity. The charity must be made both the owner and beneficiary of an existing policy. When you gift the policy to a charity, you receive an income-tax charitable deduction for the amount that it would cost to replace the policy at your present age and physical condition. The policy's full face value is removed from your estate.

CHAPTER 5 ABUNDANCE STRATEGIES

1. When doing volunteer work for a qualified charity, you may deduct commuting expenses, parking fees plus the cost of telephone calls, materials, stamps and supplies that you may have contributed. If you host a fundraising event for a charitable organization, you may deduct the costs of food and drinks. Get written confirmation of your expenses from the qualified charity.
2. Do not "donate" the use of your vacation rental property to a silent auction for your favorite charity. The rental value of the property is not deductible, plus the IRS will consider this "personal use" of the rental property.
3. Never give cash to a charity. Either a bank receipt or a statement from the charity for the amount contributed is now required for all gifts. When the gift is over $250, you must have a written statement from the charity.
4. You can only deduct the fair market value (FMV) of clothing, furniture or appliances if they are in "good" condition or better. You may no longer deduct items of "minimal monetary value."
5. Your deduction is the amount that a charity receives when it sells your donated motor vehicle, boat or airplane that is valued at over $500. If the charity states in writing that it is either giving away or selling the vehicle at below FMV to a needy person, as part of its charitable purpose, you may be able to deduct the full appraised value of the vehicle.
6. Never give capital property that has depreciated in value to a charity. Sell the property to get the capital loss and

then donate the proceeds. Only donate highly appreciated tangible property to a charity that will use the property for its primary tax-exempt purpose. When this occurs, you may deduct the FMV of the property. Otherwise, you may only deduct the amount that you paid for the tangible property.

7. When donating capital property that has a small gain, if you are close to your annual Adjusted Gross Income (AGI) deduction ceiling, you may choose to deduct your cost of the property instead of the FMV. By doing this, the 50 percent AGI ceiling will apply to the donated property instead of the 30 percent ceiling.

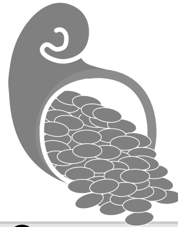
8. Whenever possible, give highly appreciated, long-term *capital assets*, instead of cash, to your favorite charitable organizations. You receive a charitable gift tax deduction for the asset's market value and you reduce your taxes by not paying any capital gains tax on the asset's appreciation.

> **Capital Assets:** Property that is subject to capital gain/loss treatment for tax purposes. This includes most of your assets, except for certain business assets or works that you have created.

9. Set up a Donor Advised Fund and transfer appreciated stock into the fund. When the stock is transferred, it is sold and you receive a tax deduction for the FMV of the stock. You can then recommend grants to your favorite charities using the assets in your Donor Advised Fund.

10. On an after-tax basis, a Charitable Gift Annuity often offers better rates than a commercial immediate annuity. The charitable organization receives all remaining assets after your and your spouse's deaths, and you get an immediate tax deduction for the remainder interest.

11. Set up a Deferred Charitable Gift Annuity before retirement, while your income is high. You will receive the tax deduction when you set up the annuity, but you may defer collecting annuity payments until after you retire.
12. With Charitable Remainder Trusts, the remaining assets go to your designated charity after a period of time or over one or two lifetimes. You receive an immediate charitable deduction for the remainder interest.
13. To provide your heirs a guaranteed inheritance, use an Irrevocable Life Insurance Trust (ILIT). Your heirs get the full value of the insurance proceeds and the insurance policy is not included in your taxable estate. Combining an ILIT with a Charitable Remainder Trust provides lifetime income, the remainder interest goes to your favorite charity and your children receive a guaranteed inheritance.
14. Use the Non-Grantor Lead Trust to remove appreciating property from your estate while reducing your gift-tax liability. If the lead period is long enough, the remainder interest, for which you have gift-tax liability, is significantly less than the present value of the property. This allows a large, appreciating asset to be passed to the next generation with a smaller gift-tax liability and with a significant amount of income going to your favorite charity for up to 20 years.



Chapter 6

Other Methods to Reduce Your Taxes

"Be thankful we're not getting all the government we're paying for."

–Will Rogers

The federal tax code has many legal methods to decrease income taxes, providing many opportunities to increase your financial abundance. In this chapter, we will provide some of these tax-saving strategies.

Sales Tax Deductions

If you itemize your income tax deductions, you can deduct your state income taxes paid from your federal taxes. Since 2005, you are allowed to either deduct your state income taxes or your general sales taxes paid. However, this deduction has not been made permanent and could be withdrawn by Congress at any time.

If your state has no income tax, the sales tax alternative is an obvious choice. Using the federal guidelines, the sales tax deductions you receive are fairly low and can only be augmented by specific large purchases. To get a larger

deduction, you can choose to use your actual sales tax receipts.

At age 55, Joel decided to leave his position as the director of finance in a sporting goods company. With his wife Irene, age 52, Joel has opened a bed and breakfast in a small mountain community. This year, their net income will be only $65,000, a significant decrease from Joel's previous $125,000 per year salary.

Joel and Irene have contributed a total of $10,000 to their IRAs. Combining this deduction with their Schedule A itemized tax deductions of $15,000 has left them with total taxable income of $33,200 and a federal tax bill of $4,200. With a 5 percent state income tax, their state income tax bill will be $1,660.

Irene wishes to pay the minimum in taxes that she legally can. At the beginning of the year, she found a large container and began saving every receipt from items purchased, dining out and groceries.

At the end of the year, Irene found that she and Joel had spent more than $60,000 on various taxable goods. The mountain community in which they live has general sales taxes of 8.5 percent. When Irene added all of the sales tax receipts, the total was $5,100.

Using the actual sales taxes paid, instead of their state income taxes, Irene and Joel were able to increase their Schedule A state tax deductions by $3,440. Increasing the Schedule A tax deduction lowered their taxable income to $29,760 and lowered their federal taxes to $3,680. By using their actual sales receipts, Irene and Joel saved $520 in

federal income tax and $170 in state income tax, for a total income tax savings of $690.

If you are retired, you will often owe little state income tax. As a retiree with a fairly high standard of living, you may be spending significantly more than your annual taxable income. This will be especially true if you have significant tax-free income from municipal bonds or you are spending previously taxed income.

You may have a higher Schedule A federal income tax deduction by computing your actual sales taxes paid instead of using the state and local income taxes paid.

To determine the approximate annual sales taxes that you pay, estimate your yearly expenses on taxable goods and multiply this amount by your local sales tax percentage. If you are planning on buying a new car, a boat or any other expensive item, be sure to include this purchase in your estimate.

If the sales tax amount calculated is significantly more than you expect to pay in state and local income taxes, save all of your receipts during the year. At the end of the year, total your sales taxes paid during the year.

It may be a pain to add up all those numbers, but you may be glad you did when you see your income tax savings! This simple approach could save you hundreds of dollars in federal and state income taxes.

Tax Exempt Bonds and Bond funds

Considering after-tax return, tax-exempt bonds and bond funds are often an attractive alternative to taxable bonds and bond funds, depending on your tax bracket. Use the following formula to evaluate the investment value of your taxable

income rate to your tax-exempt income rate:

$$\text{Taxable return} = \frac{\text{Tax-free return}}{1.0 - \text{Marginal Tax Rate}}$$

As an example, suppose that your *marginal tax rate* is 25% and you can receive a tax-free return of 4%.

Marginal Tax Rate: The percentage of income tax rate (tax bracket) that you will pay on each additional dollar of ordinary income that you earn.

To determine the equivalent taxable return:

$$\text{Taxable Return} = \frac{4\%}{1.0–25\%} = \frac{.04}{1.0-.25} = \frac{.04}{.75} = .06 = \mathbf{6\%}$$

Aboud is the vice president of operations for a small medical device manufacturer. While reallocating his financial resources, he realizes that he has too much of his portfolio in stocks and not enough in bonds. After selling some of his stocks, Aboud has $100,000 to invest in bonds. His broker suggests that he purchase 10-year corporate bonds yielding 6 percent annual interest.

Aboud is always trying to cut his federal tax bill, so he asks his broker to look at *insured municipal bonds* issued in his home state. His broker finds municipal bonds, but they yield only 4.5 percent annually.

Insured Municipal Bonds: Tax-free bonds that are insured against default by an outside insurance agency.

Being in the 28 percent federal income tax bracket, with a 5 percent state income tax, Aboud has a total marginal tax bracket

of 33 percent. Aware of the formula for converting tax-free return to taxable return, he finds that the 4.5 percent tax-free return is equivalent to a 6.7 percent taxable return. Aboud also calculates that the 6 percent taxable return yields him only 4 percent on an after-tax basis.

By doing this analysis, Aboud can tell his broker that he is happy to receive the "lower" 4.5% yield of the insured municipal bonds.

The following chart compares tax-exempt and taxable bond yields. For bonds from your state of residence, add your state income tax rate to your federal income tax rate to get your total Tax Bracket.

Tax Bracket	**Fully Taxable Bond Yields**				
15%	4.7%	5.9%	7.1%	8.2%	9.4%
25%	5.3%	6.7%	8.0%	8.3%	10.7%
28%	5.6%	6.9%	8.3%	9.7%	11.1%
33%	6.0%	7.5%	9.0%	10.4%	11.9%
35%	6.2%	7.7%	9.2%	10.8%	12.3%
	Equivalent Tax-Exempt Bond Yields				
	4.0%	5.0%	6.0%	7.0%	8.0%

If you are subject to the Alternative Minimum Tax (AMT), do not purchase *private activity municipal bonds*. The interest income of a private activity municipal bond is considered taxable income for AMT purposes, even though it is considered tax-free income for regular income tax computations.

Private Activity Municipal Bonds: Bonds that provide private developers and operators with access to tax-exempt interest rates for government projects. Income from these bonds is taxable under the Alternative Minimum Tax (AMT).

IRA to Roth IRA Conversions

Your Roth IRA can accept converted IRA funds. If your Modified Adjusted Gross Income (MAGI) does not exceed $100,000, funds in a traditional IRA, SEP IRA, or SIMPLE IRA may be converted to a Roth IRA. The $100,000 limit does not include the amount that you converted from your IRA.

Beginning in 2010, you may make a Roth IRA conversion from a qualified IRA, regardless of your MAGI. While immediate taxes will be due on the amounts converted, the converted funds will grow tax free and can be withdrawn tax free through a qualified distribution.

There is no requirement to begin making withdrawals from your Roth IRA at age 70 ½. Passing on income tax free assets to your children is an excellent use of a Roth IRA. With the proper election after your death, your children can continue to earn tax-free income from your Roth IRA assets throughout their lives.

Selling your Vacation Home

Assuming that your net gain is no more than $500,000, you and your spouse can sell your primary residence and pay no capital gains taxes on the sale. If you are single, the maximum tax-free gain is $250,000.

> Francois and Nancy live in Boulder, Colorado, and own a vacation home in Frisco, Colorado. Their Frisco home was purchased in 1996 for $300,000 and it is now worth $700,000. Based on past appreciation, they expect this house to be worth $800,000 in two years.

In two to three years, Francois and Nancy wish to move to a warmer climate on the East coast. If they sell their Frisco home, they will pay 15% long-term capital gains taxes on their $400,000 profit, for a total of $60,000 in federal taxes

With the advice of their financial planner, Francois and Nancy move into their Frisco home and make it their primary residence for two years. They love Frisco, so it's no sacrifice to make the move.

Since they need to live in Frisco only 50 percent of the time to claim it as their primary residence, they can also pursue their dream of world travel and even visit their Boulder friends occasionally. At the end of two years, they sell their Frisco home for $800,000 and pay no capital gains taxes, since it has been their primary residence for at least two years.

While they were living in Frisco, Francois and Nancy rented their Boulder residence to college professors on sabbatical. Upon returning to Boulder, they decide to sell this house and move to the Gulf Coast.

Francois and Nancy paid $400,000 for the house in 1994 and sell it for $900,000. They pay no capital gains on the $500,000 of the capital appreciation, since this house also qualifies as their primary residence for two of the past five years.

With this simple approach, Francois and Nancy were able to sell both homes and pay no taxes on capital gains of $1,000,000, in a two-year period. Not only are Nancy and Francois benefiting financially from their long-term planning, they are also benefiting psychologically. Saving money on taxes feels good and can be a very empowering experience.

If you plan on selling a vacation house that has significantly appreciated, you might consider making your vacation house your primary residence for a two-year period. You must live in the house at least 50 percent of the time during the year for it to be considered a primary residence.

Flexible Spending Accounts

If your company offers a Flexible Spending Account (FSA), take advantage of it. With an FSA, Uncle Sam will pay for a portion of your covered benefits, which can include your share of health insurance premiums, child care and medical expenses not covered by your health insurance plan.

Julie, a single mom, is a senior engineer with a disk drive manufacturer. Although she is paid $80,000 per year, she must spend $5,000 each year on child care, $2,500 on her share of medical insurance and $2,500 on medical expenses not covered by her medical insurance.

This year, Julie's company began offering a Flexible Savings Account (FSA). Julie has enrolled and asked for a salary reduction of $10,000 to fund her FSA.

At tax time, Julie's W-2 form will show her income as $70,000. By doing this, she will avoid paying 25 percent federal income tax and 5 percent state income tax. She will also avoid paying 7.65 percent in Federal Insurance Contributions Act (FICA) taxes on the $10,000 "salary reduction".

By paying for the qualified services with pretax dollars, she is effectively buying these services at a "discount" of 37.65 percent, the total of her federal, state and FICA tax savings.

> When expenses for qualified benefits arise, Julie files a claim against her benefit account and her employer reimburses her for the expense. At the end of the year, Julie has fully depleted her FSA account. By using her FSA to pay for qualified expenses with pretax funds, Julie keeps an additional $3,765 of her salary instead of paying it in taxes.

Be careful not to overestimate your FSA requirements. Any funds remaining in the flexible spending account at the end of the benefit period are forfeited back to the company plan.

Like-Kind Property Exchanges

Investment or business purpose property can be exchanged for similar property without any capital gain recognition. With this type of property exchange, it is recommended that you get advice from a qualified tax professional.

If the exchange transfers only like-kind properties, there is no capital gain or loss recognized. However, these transactions usually include some cash or debt relief so that the exchanged property values are equal. When this occurs, a partial capital gain or loss may need to be recognized.

Exchange Traded Funds vs. Actively Managed Mutual Funds

Exchange Traded Funds (ETFs) are often more tax efficient than *actively managed mutual funds*. With mutual funds you are

Exchange Traded Fund (ETF): A mutual fund that can be traded like stocks at any time during the trading day.

Actively Managed Mutual Funds: A portfolio management strategy in which the manager takes an active role in making investments, with the goal of outperforming a specific equity index.

responsible for paying taxes on all realized capital gains that the fund incurs during the year. Actively managed mutual funds often buy and sell stocks frequently, creating significant amounts of short term capital gains within the fund.

When you own a mutual fund, taxes on the capital gains generated by the fund must be paid each year, even if you still own the mutual fund at the end of the tax year. Since the stocks within an ETF are fixed, most ETFs never generate capital gains during the year. Capital gains taxes are paid only when you sell an ETF.

Selling Mutual Funds

If you buy mutual funds, keep track of the capital gains and dividends on which you pay taxes each year. Distributions should be added to your cost of the mutual fund or you will pay taxes twice on these distributions.

Roberto paid $10,000 for a mutual fund and kept it for five years. He re-invested all capital gain and dividend distributions. Each year, Roberto received and paid taxes on $1,000 in distributions from his mutual fund.

At the end of five years, Roberto sold the mutual fund shares that he owned for $17,000. Concerned about his capital gains taxes, he consulted his CPA. His CPA informed him that the past distributions, upon which Roberto had already paid taxes, should be added to his $10,000 cost. Since his *basis* (cost) is now $15,000, his capital gain is only $2,000.

Basis: The amount that you paid for a property or investment.

Buying Series EE Bonds

Since interest on Series EE bonds is typically payable only upon bond redemption, your investment in Series EE U.S. savings bonds will defer taxable income. Series EE bonds may be totally tax free if you apply the full proceeds of the EE bond redemption to qualified educational expenses for yourself, your spouse or a dependent.

This exclusion may also apply to the Series I savings bonds. There are some restrictions, such as Adjusted Gross Income (AGI) phase-out rules. The tax exemption for a married couple filing jointly begins to phase out when your AGI is $98,400 and is completely eliminated when your AGI reaches $128,400 (2007).

If you have family income of under $100,000 annually and are looking for an easy-to-use vehicle to save for your children's college education, consider these bonds, backed by the U.S. government.

Hybrid Vehicle Deduction

Through 2010, if you purchase a gas-electric hybrid vehicle, you may qualify for the alternative motor vehicle income tax credit on your federal income taxes. Depending upon the type of vehicle you purchase, this tax credit can exceed $3,000. However, if you are subject to the Alternative Minimum Tax (AMT) you may not be eligible for this tax credit.

There are many rules that apply to the tax credit, including a phase-out after a manufacturer has sold more than 60,000 qualified cars. Toyota's phase-out began in the forth quarter of 2006 and will be totally phased out by third quarter of 2007. If you plan on buying a hybrid vehicle, ask your dealer for the exact tax credit amount available on the new car that you are planning to purchase.

IRA Contributions

Contributing to your IRA and other tax-deferred accounts at the beginning of the year instead of at year-end takes advantage of a concept called the "time value of money." This approach provides for greater IRA funds at retirement.

Assume that you make a $4,000 annual contribution to an IRA, at the beginning of the year, for 35 years. With an 8 percent annualized total return, you will have $59,141 more than you would have if you made the same contribution at the end of each year.

Accurate Records Keep the IRS at Bay

There are certain records that you must keep to support your tax return. These records should be kept for a minimum of three years after you actually file your income taxes.

Papers dealing with any real property that you own must be kept. These include any receipts, tax returns or schedules dealing with the purchase or sale of a residence or other property.

The IRS requires that you have receipts for all expenses and deductions that you claim. If a charitable gift is more than $250, you must have written confirmation of the gift from the charity. For gifts less than $250, you must have check stubs or bank statements to support your deduction.

The IRS has three years after the later of the due date of your return or when you actually filed your return, during which they can audit your return. Under special circumstances, such as suspected fraud, your return can be audited up to six years after you file. Be sure to keep your tax returns and all supporting evidence of expenses and deductions together for at least three years. By doing this, If you are ever audited, you will be able to fully support any claims made on your tax returns.

CHAPTER 6 SUMMARY

1. On Schedule A of your federal income tax return, you may deduct state income taxes or your general sales taxes paid. In states where there is no income tax, the sales tax approach is always preferable. Congress has not made this choice permanent, and could eliminate it in 2007.
2. In states with an income tax, deducting your actual sales taxes paid may provide a higher deduction, especially in years where your spending is significantly more than your taxable income. To maximize this deduction, save all of your receipts, since the IRS deduction tables provide a relatively small amount that you can deduct.
3. When after-tax return is considered, tax-exempt bonds and bond funds are often a better investment than taxable bonds and bond funds. If you buy tax-exempt bonds issued in your state of residence, income will be exempt from federal and state taxes, providing an even higher after-tax return.
4. Beginning in 2010, you may make a Roth IRA conversion from an IRA, regardless of your Modified Adjusted Gross Income (MAGI). Conversions are particularly attractive in years in which you have little taxable income, especially if you have sizable tax deductions and exemptions.
5. When selling a second home with significant appreciation, consider making it your primary residence for a two-year period before selling it. By doing so, you will escape paying capital gains taxes on up to $500,000 of the home's appreciation for joint tax filers or up to $250,000 if you are a single tax filer.

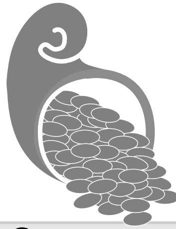
6. A Flexible Spending Account (FSA) reduces your salary to pay for qualified benefits with pretax dollars. Benefits can include health insurance premiums, medical expenses and dependent-care expenses. These services are purchased at a discount equal to the sum of your federal, state and FICA tax rates. If you overestimate your requirements, funds remaining in your FSA at year-end are forfeited.
7. With a Like-Kind Property Exchange, you exchange property used for investment or business purposes for similar property, without the recognition of any capital gain.
8. Exchange Traded Funds (ETFs) are more tax efficient than actively managed mutual funds. With mutual funds, you must pay taxes on capital gains that are realized each year, even if you still own the mutual fund. ETFs seldom have realized capital gains, until you sell them.
9. Interest on Series EE bonds and Series I bonds is typically paid only upon bond redemption. These government bonds are tax deferred and can be totally tax free if you apply the proceeds to qualified educational expenses for yourself, your spouse or a dependent.
10. Through 2010, purchasers of gas-electric hybrid vehicles may qualify for an alternative motor vehicle tax credit that can exceed $3,000 on your federal income taxes. This is a tax credit, not a deduction, lowering the federal income tax owed by the credit amount.
11. Contributing to your IRA and other tax-deferred accounts at the beginning of the year, instead of at the end of the year, allows your total retirement funds to be much greater.

12. The IRS can audit your return within three years after the later of the due date of the return or when you actually filed the return. Keep your tax returns and all supporting evidence of expenses and deductions together. Should you ever be audited, you will be able to fully support any claim that has been made on your tax returns.

CHAPTER 6 ABUNDANCE STRATEGIES

1. If you will likely spend more on sales taxes than you pay in state income taxes, put all of your receipts in a large jar, especially those for purchases of more than $100. By doing this, you could decrease the amount of federal and state taxes owed by several hundred dollars. If you claim the actual sales tax amount paid, put the receipts in a two-gallon zip-lock bag and store them with your other tax return records.
2. When buying bonds or bond funds, always compare taxable bonds to tax-exempt municipal bonds or bond funds. On an after-tax basis, municipal bonds often provide a better yield, especially if the bonds are issued in your home state.
3. If you have a low-income year, do some year-end tax planning to see if you can take advantage of your itemized deductions by converting some of your taxable IRAs (including SEPs or SIMPLE IRAs) to a Roth IRA. Transfer any amounts possible at total tax rates of 15 percent or below, which is taxable income below $31,850 for single filers and $63,700 for joint filers (2007).

4. When possible, make your vacation house your primary residence for two years before you sell it. You must live in it at least 50 percent of the time during each year. If your second home has appreciated $500,000, you can save $75,000 in capital gains taxes.
5. If your company has a Flexible Spending Account (FSA), use it to pay for health insurance premiums, child care and medical expenses not covered by your health insurance plan. Using an FSA, these expenses are paid for with pretax dollars. If your combined federal and state income taxes are 30 percent, you are buying these services at a 37.65-percent discount, including your Social Security (FICA) tax savings.
6. Exchange Traded Funds (ETFs) represent almost every segment of the equity marketplace. ETFs will often perform as well or better than managed mutual funds in their respective market segment. ETFs do not have taxable annual capital gains, a tax advantage over mutual funds.
7. Fund IRAs, HSAs and any other tax-deferred accounts as early in the year as possible. This strategy will provide you with a large financial benefit over the years.
8. When you save all of your receipts and records, you never have to worry about an IRS audit, since you will always be able to prove your deductions and claims. Get a large plastic storage bin and keep at least the past three years of your tax records in it.



CHAPTER 7

Investment Strategies for Financial Abundance

"90% of the people in the stock market, professionals and amateurs alike, simply haven't done enough homework."

–William J. O'Neil

Investing your financial resources sensibly is a requirement in maintaining financial abundance.

Financial resources include stocks, bonds, mutual funds, Exchange Traded Funds, *Real Estate Investment Trusts* (REITs), rental real estate and any other assets that provide for income or growth. These resources may be held in taxable brokerage accounts, Individual Retirement Accounts, company-sponsored defined contribution plans, tax-deferred college savings plans or Health Savings Accounts.

Real Estate Investment Trusts (REITs): A security that invests in real estate and sells like a stock on the major

Asset Allocation, or Where to Put your Money

Maximizing your return while maintaining an acceptable

level of risk that your investments may decline is the key to successful investing. To achieve this, you must allocate your financial assets well. `In other words, you need to answer the question: "How much should I invest where?"

The way that you choose to allocate your assets between stocks, bonds and cash investments, accounts for up to 90 percent of the success in the total income and growth you will receive from your financial resources.

Wisely choosing the percentage of your assets that you invest in each category is your first priority. Which particular stock, bond or cash investment you choose is secondary to the amount that you invest in each category.

To simplify the asset allocation process, let's consider only the three major asset classes:

1. Equities. This includes stocks, stock mutual funds and stock-based Exchange Traded Funds (ETFs).
2. Fixed Income. This includes tax-free bonds and bond mutual funds as well as taxable bonds and bond mutual funds.
3. Cash Investments. This includes your checking and savings accounts, money market funds and Certificates of Deposit (CDs).

There are many other asset classes, including real estate, commodities, derivatives, collectibles, precious metals, hedge funds and more.

Other than real estate, these assets often involve risks that make them unacceptable investments for the average investor. If you choose to include these investments in your portfolio, get professional help from a financial advisor who has expertise in dealing with these types of assets.

"Risk tolerance" is the operative term when it comes to asset allocation. This concept revolves around your answer to

the question: "During the inevitable periodic market declines, what percentage of my assets can I afford to lose, in the short term, and still be able to sleep soundly at night?"

Asked another way: "How much risk of temporary loss can I live with comfortably?"

After you make your initial asset allocation choices, be prepared to make periodic adjustments, typically on an annual basis. You may make these adjustments because of changes in the economy, market conditions or changes in your goals and objectives.

Cash Investments

Of the three asset classes, cash investments, such as certificates of deposit (CDs) and money market funds, have the least downside principal risk. The face value of your cash investment, its principal, remains constant. However, cash investments also provide you with the least protection against inflation.

"Inflation risk" is when your investment value does not increase at a rate that will at least match the rate of inflation.

Historically, cash investments have had a rate of return that is less than the rate of inflation. If your cash investment annually yields 2 percent less than the rate of inflation, every 36 years your purchasing power is cut in half by inflation. It is critical that you choose other investments to help reduce your inflation risk.

Fixed Income

Fixed income investments include bonds and bond funds. When bought at its face or *par value* and held until maturity, a

Fixed Income Investments: Any type of investment that yields a regular or fixed return for the investment. Bonds and bond mutual funds are typical examples of fixed-income investments.

Par Value: The face value of a bond.

bond is similar to a cash investment with its main risk being "inflation risk."

One of the major benefits of holding bonds in your investment portfolio is to reduce overall risk. Bond holdings will often increase in value when the stock market is declining. This helps to smooth out the inevitable stock market bumps.

Except for Treasury Bonds, backed by the U.S. government, bonds will also have "credit risk" and "default risk." Default is when the bond issuer does not make interest payments and may not be able to repay the principal upon the bond's maturity date.

In 2005, Jacques decided to buy $50,000 in 10-year U.S. Treasury bonds, yielding 4.4 percent, and $50,000 in 10-year Ford Motor Company bonds, yielding 5.8 percent. In 2006, while reviewing his brokerage statement, Jacques found that the market value of his Treasury bonds was still $50,000, but the value of his Ford bonds had fallen to $42,500.

Calling his broker to find out why the Ford bonds had fallen by 15 percent, he was told that, due to the ongoing problems in the U.S. car industry, Ford's credit rating had been lowered. With the lowering of its credit rating, Ford is now forced to sell 10-year bonds at a 6.8 percent interest rate.

Jacques must decide whether to sell his Ford Motor Company bonds and take a 15 percent loss, or whether to hold onto the bonds until maturity, with the hope that Ford will continue to make interest payments and be able to redeem the $50,000 bond in nine years.

Now, Jacques fully understands the concept of "credit risk."

Another risk associated with fixed income investments comes when you sell a bond before its maturity date. In this case, you encounter "interest-rate risk."

> Danielle buys a $50,000 10-year Treasury bond yielding 5 percent. Two years later, 10-year Treasury bonds were yielding 7 percent. Looking at her brokerage statement, Danielle saw that the value of her Treasury bond had fallen by more than 20 percent.
>
> Danielle must decide whether to sell the bond yielding 5 percent, at a loss of over $10,000, and buy a new Treasury bond that yields 7 percent or continue to hold her bond for 8 more years to receive the $50,000 that she paid for it.

The increase or decrease in a bond's value depends upon the change in interest rates and the amount of time until the bond's maturity date. The longer period of time until a bond matures, the more interest rate changes will affect your bond's value.

For the past 80 years, 30-year Treasury bonds have had an average yield of 5.5 percent, while inflation has increased an average of 3 percent annually. Historically, the average return has been 2.5 percent above inflation, when investing in Treasury Bonds.

Equities

Business risk, financial risk, credit risk, liquidity risk and event risk are all associated with individual company stocks. There are lots of opportunities to lose money!

If you wish to invest in individual company stocks, you may

want to hire a fee-based asset management firm, with a successful long-term track record. Otherwise, plan on spending a significant amount of time doing research on companies before you invest.

For most individual investors, it is safer to use diversified equity funds, including actively managed mutual funds, *index mutual funds* and Exchange Traded Funds (ETFs). Diversification, provided by equity funds, eliminates risks associated with investing in individual stocks. With a diversified equity portfolio, the primary risk is "market risk," the risk that the stock market will decline.

> **Index Mutual Funds:** A mutual fund that attempts to replicate the movements of the index of a specific financial market.

Over the past 80 years, the S&P 500 has had an annualized total return of approximately 10.5 percent, which is 7.5 percent greater than inflation.

Considering this, *equity investments* may appear to be the logical choice for all of your investments. However, equities will significantly underperform fixed income and cash investments on a periodic basis. To protect your assets from this periodic decline, proper asset allocation is critical to your long-term investing success.

> **Equity Investments:** Investments in publicly traded stocks or stock funds that hold publicly traded stocks.

Mary, Nancy and Joan decided that it was time to begin investing in the stock market. They each had $100,000 to invest.

Mary, the most "aggressive" investor, decided to allocate 80 percent of her portfolio to stocks and 20 percent to fixed income and cash. Nancy decided to invest 60 percent in stocks and 40

percent in fixed income, while Joan decided upon a 50/50 split.

To have a diversified stock portfolio, they decided to buy an Exchange Traded Fund (ETF) that tracks the performance of the S&P 500 stock index. They choose the Ishares S&P 500 index fund whose stock market symbol is IVV.

On January 2, 2001, Mary, Nancy and Joan bought $80,000, $60,000 and $50,000 of the S&P 500 index fund (IVV), respectively. The remainder of their $100,000 was put into fixed income and cash investments, including a mixture of bond and money market funds that annually provided a 5-percent total return.

In the bear markets of 2001 and 2002 the S&P 500 index returned minus 11.96 percent and minus 21.4 percent in each year.

On December 31, 2002, Mary's portfolio of 80 percent equities and 20 percent fixed income and cash investments, had lost 22.6 percent, leaving her with only $77,409. Nancy's portfolio of 60/40 equities to fixed income and cash investments reduced her loss to 14.4 percent with $85,619 remaining.

Joan was the happiest member of the group! Her 50/50 portfolio reduced her loss to 10.3 percent with $89,725 remaining on December 31, 2002.

As long-term investors, none of the three panicked and sold during this bear market. By staying invested, they were rewarded with the 2003 to 2006 bull market. From 2003 to 2006 the S&P 500 Index increased each year by 28.2 percent, 10.7 percent, 4.8 percent and 15.8 percent.

From January 2, 2003 until December 31, 2006, Mary's "aggressive" 80/20 portfolio

> increased by 61 percent, Nancy's 60/80 portfolio increased by 52 percent, and Joan's 50/50 portfolio increased by 46 percent.
>
> On December 31, 2006, Mary, Nancy and Joan had a New Year's Eve party to celebrate their many blessings, including the four-year bull market. They each brought a copy of their on-line brokerage statements.
>
> Having invested $100,000 on January 1, 2001, they were immediately hurt by a two- year bear market. Thanks to a four-year bull market, they were all ahead on December 31, 2006. However, when comparing statements, they were surprised by what they found.
>
> At the end of 2006, Mary, the "aggressive" investor with a 80/20 ratio of equities to fixed income has seen her $100,000 grow to $125,475. Nancy, with her 60/40 ratio now has $130,100. Joan, the most "conservative" investor with her 50/50 ratio had the highest six-year return at $131,800.
>
> For this six-year period, the investment returns for the 50/50 ratio performed the best.

Different time periods will lead to different results, and no one knows what the future will hold. While equities provide excellent financial growth over the long term, they have the greatest short-term downside risk of the three asset classes.

For most investors, portfolio allocation ratios of equities to fixed income and cash investments between 80/20 and 50/50, should be considered.

Non-U.S. Equities

Keeping a portion of your equity investments in non-U.S.

funds is prudent. Non-U.S. equities further diversify your portfolio, helping to reduce your overall risk.

Investing in foreign funds will introduce an "exchange rate risk," the risk that foreign currency will depreciate against the dollar. If the dollar increases in value, the value of foreign funds will decrease. Some foreign funds hedge against the dollar, attempting to remove the "exchange rate risk."

Real Estate Investments

While not considered a liquid investment, rental real estate property is an asset class to consider. Rental property should provide consistent rental income, tax deductions through *depreciation* and the possibility of property appreciating over time.

Depreciation: The cumulative decrease in value of a tangible asset over its useful life.

If you own rental property with a steady income stream, you could consider this in the fixed income investment class.

Your rental income plus your tax savings, minus operating expenses and property taxes provide your annual return from this asset. The current value of the rental property is the estimated sales price, less any sales costs, including realtor fees. Your yield is annual return/current value.

Lacking liquidity, rental real estate should be only be considered as a long-term investment.

Where to hold your assets

All of your financial resources should be included when allocating your assets. Be sure to include checking and savings accounts, taxable brokerage accounts, trust funds, deferred annuities, IRAs, company-sponsored defined contribution plans, tax-deferred college savings plans, Health Savings

Accounts and rental property.

It is typically wise to keep equities in your longer-term investment accounts, including tax deferred IRAs and company retirement plans. Equities will out-perform fixed income investments over long periods of time. With their longer time horizons, retirement accounts are often a good place for equities.

Municipal bonds or bond funds should only be held in your taxable accounts.

Funding that you will need in the next three to five years, such as college savings accounts, should be mainly invested in short-term fixed income or cash investments.

With dividend and capital gains taxes currently at a 15 percent maximum rate, many advisors recommend putting equities in taxable accounts and putting taxable fixed income investments into retirement plans. Stock dividends and stock sales become currently taxable with this approach.

If you expect to be in a high tax bracket during retirement or plan on leaving your equity investments to your heirs, this approach is usually advisable.

Asset Selection

Determining the appropriate asset allocation that is consistent with your downside risk tolerance will significantly affect your investment portfolio performance. After deciding on the appropriate asset allocation, you must choose your assets in each asset class.

Equities

Outperforming index mutual funds is difficult, especially on a long term, after-tax basis. After the 1.5 percent to 2.5

percent annual fees charged by most actively managed equity mutual funds, few active managers can consistently beat their respective *equity indexes*.

Equity Index: A performance measurement for a specific group of stocks. For example, the S&P 500 Index measures the stock performance of the top 500 U.S. companies, as chosen by Standard and Poor's.

Buying an index mutual fund or an Exchange Traded Fund that replicates the S&P 500 Index of the 500 largest U.S. based companies or the Russell 3000 Index of the 3000 largest U.S. companies is one investment approach.

While simple, this approach does not provide enough diversity of asset classes to help minimize your risk and maximize your return.

Diversification by Market Capitalization

For better diversification, consider allocating a portion of your equity portfolio by *market capitalization*. Multiplying a stock's price per share by the number of shares outstanding provides the company's market capitalization.

Market Capitalization: The total dollar value of all outstanding shares in a company. It is calculated by multiplying the number of shares outstanding by the current market price of the company common stock.

Market capitalizations of Small Cap stocks are under $1 billion, Mid Cap stocks are $1 billion to $5 billion and Large Cap stocks are over $5 billion.

Jose has been actively tracking equity indexes for years. In 1981, he began following the Mid Cap market sector. Jose knew that stocks with a market capitalization of over $1 billion would be less risky than stocks with a smaller capitalization. Jose also believed that Mid Cap companies would be likely

buyout candidates for larger companies. When buyouts are announced, the company that is being purchased usually has a significant increase in the price of its stock

In 1981, Jose decided to buy index mutual funds representing all three market capitalizations. He invested $10,000 each in the Russell 2000 Small Cap Index, the S&P 500 Large Cap Index and the S&P 400 Mid Cap Index.

From 1981 until 2006, Jose's $10,000 invested in the Small Cap Index grew to $152,009. The $10,000 he invested in the Large Cap Index grew to $203,108. However, even he was astonished to find that the $10,000 invested in the Mid Cap index grew to $383,119.

The Mid Cap Index earned 90 percent more than the Large Cap Index and 170 percent more than the riskier Small Cap Index.

For this 25-year period, Jose found that his investment instincts were correct. On an annualized basis, the S&P 400 Mid Cap Index had a 15.7 percent total return. Annually, it out-performed the Russell 2000 Small Cap Index by 4.2 percent and out-performed the S&P 500 Large Cap Index by 2.9 percent.

Value, Growth and Blend

Another area of diversification is value, growth and blend. Value-based stocks have a lower price-to-earnings ratio and typically pay higher dividends. Growth-based stocks will typically grow their sales and earnings faster than value-based stocks. Blend means that the portfolio is a mixture of value and growth-based stocks.

Royce is a conservative, long-term stock investor. He knows that growth stocks typically out-perform value stocks in upward markets. However, he believes that the higher dividend payments and the lower volatility of value-based stocks will provide for a greater total return over the long term.

At the beginning of 1993, to test his beliefs, Royce invested $10,000 in the S&P 500 Large Cap Growth Index and $10,000 in the S&P 500 Large Cap Value Index.

At the end of 2006, the $10,000 invested in the Large Cap Growth Index had grown to $32,153. The $10,000 invested in the Large Cap Value Index was $46,236, a 44-percent advantage for Large Cap Value over Large Cap Growth.

Knowing that different market capitalizations will perform differently, in 1993, Royce also invested $10,000 in the Mid Cap Growth Index and $10,000 in the Mid Cap Value Index.

By the end of 2006, the Mid Cap Growth Index had grown to $35,348. However, the $10,000 he invested in the Mid Cap Value Index had become $62,227, an incredible 76-percent advantage for the Mid Cap Value Index over the Mid Cap Growth Index.

Royce found that the Mid Cap Value Index had an annualized total return of 15.1 percent. The Mid Cap Value Index annually out-performed the Large Cap Value Index by 2.6 percent, the Mid Cap Growth Index by 4.9 percent and the Large Cap Growth Index by 5.7 percent over this 13-year period.

The past is never a guarantee of the future. Your comfort level and goals must be considered in deciding your equity approach.

If you are uncomfortable making these decisions, find an investment advisor that will carefully listen to your wishes and who will always place your interests before his or her own.

Fixed Income

For bond-based investments, I suggest two possible approaches. If you have adequate financial resources, consider building a bond ladder.

In 1995, Jennifer had $100,000 that she allocated to fixed income investments. Being in the 33-percent combined federal and state income tax bracket, she decided to build a bond ladder using municipal bonds issued in her home state.

She made sure that all of the bonds that she purchased were both insured and *noncallable*. A noncallable bond cannot be redeemed, by the bond's issuer, before its maturity date.

> **Noncallable Bonds:** Bonds that may not be redeemed by the bond issuer before the stated bond maturity date.

Since interest rates were relatively high, Jennifer decided to immediately build her entire ladder. She bought ten $10,000 municipal bonds, each maturing in a different year over the next 10 years. Her longest *bond maturity date* was 10 years, since 10-year bonds often have interest rates similar to longer-term bonds

> **Bond Maturity Date:** The date upon which a bond will be redeemed by the bond issuer at it face (par) value.

Her average yield was 5.5 percent, somewhat lower than

the 7 percent yield that she could have received on high-quality taxable bonds. However, Jennifer calculated that on an after-tax basis, she would receive an additional $810 annually or 17 percent more than she would receive from the taxable bonds.

Each year, one of the $10,000 municipal bonds matures. Jennifer uses the $10,000 proceeds to purchase another bond that will mature in 10 years.

With her ladder, she removes "interest rate risk," since each year she will be buying a new bond at the current interest rate. Her bond interest rates are representative of a 10-year interest rate spread.

As Jennifer approaches retirement, she may begin buying corporate bonds for her ladder, since her income tax rates may drop in retirement.

If buying individual bonds is not appropriate for you, consider investing in low-cost bond mutual funds. The type of bond funds you buy will change as interest rate conditions change.

Jesse has allocated $40,000 of his portfolio for fixed income investments. Current long-term Treasury bond interest rates are 7 percent, and 30-day short-term rates are 4 percent. Inflation is decreasing, and the business climate appears to be improving. Based on these conditions, Jesse feels confident that long-term interest rates will soon be decreasing.

Since Jesse does not feel comfortable building a 10-year bond ladder, he decides to invest $40,000 in a long-term bond mutual fund.

Knowing that the prices of longer-term bonds are more sensitive to rising or falling interest rates than shorter-term bonds, he expects that the long-term bond fund's value will rise significantly when long-term interest rates decline.

Three years later, both long-term and short-term interest rates are at 5 percent. Inflation appears to be increasing, yet the business climate is still positive.

Believing that long-term interest rates have bottomed out and may be headed upward, Jesse decides to sell his long-term bond funds and reap a significant capital gain. He reinvests these assets by putting half into a short-term bond fund and half into a money market fund yielding 5 percent.

With this investment approach, Jesse maximizes his current return, since short-term rates are the same as long-term rates. He also has cash available to invest when the future direction of interest rates becomes clearer.

Cash Investments

Cash investments are short-term investments where the principal is secure.

Checking and savings accounts, money market funds and short term CDs maturing in one year or less are all considered cash investments. Typically, you will have no more than 10 percent of your liquid portfolio in cash investments.

Keeping your emergency fund in cash investments allows you to cover your expenses without having to invade your more volatile equity or fixed income investments.

When building your emergency fund, you may lose some diversification if it is totally in cash. If necessary, use cash and short-term bond funds for your emergency fund.

For financial resources required in the next three to five years, keep the required funds in either cash investments or short-term bond funds. Keeping the required principal safe is critical when you are saving to buy a house or to fund a teenager's college education.

Use your cash investments and short-term bonds/bond funds for three-to-five-year goals and use equities and longer-term bonds/bond funds for longer-term goals.

Financial Advisors

Are you willing to spend the time and effort required to manage your financial resources? If not, finding a qualified financial advisor, who puts your interests first, is critical for your long-term financial abundance.

Financial advisors are either fee-based, commissioned or a combination of both.

Larry, Manuel and Paul have been golfing friends for years. On a recent golf trip to Myrtle Beach, they began discussing their financial advisors. They each have portfolios worth $300,000 in a taxable account and $200,000 in their 401(k) plan.

Larry works with a Certified Financial Planner®, who helps him plan for his future financial requirements, discover tax savings opportunities and develop an index based ETF equity portfolio and a municipal bond ladder. Larry's financial planner charges $150 per hour.

This year, his planner helped him to:

1. Restructure his investment plan to pay for his son's college education

2. Set up a donor-advised charitable giving fund

3. Set up an HDHP/HSA medical plan

4. Rebalance his portfolio, including his company 401(k)

5. Determine which municipal bond to add to his bond ladder.

Larry's planner required 10 hours to provide these services, charging him $1,500 for the year.

Manuel works with a fee-based asset management firm, charging 1.25 percent of Manual's assets under management. His financial advisor is a *Certified Financial Analyst*, who picks specific stocks using a value-based approach.

Certified Financial Analyst (CFA): A professional designation, given by the Association for Investment Management and Research, that measures the competence and integrity of financial analysts. Candidates must pass three levels of exams covering accounting, economics, ethics, money management and security analysis.

This year, his advisor:

1. Set up a 529 College Savings Plan for his 4-year-old son

2. Rebalanced his portfolio, including advice on his company 401(k) plan

3. Bought a municipal bond for his bond ladder

4. Minimized taxes by selling stocks that have declined in value

5. Added stocks with higher dividends to protect against a stock market decline.

Manuel paid his financial advisor $3,750 in asset management fees for the year.

Paul's financial advisor works for the brokerage arm of a large bank. Paul said that his advisor's advice is "free," as he is compensated only by commissions.

All of the equity assets that he manages for Paul are in mutual funds B shares that have a back-

end sales load. Paul only pays a commission on the funds if he sells them within five years of purchase. If a mutual fund is sold, he could pay as much as a 5-percent commission.

Paul's funds also have a 0.5-percent sales load called a 12-b1 fee. Each year the fund assets are charged a 0.5-percent commission, paid to his advisor.

This year, his advisor:

1. Sold $50,000 in a two-year-old, under-performing equity fund for a taxable loss
2. Rebalanced the funds that he is managing
3. Sold his longer-term bond fund and bought a short-term fund
4. Recommended putting a 401(k) plan from a previous employer into an IRA
5. Recommended that he buy a deferred annuity to defer current taxes.

Although Paul did not see the commission charges, he paid $1,200 in 12-b1 fees plus $1,500 in back-end sales commissions on the $50,000 sale of his mutual funds, for a total of $2,700.

Researching deferred variable annuities, Paul found that they are a combination of life insurance, guaranteeing a minimum payment upon death, and *load mutual funds*. He also discovered that his advisor would be paid a 10-percent commission if Paul buys the deferred annuity.

Load Mutual Fund: A mutual fund that includes a sales charge. If the sales fee is included when you buy the shares, it is called a "front end load." If the sales fee is included when you sell the shares, it is called a "back end load." If the sales fee is included annually, it is called a "12-b1 fee."

If Paul sold the deferred annuity within one year of purchase, he would be penalized 10 percent of his investment. A penalty would remain in place if he sells the deferred annuity

> within seven years of purchase.
>
> Paul's research helped him realize that a deferred variable annuity was mainly in the best interest of his financial advisor. He is beginning to question what he is really paying for his "free" financial advice.

Receiving unbiased financial advice is often easier if you choose a "fee-based" financial advisor. There should be no conflicts between your interests and the manner in which your advisor is compensated. Often, "commission-based" advisors will be faced with this potential conflict.

When your advisor is a Certified Financial Analyst (CFA) and/or Certified Financial Planner (CFP®), he or she will have passed rigorous financial examinations and have signed a code of ethics, certifying that they will always hold out their clients' interests before their own.

Regardless of how they are compensated, financial advisors will often be better able to serve you if they have at least one of these certifications.

CHAPTER 7 SUMMARY

Liquid Assets: Property that can be quickly sold for cash, without a significant decrease in the value of the property.

1. The allocation of your *liquid assets* between cash investments, fixed income and equities accounts for up to 90 percent of your portfolio's performance. Fixed income includes bonds and bond funds; equities include stocks, stock-based mutual funds and ETFs.
2. Cash investments, including savings accounts, money market funds and short-term CDs, will provide you with the least protection against inflation risk, the risk that your investment will lose value over time due to the effects of inflation.
3. Fixed income investments, such as bonds and bond funds, have "default risk" and "interest rate risk." "Default risk" is the possibility that the issuer will not make future interest payments. Purchasing high-quality bonds helps eliminate this risk. Holding bonds until maturity eliminates "interest rate risk," in which rising interest rates can cause your bond's value to fall.
4. Equity investments include stocks and stock funds. With diversified stock funds, you face "market risk," the risk that the stock market will fall. Foreign stock funds often have "exchange rate risk," the risk that the dollar will appreciate against the value of the foreign currency.
5. For preretirement portfolios, keep the equity-to-fixed income/cash ratio between a "conservative" 50/50 ratio and an "aggressive" 80/20 ratio.
6. Index based Exchange Traded Funds (ETFs) provide

diversity, tax efficiency and trade in the same manner as stocks.

7. For the past 25 years, Mid Cap indexes have outperformed both Small Cap and Large Cap indexes. Value-based indexes have outperformed Growth indexes over the past 13 years.
8. Building a high-quality 10-year bond ladder, with bonds maturing each year, is a good investment strategy for fixed income investments. Another strategy is to buy no-load bond mutual funds. When interest rates are falling, buy longer-term bond funds. When interest rates are rising, buy short-term bond funds or money market funds.
9. Cash investments and short bond funds are best for short-term goals that require funds in the three-to-five-year time frame.
10. "Fee-based" financial advisors charge either an hourly rate for their advice or a fee, based on the amount of assets that they are actively managing. Other financial advisors are "commission based," receiving sales commissions for the financial products that they sell.
11. An advisor who is a Certified Financial Analyst (CFA) and/or a Certified Financial Planner (CFP®), will have passed stringent financial examinations, as well as signed a code of ethics in which they certify that they will hold out their clients' interests above their own .

CHAPTER 7 ABUNDANCE STRATEGIES

1. Be sure to include all of your liquid assets and rental property in the asset allocation process. Use only financial advisors who include all of your financial resources when providing asset allocation.
2. Your liquid financial resources include your checking and savings accounts, taxable brokerage accounts, trust funds, deferred annuities, IRAs, company-sponsored defined contribution plans, tax-deferred college savings plans and Health Savings Accounts.
3. To determine your acceptable asset allocation risk level, assume that equities could go down 30 percent with fixed income/cash returning 5 percent. If your portfolio is 80 percent equities and 20 percent fixed income, your portfolio will decrease by 23 percent. If your portfolio is 50 percent equities and 50 percent fixed income your portfolio will decrease by only 12.5 percent. How much downside portfolio movement can you absorb without loosing sleep at night?
4. If equities are up 30 percent, with a 5-percent fixed income return, your 80-percent equity portfolio will increase by 25 percent while the 50-percent equity portfolio will increase by only 17.5 percent. Allocations such as 60 or 70 percent equities should also be considered.
5. An equity asset class that is often overlooked is Mid Caps, with market capitalization of between $1 billion to $5 billion. Since 1981, the Mid Cap Index has outperformed the Small Cap Index by 170 percent or 4.2 percent annually and the Large Cap Index by 90 percent or 2.9 percent annually. Consider this

overlooked investment class as part of your equity portfolio.

6. Value-based equities are considered more conservative than growth equities, yet value-based equities have out-performed growth equities over the past 13 years. Paying higher dividends helps protect their return in declining markets.
7. When interest rates rise, longer-term bonds and bond funds will fall significantly more than short-term bonds and bond funds. When you believe that interest rates will rise, buy short-term, low-duration bond funds or even money market funds. As interest rates peak, buy long-term bond funds for their capital gain potential.
8. If you have three-to-five-year requirements for funds, such as college expenses for a teenager, use money market funds and CDs and/or short-term bond funds to meet these requirements.
9. It is often preferable to choose a Certified Financial Analyst (CFA) and/or a Certified Financial Planner (CFP®) as your financial advisor. You will get an advisor who has successfully completed a rigorous financial education course, plus has signed a code of ethics, agreeing to put your interests before his or her own.
10. If your financial advisor receives any compensation through sales commissions, compare their products with similar products offered by noncommissioned sales companies such as Schwab or Fidelity. This is especially important if the product is a fixed or variable deferred annuity.

CHAPTER 8

Manage Risk to Protect Your Abundance

"Risk is a part of God's game, alike for men and nations."

–George E. Woodberry

We face many financial risks. To protect your abundance, it is important to determine which financial risks could be catastrophic. These risks include premature death, disability, health care, long-term care, property and personal liability. Insurance should be used for risks that would have a serious financial impact upon you if you were not protected.

Insurance companies pool the risks of many people. They must charge enough to pay for each occurrence of the insured risk, pay for their administrative overhead and make a reasonable profit.

When considering the risks discussed in this chapter, first decide if you have adequate financial resources to "self-insure" against the risk. If not, you must decide what portion of the risk (often called a deductible) that your financial resources can cover. Typically, the larger portion of the risk that you can handle financially, the lower will be your annual insurance premiums.

By properly managing your financial risks, you can live from a position of abundance, regardless of what the future holds.

Premature Death Risk

Linking us all together is the fact that we will die. Your present stage in life, financial resources and the number of people who are financially dependent upon you help determine how you manage the risk of premature death.

With the help of an insurance agent or with on-line Internet resources, you should be able to determine the amount of life insurance that you require, if any.

What Type of Life Insurance?

Assuming that a need for life insurance exists, the next step is to decide which type of life insurance product to purchase.

The two basic types of life insurance are term insurance and whole-life or permanent insurance. While term insurance will always cost less than permanent insurance, it is not always the best choice.

Using term insurance to cover expenses that will go away in the future, such as college education costs, is always wise. Permanent policies may be better for more permanent expenses, such as a guaranteed inheritance for your children.

Ming, age 35, is the marketing manager for a Silicon Valley technology company. He and his wife Choi have two children, ages 3 and 5. Based on his present income and his future prospects, Ming believes that he will be able to retire by the time he is 55.

Before having children, Choi was an Internet security analyst. She is now a stay-at-home mom, and does not plan on re-entering the work force until her children are in middle school.

Ming knows that if he were to die prematurely, his death would be a financial catastrophe for his family. Examining his life insurance requirements, the major expenses he must cover are adequate living expenses for his family and educational expenses for his children.

He and Choi determine that a $1 million life insurance policy on Ming would be adequate.

Ming visits an insurance agent who describes the benefits of a whole-life policy. A major benefit described is the cash value that continues to increase for as long as Ming keeps the insurance policy.

At some point in the future, Ming can even convert the policy to a fully paid up policy. Upon converting to a fully paid up policy, the death benefit would be lowered to reflect the amount that Ming has paid into the policy up to that point.

After Ming returns home, he finds term insurance brokers on the Internet. Eliminating quotes that do not come from large and secure insurance companies, Ming finds that $1 million coverage for a 20-year term insurance policy will cost him $4,000 per year less than the whole-life policy that he was quoted.

Using his financial calculator, Ming determines that if he "pays himself" the $4,000 difference and invests it with an 8 percent return, he will have $183,000 in 20 years, when both of his children will have completed undergraduate school. Ming also expects to have sufficient financial resources to retire at this time.

Since he would have no further requirement for life insurance in 20 years, Ming decides that term insurance is the better choice.

A term insurance product has much lower costs since it does not include a cash value component. Term policies also usually have low sales commissions, while permanent or whole-life policies often provide a fairly high sales commission for the insurance agent.

Term policies are sold for terms of 10, 20 or even 30 years. During the selected term, premiums remain level and will not increase. However, at the end of the term, the policy's annual rates will substantially increase, if you are unable to get a new term insurance policy.

This is the major risk in buying a term insurance policy - especially if your health has deteriorated. If you expect that life insurance will be required after the term expires, either buy a term policy that allows for the conversion to whole life insurance or buy a whole life policy, to protect yourself from becoming uninsurable in the future.

It is never pleasant to consider our deaths and the financial consequences that come with that inevitable event. However, life insurance planning is a critical component of helping assure that your loved ones will have the financial resources for continued abundant living.

Disability Risk

Did you know that you are more likely to be disabled, before reaching age 65, than you are to die?

Dieter, age 45, is the supply chain manager for

a manufacturer of DC Power Systems. His company offers health insurance, but no disability insurance. Dieter recently met with a financial planner, who suggested that he consider disability insurance to protect his family from the devastation that a long-term disability could cause.

Dieter has spent the past 15 years building his financial resources. His son will soon graduate from college, allowing Dieter to save even more. However, as Dieter's family has a history of strokes and heart disease, he is concerned about his wife's and son's financial well-being if he were to become disabled.

After doing some research, Dieter finds that he would qualify for disability income from Social Security (SSI), if he is disabled for at least six months and if the impairment would prevent him from doing "substantial" work for at least a year. However, SSI will only provide approximately $24,000 per year, well short of the $96,000 per year that Dieter earns.

His insurance agent recommends that Dieter purchase a long-term disability insurance policy with a six-month "waiting period", to provide him with the best cost and benefits. The agent says that the waiting period is the time between when a disability begins and when Dieter receives his first disability payment.

Dieter agrees to the six-month waiting period, since he has an emergency fund that he can use for the first six months of any disability.

Since Dieter will pay his own premiums, the disability insurance income is tax free. A policy providing 50 percent of his pretax income will pay $4,000 per month tax free. Combining this 50-percent policy with Social Security, Dieter would have almost $6,000 per month in after-tax income.

Being in the 25 percent federal and 5 percent state income tax brackets, Dieter's income, after taxes and FICA is $5,200 per month. A 50-percent replacement policy will provide Dieter and his family with more than his present after-tax income.

Dieter's insurance agent has reviewed the various options from which he can choose. The options that Dieter finds most important are:

1. An "additional purchase option," allowing him to buy more insurance as his salary increases, and

2. The "partial disability rider," allowing him to return to work on a part-time basis and still receive partial insurance benefits.

Dieter must also choose the appropriate "benefit period." The benefit period is the length of time in which he will receive benefits after becoming disabled. His choices range from lower cost five or ten-year benefit periods, to the higher cost benefit period that ends at age 65. Since Dieter is 45 and has significant savings, he decides that a plan with a 10-year benefit period is his best choice.

There are two types of disability policies to choose from. A "noncancelable" policy will never have an increase in premiums or any reduction in benefits. With a "guaranteed renewable" policy your insurer has the right to increase your premiums as long as it does so for all other policyholders in your same rating class. With both, the policies cannot be canceled by the insurance company for any reason, other than your nonpayment of premiums.

While it is more expensive, a "noncancelable" policy will keep your long-term costs level for as long as you keep the policy.

Other options for disability insurance policies include:

1. The "additional purchase option," which allows the purchase of more insurance at a later time, to help protect you as your income increases.
2. "*Cost of living adjustments* (COLA)" that automatically increase your disability benefits over time, based on increased costs of living as measured by the *Consumer Price Index* (CPI).

Cost of Living Adjustment (COLA): An annual adjustment to offset a change in purchasing power, as measured by the Consumer Price Index.

3. The option to return to work part time, with the "partial disability riders," allowing you to collect part of your salary and receive a partial disability payment while still being partially disabled.

Consumer Price Index (CPI): The weighted average of prices of a "basket" of consumer goods and services. CPI is calculated by taking price changes for each item in the predetermined "basket," weighted by importance, and averaging them. CPI is used to determine cost-of-living changes.

4. A "return of premium rider," which requires the insurance company to refund part of your premium if no claims are made for a specified period of time.
5. A "waiver of premium provision," through which you do not have to pay premiums on the policy after you are disabled for 90 days.

A disability policy with a six-month "waiting period" allows you to tailor the payments and benefits at an affordable cost, especially when you consider the potential financial devastation of a long-term disability.

Health Risk

Health Insurance is critical to protecting your financial abundance. It is assumed that you already have a health-care policy that is provided by your employer, Medicare or you.

If you receive health insurance from your employer, you most likely have an HMO policy, with which you get care from providers within the maintenance organization; or a PPO policy, with which you receive increased benefits as long as you are in the PPO network.

As health-care costs continue to increase, more employers are not offering health insurance to their employees. If you are responsible for your health insurance, consider the combination of a High Deductible Health Plan (HDHP) with a Health Savings Account (HSA).

Your HSA deposits are deductible on your income taxes up to the maximum amount allowed. Regardless of your earned income, you are allowed your full HSA deduction. Even if you don’t itemize your tax deductions, you get a federal income tax deduction for your HSA deposits.

If your employer makes an HSA contribution for you, the employer’s contribution is excluded from your income and is not subject to any income tax or FICA. Whether you or your employer make the contribution, it will reduce your federal income tax due for the year. Most states also allow you to take a state income tax deduction for HSA contributions.

For more information on the benefits of combining a High Deductible Health Plan (HDHP) with a Health Savings Account (HSA), as well as how the HDHP/HSA combination can cut insurance costs in half, please refer to Chapter 4.

Long-Term Care Risk

A potentially devastating risk is when you or your spouse

might require long-term care. Long-term care can be broadly defined as care provided by another party for the benefit of those who are unable to care for themselves. Care may be provided at your home, in an assisted care facility or in a nursing home.

The need for long-term care can occur in an instant or gradually, as a person's health declines. Reasons for receiving long-term care include chronic disease, prolonged illness, injuries sustained as a result of an accident, disability or cognitive impairment, such as Alzheimer's disease, that limits your ability to think or reason.

Medicare and Medicaid do not adequately cover long-term care services. Medicare generally covers some nursing-home care, but only for 90 days or less, while Medicaid pays for nursing home care only after you have consumed most of your financial resources.

Long-term care can be very expensive. The national average cost for a private room in a nursing home is $71,000 a year, while home care has an average cost of $46,000 per year, for 40 hours of help per week.

In the future, these costs will continue to increase. At a 3-percent annual inflation rate, a year in a nursing home could cost over $95,000 in 10 years and $128,000 in 20 years. The cost per year of in-home care, with 40 hours of help per week, could be $62,000 in 10 years and $83,000 in 20 years.

If your future financial resources might be inadequate for these expenditures, you should consider buying an appropriate long-term care insurance policy.

Property Risk

Your house and your cars represent two of your most valuable physical assets. To protect these assets, you undoubtedly carry insurance policies on your home and your

automobiles. Considering a few common pitfalls, that can often cost you money, will be our focus.

Bill and Judy own a home as well as three automobiles. Their home was built in 1993 and cost them $250,000. Homes in their neighborhood that are similar to theirs have recently sold for $700,000!

When they purchased their home, Bill and Judy insured it for $200,000, the cost to replace their home on the $50,000 lot. They have continually increased the insurance amount and now have their house insured for $600,000.

As their home insurance costs have continued to rise, they have decided to consider other insurance companies.

James, an insurance broker, researched their community and found that lots in their neighborhood were selling for more than $300,000. Upon further research, he showed Bill and Judy that the cost to rebuild their home was no more than $400,000.

James found a policy with a reputable insurance company that provides full replacement value of Bill and Judy's home and its contents. The policy also would cover up to 25 percent more than the face value of the policy, if it were necessary to rebuild their home. The homeowners' policy also includes a cost of living adjustment (COLA) rider that automatically increases coverage each year.

By reducing their coverage to the required amount, Bill and Judy were able to reduce their home insurance costs by 25 percent.

With two teenagers driving their cars, Bill and

> Judy are paying very high auto insurance rates. Bill already has a $1,000 deductible and a 10-percent "discount" for using the same insurance company for both home and auto insurance. After the success they had with James on homeowners' insurance, they asked him to research auto policies.
>
> After doing his research, James found a nationally recognized insurance company with an excellent reputation for customer service. This company could provide the same insurance coverage with a lower deductible of $750 and still save Bill and Judy an additional 15 percent off their present auto policy.

As Bill and Judy found, by shopping for their homeowners' and automobile insurance policies, you can often find better coverage at a lower price. Getting a "discount" when you buy both policies from the same company is not necessarily less expensive than buying each policy from different insurers.

Make a video of your house and its contents to help assure that you get full replacement value for all of your home's unique features and contents. When your video is completed, store it in a safe deposit box or some other secure place that is not at your residence.

Covering uninsured motorists on your automobile policy is critical. While automobile insurance is mandatory, approximately one third of all drivers in Colorado do not have automobile insurance. If you have an accident with one of the multitude of uninsured motorists on our streets and highways, uninsured motorist protection will help protect your family and your property.

Only consider insurance companies that have excellent reputations for high-quality customer service, especially for claims. If you are not certain which companies offer this level

of service, research them with Consumer Reports or other consumer-oriented web sites.

Liability Risk

A substantial risk to families with financial resources is the possibility that you might be held liable for injury or loss to another person. Taking the maximum liability coverage offered on both your homeowners' and automotive policy is highly recommended.

You should also consider whether an "umbrella liability insurance policy" is appropriate.

A personal umbrella insurance policy provides coverage beyond your homeowners' or auto policy. Umbrella policies add an extra layer of liability coverage in $1 million increments. Umbrella liability insurance may also cover claims, such as slander or libel, which may not be covered by any other policy.

With our litigious society, it is wise to consider umbrella liability insurance. You are more vulnerable to liability claims when you have the following high-risk factors:

1. Own any type of watercraft
2. Have a teenager or an irresponsible driver in the family
3. Have a swimming pool or
4. Own a recreational vehicle.

If any of these apply to you and your family, consider the purchase of an umbrella insurance policy. Even if none of these high-risk factors apply, you may still sleep better at night if you have this extended liability coverage.

CHAPTER 8 SUMMARY

1. Term insurance is always less expensive than permanent insurance. Use it to cover expenses that will be gone in 10 to 30 years. Whole Life policies are used for more permanent expenses, such as providing a guaranteed inheritance for your children.
2. Before age 65, you are more likely to be disabled than you are to die.
3. Long-term disability insurance that covers at least one half of your gross income, with a six-month waiting period, will typically provide adequate financial protection at a reasonable cost. If you are younger than 40, consider a policy that will pay you until age 65. If you are nearer retirement you may want a lower-cost policy with a five or 10-year maximum benefit period.
4. If you are responsible for your family's health insurance, consider the combination of a High Deductible Health Plan (HDHP) with a Health Savings Account (HSA). On an after-tax basis, this approach could cut your health insurance costs in half!
5. Long-Term Care insurance can help to minimize the risk of financial ruin if you or your spouse require extended care. If your financial resources are inadequate to cover the cost of extended care expenditures for several years, consider an appropriate long-term care insurance policy.
6. To minimize property insurance costs, find the deductible "sweet spot," where increasing the deductible is no longer cost effective in lowering the premiums.

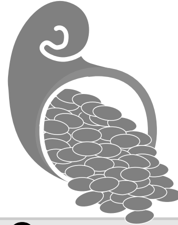
7. For your homeowners' policy, do not over-insure. Insure for the cost of rebuilding your home but not for the cost of your land.
8. Automobile policies should include coverage for uninsured motorists, even in states where insurance is "mandatory."
9. A personal "umbrella liability insurance policy" provides liability coverage beyond your homeowners' or auto policy by adding extra liability coverage in $1 million increments. If you own watercraft, have a teenager or an irresponsible driver in the family, have a swimming pool or a recreational vehicle, consider purchasing an umbrella insurance policy.

Chapter 8 Abundance Strategies

1. Be sure to include "postmortem liabilities" when considering life insurance requirements. "Postmortem liabilities" include estimated last illness expenses, estimated funeral expenses and estimated probate costs. A term insurance policy to provide for these expenses as well as additional funds to help your survivors through the transition period of life without you could be beneficial.
2. If you want to provide a guaranteed inheritance for your children, consider using permanent life insurance. You and your spouse can then consume or give to charities your remaining assets. For most other needs, term life insurance is often the better choice.
3. A disability income insurance policy that replaces 50 percent of your income is typically adequate, when combined with Social Security payments. If you make your own insurance payments, the disability payments are tax free. If you earn over $200,000 annually, a higher income replacement percentage may be required.
4. Consider a "non-cancelable" disability policy that can be annually renewed without any increase in the premium or a reduction in benefits. Your policy should allow you to buy more insurance in the future and to return to work part time while receiving insurance benefits.
5. Be sure to name your spouse as the beneficiary of your Health Savings Account (HSA). This allows your spouse to continue using your HSA funds tax free.
6. An alternative to long-term care insurance may be

selling your home and using the proceeds to move into a retirement home that offers continuous health-care facilities.

7. Purchase homeowners' insurance that provides full replacement value of your home and its contents. To get full reimbursement for your home and its contents, make a video of your house and all the contents and place this video into your bank's safe deposit box.
8. An "umbrella liability insurance policy," providing $1 million in additional liability insurance, typically costs only a few hundred dollars annually. If someone is hurt at your home or seriously injured in an automobile accident that you or a family member is responsible for, injury awards of over $1 million are not uncommon.



CHAPTER 9

Maintain Financial Abundance in Retirement

"The question isn't at what age I want to retire, it's at what income."

–George Foreman

Whether you are already retired, nearing retirement or many years away from your planned retirement, the ability to continue living in abundance is important.

Maintaining at least the same standard of living that you had before you retire makes this possible. Inadequate financial resources will allow the fear of scarcity to creep into your retirement years.

Your retirement income will typically come from three sources:

1. Social Security benefits,
2. Employer-provided pension and profit sharing plan distributions, and
3. Retirement plan savings and other investment income.

Let's explore how you can use each to have an abundant retirement.

Social Security Income

For the first $97,500 that you earn in 2007, you and your employer are "taxed" a total of 12.4 percent of your income for Social Security benefits.

At the maximum level, the combined Social Security payments made by you and your employer are $12,090 annually. It is important to get the maximum benefit possible from this significant reduction in your total compensation.

An important concept in Social Security is your *Full Retirement Age* (FRA). FRA is the age at which total Social Security retirement benefits are available. The following table provides Social Security FRAs:

Full Retirement Age (FRA): The age at which your full Social Security retirement benefits are available.

Full Retirement Age Table

Year of Birth	Full Retirement Age
1937 and prior	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-54	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

Reduced Benefits before your FRA

Regardless of your FRA, you may begin receiving a reduced Social Security benefit at age 62.

Fritz, born in 1947, took early retirement from his company to pursue his life-long passion of making furniture. To supplement his retirement income, he is considering receiving his Social Security benefits when he turns 62.

Curious about the amount that his benefit will be reduced, he found the benefit reduction formula on the Social Security web site www.ssa.gov.

To determine a reduced Social Security benefit:

1. Determine the number of months between when you begin taking Social Security benefits and your FRA. For Fritz, whose FRA is age 66, at age 62 he would be 48 months from his FRA.

2. For the first 36 months before FRA, multiply the number of months by 5/9 of one percent. Since Fritz is considering benefits a total of 48 months before his FRA, he multiplies 36 X 5/9 = a 20 percent benefit reduction.

3. If Social Security benefits are received more than 36 months before your FRA, each additional month is reduced by 5/12 of one percent per month. Fritz has 12 additional months before his FRA. To determine this reduction he multiples 12 x 5/12 = a 5 percent benefit reduction.

4. Add the percentage reductions in Numbers 2. and 3. above. For Fritz his total benefit reduction is 20 percent + 5 percent = 25 percent.

Based on the yearly Social Security Statement that Fritz receives, his Social Security benefit at his “full retirement age (FRA)” will be $2,500 per month. If he begins receiving Social Security at age 62, his Social Security payments will be reduced by 25 percent to $1,875 per month or $22,500 annually.

Fritz understands that the reduced benefit payment continues throughout his life. His benefits will not increase when he reaches age 66. He must carefully consider whether taking early Social Security benefits will be in his long-term best interests.

Social Security Earnings Limit

If you retire before your FRA, will you continue to earn income between the time you begin collecting Social Security benefits and your FRA?

If so, the Social Security Administration uses a "retirement earnings test" that will reduce your benefits if your earned income exceeds $12,960 in 2007. The Social Security "earnings limit" increases annually with inflation.

While Fritz mainly makes furniture for his own enjoyment, a friend suggests that he sell his furniture on eBay. To Fritz's surprise, he finds that he is able to sell every piece that he has made. Based on his current projections, he expects to sell enough furniture at age 62 to have a net income of $30,000.

From the Social Security web site, Fritz finds that his Social Security benefits will be reduced by $1 for every $2 that he earns over $12,960 (2007). If Fritz earns $30,000, his Social Security benefit would be reduced by ($30,000 − $12,960) ÷ 2 = $8,520.

He has previously calculated that his reduced Social Security benefit would be $22,500 annually. Due to the Social Security "earnings limit," this amount would be reduced by an additional $8,520,

> leaving him only $13,980 annually or $1,165 per month.
>
> Considering the income reductions if he takes his benefits early, Fritz has decided to wait until he is 66 to begin his Social Security retirement benefits

Upon reaching your FRA, you can earn unlimited income with no benefit reduction. The "earnings limit" reduction only applies to earned income. Any pension or investment income will not lower the amount of Social Security benefits paid.

Social Security Income Taxes

Income taxes on Social Security benefits are paid at the same marginal rates as earned income and the income thresholds are not indexed for inflation.

If you file a single income tax return and earn between $25,000 and $34,000, you will have to pay income taxes on up to 50 percent of your Social Security benefits. If you earn more than $34,000, you will have to pay income taxes on up to 85 percent of your benefits.

If you are married, filing a joint tax return, and earn between $32,000 and $44,000, you will have to pay income taxes on up to 50 percent of your Social Security benefits. If you earn over $44,000, up to 85 percent of your Social Security benefits will be taxable.

Postponing Social Security benefits

Upon reaching your FRA, you may choose to postpone receiving your Social Security benefits. Continuing to work will earn you "delayed retirement credits" for each year you work between your FRA and age 70 1/2. These credits may increase your full Social Security benefits by up to 8 percent per year.

> Fritz will soon be 66. He is now earning over $100,000 per year on his furniture-making "hobby." Fritz is healthy and expects to live many more years. When he turns 70, he will stop making furniture and begin to travel around the world.
>
> If Fritz begins taking Social Security benefits at age 66, his full retirement age, 85 percent of his Social Security benefits will be taxed at his present marginal income tax rate of 28 percent. This will reduce his $30,000 Social Security benefit to $22,860 after taxes.
>
> If Fritz postpones his Social Security benefits until age 70, he will receive $39,600 annually for the rest of his life. Since he will no longer have any earned income, this payment could be completely tax free.
>
> Once again, Fritz decides that "postponing" his Social Security benefits will serve him well!

Spouses will not see any increase in their benefits as a result your "delayed retirement credits." Determining whether to postpone Social Security benefits for higher future benefits depends on your income as well as your health and life expectancy.

Social Security Spousal Benefits

If your spouse has not had significant earnings, he or she is entitled to 50 percent of your Social Security retirement benefit.

To receive the full 50 percent of your benefit, your spouse must be at or above his or her FRA. Your spouse can receive reduced benefits starting at age 62. If your spouse is entitled to

his or her own Social Security benefit that is greater than 50 percent of your benefit, the higher amount would be paid.

If you have already reached your Social Security FRA, you can elect to receive 100 percent of your deceased spouse's benefits, as long as you were married for at least nine months. If you are between age 60 and 65, you may elect to receive a reduced benefit.

George recently died at age 67. His wife, Barbara, turns 63 next month and must make decisions concerning her Social Security benefits.

Barbara spent much of her adult life as a stay-at-home mom and has paid very little into her Social Security account. As a stockbroker, George annually paid in the maximum to Social Security and was receiving $2,500 per month in Social Security benefits.

Barbara is entitled to George's Social Security benefit for the rest of her life. However, since Barbara is 36 months from her FRA, if she begins taking the benefits immediately, they will be reduced by .396% per month for a total of a 14.25% reduction. At age 63, Barbara would receive $2,144 per month.

Since Barbara has no earned income above $12,960 (2007), she does not have to worry about her payments being further reduced, even though she is under age 66.

Next week, she will meet with her financial planner to determine whether she should begin taking $2,144 per month now or postpone her benefits until age 65. If she postpones her benefits, she will receive $2500 per month, increased by two years of cost of living adjustments, for the rest of her life.

Social Security benefits are annually indexed to the cost of living. As the cost of living rises, based on the consumer price index (CPI-U), Social Security benefits increase at the same rate. For the portion of your total retirement income that Social Security will cover, your purchasing power should remain intact, unless your own expenses increase faster than the CPI-U as they might with large medical expenses.

Medicare Parts B and D costs continue to rise annually. Since these costs come directly out of your Social Security check, the amount that you receive in your monthly Social Security check may actually decrease annually.

If you are age 25 or older, the Social Security Administration provides an annual statement that shows the earnings for which you paid Social Security taxes, as well as a summary of the estimated benefits you and your family may receive.

Always verify that the earnings information on the report is accurate. If you notice any discrepancies, immediately notify the Social Security Administration to correct inaccuracies. Incorrect information could potentially reduce the amount that you will receive at retirement.

Pension Benefits

Retirement income may also come from your company-sponsored defined benefit pension plan. If your company offers a pension plan, ask you HR department for an estimate of what your present benefit amount would be at your retirement age.

If possible, get the anticipated future dollar amount that you would receive at retirement, if you remained with your employer, as well as the amount that you are currently due to be paid at retirement, if you were to leave tomorrow. The "currently due" amount will not increase with inflation and

will be considerably less that the amount you will get if you remain with your employer until you retire.

Nadine has been a middle school teacher for 20 years and is paid $60,000 per year. She is planning to retire from teaching in 10 years. She expects to receive pay increases over the next 10 years that will at least keep her pay even with inflation.

Throughout Nadine's career, she has participated in her school district's pension plan. Her recent pension benefit statement showed that if she retired after teaching for 30 years, she would receive monthly benefits equal to 90 percent of her current salary or $54,000 per year.

With current annual expenses of $40,000 per year, Nadine feels comfortable that she will be able to live on her pension when she retires.

Nadine's pension plan includes a cost of living adjustment (COLA). With a COLA provision, her retirement payments will keep pace with inflation. As with Social Security, her retirement payments will increase annually, so that her real (after-inflation) income remains constant throughout retirement.

Most pension plans are *fixed-benefit pension plans* without a COLA benefit. With a fixed benefit pension plan, the amount of pension that you receive in the first year of retirement will be the same amount you receive in the 25th year.

Fixed-Benefit Pension Plan: A pension plan in which payments remain fixed throughout your lifetime.

Assuming inflation averages 3 percent per year, after 24

years of retirement, your fixed pension plan benefits, on an *inflation-adjusted dollars* basis, will have only half of their original purchasing power!

Inflation Adjusted Dollars: The purchasing power, in today's dollars, that a future amount of money will have, discounted by a specified inflation rate.

If you have a fixed benefit pension plan and expect to be with your employer until you retire, use no more than 66% of the projected retirement benefit in your retirement planning. This planning approach will help offset the inflation erosion of your fixed benefit.

Retirement Savings and Other Investment Income

If you are like most Americans, Social Security benefits and pension plans will not provide adequate coverage of your retirement expenses. Retirement savings and other investment income are critical.

Retirement savings include 401(k) plans, 403(b) plans plus any other employer-sponsored defined contribution plans. It also includes IRAs and Roth IRAs, as well as investments in brokerage accounts, savings accounts, rental property, limited partnerships, etc.

Investing the maximum amounts allowed into tax-deferred retirement accounts often provides an immediate tax benefit and allows your investments to grow tax free until funds are withdrawn. With the possible exception of a nondeductible IRA, it is typically better to invest in tax-deferred accounts before investing in taxable accounts.

Jeffrey, age 55, Luke, age 50 and Ian, age 40 work for a large accounting firm.

Recently, while discussing their retirement goals, they each decided to invest in their company 401(k). Starting this year, their company will provide a 100 percent "match" of the first $5,000 invested in the 401(k).

Jeffrey and Luke each decide to invest $15,000 per year. With the company match of $5,000, they will have a total annual 401(k) investment of $20,000.

Ian has two young children and must put most of his savings aside for their college education. He decides to put in $5,000 annually. Receiving the $5,000 company "match," his annual 401(k) investment is $10,000.

Their shared goal is to have at least $500,000 in their 401(k) by the time they retire at age 65. Assuming an 8 percent annual investment return, when Jeffrey retires in 10 years he will have $305,700 in his 401(k).

Luke, with 15 years before retirement will exceed his goal with $578,500 in his 401(k). Just five additional years of investing provides Luke with almost twice the savings that Jeffrey will have.

Ian is concerned that his reduced investment will not be enough to meet his retirement goal. However, since he has 25 years until retirement, he discovers that his 401(k) will have $795,810 when he is age 65. By beginning to save for retirement earlier in life, Ian can save significantly less and still exceed his $500,000 goal.

If you assume a 3% annual inflation rate, at retirement age Jeffery will have $259,100, Luke will have $446,050 and Ian will have $497,200, in inflation adjusted dollars. Ian will still have 90% more than Jeffery at retirement age, in inflation adjusted dollars.

How Much Saving Will You Need?

It is impossible to know exactly how much retirement savings you will need. In this section, I will show you how to estimate a savings amount that should be adequate to live your retirement in abundance.

In Chapter 1 you calculated your "current expenses." In retirement, your expenses will likely be reduced in some areas and increased in others.

Areas where you may reduce your spending in retirement include:

1. Your home mortgage may be paid off by the time you retire.
2. Your clothes expenses may be reduced when you no longer have to dress for going to an office.
3. You may not need a second automobile in retirement.
4. You will no longer need disability insurance and your life insurance requirements may be reduced or eliminated.
5. Your state and federal income taxes may decrease.
6. Unless you continue to work, you will no longer pay Social Security or Medicare/Medicaid taxes.

Areas where your expenditures might increase include:

1. More travel and vacations when you retire.
2. Medical expenses no longer covered by your company (if it previously covered most of your medical insurance costs) and/or Medicare parts B and D supplemental insurance policies.
3. Spending winters in a warmer place and either buying or renting a second home.
4. Increased financial obligations for parents or grown children.

5. Eating out more than you do currently.

For each of the areas listed above, estimate the cost reduction or increase based on today's prices. Add the increases and subtract the reductions from your "current expenses" to determine your "current retirement expenses," based on today's prices.

Now that their last child has graduated from college, Jesse and Roberta are looking forward to retiring in ten years, when they both turn 66. Jesse has spent his career in life insurance sales. Roberta taught at a private school until their children were born. She now teaches part-time and volunteers at the local food bank.

Jesse and Roberta have a combined income of $140,000. They recently calculated their "current annual expenses" at $105,000, leaving them a "Net Income" (as defined in Chapter 1.) of $35,000. Of their "current annual expenses," $25,000 is paid in state and local income taxes plus Social Security/Medicare taxes.

Each year, they give $5,000 to their church and $5,000 to local charities. With Jesse putting $20,000 into his 401(k) plan each year and Roberta contributing $5,000 to her IRA, their $35,000 "Net Income" is consumed.

When they retire, they will reduce their expenses by:

1. Paying off their home mortgage to reduce annual payments by $20,000.

2. Jesse no longer requiring suits, dress shirts and ties, saving $1,500 annually.

3. Jesse dropping his disability insurance and

no longer needing his term life insurance policy, for total yearly savings of $2,500.

4. Jointly paying no more than $5,000 in income taxes and nothing to Social Security/Medicare, reducing their total tax burden by $20,000 annually.

Their total retirement expense reduction, in current dollars, will be $44,000.

Upon retirement Jesse and Roberta will increase their expenses by:

1. $10,000 annually on world travel.

2. $3,000 per year on Medicare supplemental insurance and increased medical costs.

3. $2,000 per year on eating out more often.

Their total retirement expense increases, in current dollars, will be $15,000.

Based on today's costs, Roberta and Jesse's "current retirement expenses" are:

"Current annual expenses" of $105,000 less reductions of $44,000 plus increases of $15,000 for a total of $76,000.

The next step is for Jesse and Roberta to determine how much of the "current retirement expenses", required for an abundant retirement, will be covered by Social Security and pension plans. Since Jesse has no pension plan, they will only have Social Security for retirement income.

Based on recent Social Security benefit statements, Jesse will receive $2,200 per month at his Full Retirement Age.

While Roberta's benefit statement shows that she will only receive $500 per month, Jesse explains to her that she can receive a 50 percent "spousal" Social Security benefit of $1,100. Their combined monthly benefit of $3,300 per month will provide

$39,600 annually in current benefits.

Based on Roberta and Jesse's "current retirement expenses" of $76,000, with annual Social Security benefits of $39,600, their "retirement savings" will need to provide $36,400 annually, based on today's dollars.

Their next step is to determine how much $36,400 in today's dollars will be when adjusted for 10 years of inflation.

Inflation Multiplier

Because we are consistently faced with inflation, $1,000 in 10 years will buy less than $1,000 will buy today. While the amount of inflation varies from year to year, the average annual inflation over the past 100 years has been approximately 3 percent per year.

To determine how much you will need in the future to purchase goods that can be purchased for $1,000 today, you will need to estimate an expected rate of inflation. The following table provides this information using 2 percent, 3 percent and 4 percent annual inflation rates:

Years in Future		**Inflation Rate**	
	2%	**3%**	**4%**
0	$1,000	$1,000	$1,000
5	$1,104	$1,159	$1,217
10	$1,219	$1,344	$1,480
15	$1,346	$1,558	$1,801
20	$1,486	$1,806	$2,191
25	$1,641	$2,094	$2,666
30	$1,811	$2,427	$3,243
35	$2,000	$2,814	$3,946
40	$2,208	$3,262	$4,801

Assuming 3 percent annual inflation, Roberta and Jesse determine that they will need $1,344 in 10 years to purchase what they can purchase for $1,000 today. To have $36,400 worth of purchasing power in 10 years, they will need to have $36,400 x 1.344 = $48,921.

Jesse and Roberta meet with their financial advisor to determine the amount of retirement savings that they will need to provide them with $48,921 of annual income, beginning in 10 years.

Introducing them to a new financial concept, their advisor explains that if they receive after-tax investment income of 7 percent and inflation is 3 percent, their *real rate of return* is 4 percent.

Real Rate of Return: The annual percentage return realized on an investment, adjusted for changes in prices due to inflation or deflation.

Their advisor further explains that with a 4 percent real rate of return, every $1,000 of retirement income will require approximately $17,500 in retirement savings to provide for 30 years of inflation-adjusted income. At the end of 30 years, both principal and income will be consumed.

Assuming a 4 percent real rate of return, Roberta and Jesse will require "total retirement savings" of 48.921 x $17,500 = $856,000 in 10 years.

This large amount appears daunting to Jesse and Roberta. However, their advisor shows them that they should have more than enough to cover this amount and live an abundant retirement.

They are currently saving $25,000 per year in Jesse's 401(k) and Roberta's IRA. In 10 years, these retirement fund investments will be worth over

$345,000, with a 7-percent rate of return.

In their brokerage and savings accounts, Roberta and Jesse have investments worth $200,000. Jesse's 401(K) plan presently has $75,000 and Roberta's IRA has $30,000.

In 10 years, these investments will grow to $600,000, assuming a 7-percent total return. By the time that they retire, Roberta and Jesse should have approximately $945,000 to use for their retirement expenses, allowing them to enjoy an abundant retirement.

Where to hold your investments

You likely have investments in your taxable brokerage and savings accounts, as well as in your tax-deferred and tax-exempt retirement accounts. To minimize your taxes and maximize after-tax income, it is important to determine what types of investments should be held in each type of account.

Let's first distinguish what are called "tax-inefficient" investments from "tax-efficient" investments.

"Tax-inefficient" investments generate income that is taxed at ordinary income tax rates. Investments that generate taxable interest, "nonqualified" dividends and short-term capital gains are all tax-inefficient.

Real Estate Investment Trusts (REITs) or REIT mutual funds pay *nonqualified dividends*. Actively managed mutual funds with high turnover rates generate short-term capital gains. Fixed income securities pay taxable interest income. All of these investments are considered "tax-inefficient."

> **Nonqualified Dividends:** Dividends that are taxed at your ordinary income tax rate instead of the qualified dividend rate of 15 percent (maximum).

"Tax-inefficient" investments should be held in a tax-

deferred or a Roth IRA retirement account.

Your more "tax-efficient" investments should be held in taxable accounts. An obvious example of a "tax-efficient" investment is municipal bonds. Stock index funds, including most Exchange Traded Funds (ETFs), are "tax-efficient" and are also good to hold in a taxable account.

Upon retirement, Jesse and Roberta have $400,000 in their taxable brokerage accounts, Jesse has $420,000 in his 401(k) account and Roberta has $125,000 in her IRA.

To assure that they continue to receive the maximum return from their investments, they meet with their financial planner. To gain more control over their investments, their financial planner suggests that Jesse roll over his 401(k) account into an IRA.

Their financial planner recommends that they have a portfolio that is approximately 50 percent in equities, 45 percent in fixed income and 5 percent in cash investments.

For the taxable brokerage account he recommends:

1. $250,000 in a 10-year municipal bond ladder
2. $100,000 in a value-based ETF portfolio with a 2-percent dividend yield
3. $50,000 in a short-term municipal bond mutual fund.

The annual income from this portfolio is approximately $16,000, with $14,000 tax free.

For Roberta and Jesse's IRAs, he recommends:

1. $50,000 in a REIT mutual fund;

2. $150,000 in two actively managed U.S. mutual funds;
3. $75,000 in an actively managed foreign markets mutual fund;
4. $100,000 in a value-based ETF portfolio with a 2-percent dividend yield;
5. $120,000 in a short-duration taxable mutual bond fund;
6. $50,000 in a money market fund.

Even though Jesse and Roberta are only 66, their advisor recommends that they withdraw $33,000 from their IRAs. While they must pay ordinary income taxes, after their tax deductions, their tax rate is only 10 percent for this withdrawal.

As Jesse and Roberta will require $48,913 in expenses from their retirement savings, the income from their taxable portfolio combined with their IRA withdrawals will provide for this requirement, with a total federal tax bill of under $3,500.

Withdrawal Strategies

It is important to have a plan for withdrawing funds during retirement. A well-planned withdrawal strategy can have a significant impact on your cash flow, capital preservation, taxes and the estate that is passed to your heirs.

Since funds in a tax-deferred account will continue to grow tax free, common financial "wisdom" is to withdraw funds first from your taxable accounts. The following are reasons to use taxable funds instead of tax-deferred accounts:

1. Taxable funds can be managed to lessen their tax impact. You can offset a capital gain by selling an asset with a capital loss.
2. You are only taxed on the gains, not the entire value of the asset sold.

3. You pay a maximum tax of 15 percent on long-term capital assets that are held for over one year.
4. Selling a taxable asset will only increase your Adjusted Gross Income (AGI) by the capital gain on your investment, not the full amount that your receive.
5. Non-Roth IRA retirement account withdrawals increase your AGI by the full amount of the withdrawal, potentially raising your marginal tax rate.
6. With a higher AGI, your probability of paying taxes on 85 percent of your Social Security benefits increases.

In December, Pierre, age 67, needs $10,000 to replace his roof.

Pierre's Adjusted Gross Income (AGI) for the year is approximately $32,000. He has significant savings in his IRA and is questioning whether it would be wise to use some of those funds for this repair.

If he withdraws $10,000 from his IRA, it will increase his AGI by $10,000. If his AGI is over $34,000, Social Security benefits are 85 percent taxable. By taking funds from his IRA, he will pay $700 in increased Social Security income taxes plus an additional $2,500 in federal income taxes.

Pierre also has a taxable brokerage account that includes several appreciated stocks. If he sells a stock with a cost/basis of $8,000 - now worth $10,000 - he receives the funds required to fix his roof.

With this approach, Pierre's AGI will only increase by $2,000, keeping him below the 85 percent Social Security tax rate. Since his $2,000 gain is a long-term capital gain, his tax rate on the

gain is only 15 percent for a total income tax increase of $300.

By evaluating withdrawal strategies, Pierre saves $2,900 in federal income taxes.

As Roberta and Jesse discovered, there are times when it may be advantageous to withdraw funds from a tax-deferred account, if you can do so while maintaining a low income tax rate.

If you are under 70 1/2, it may be advantageous to make withdrawals from your tax-deferred accounts, up to the maximum amount that keeps you in the 15 percent income tax bracket. By doing this, you may take smaller required distributions when you reach age 70 1/2.

Roth IRAs should generally be the last assets used, as they do not have any minimum required distributions. Roth IRAs can grow tax free indefinitely.

Roth IRA assets, left to younger heirs, can be put into an inherited Roth IRA account from which the younger heirs can take tax-free distributions over their entire life. Since younger heirs have smaller required distributions, the Roth assets may grow faster than the required withdrawals, building up even more tax-free assets.

Immediate Fixed Annuities

When you are ready to retire, consider an immediate fixed annuity as a substitute for a portion of your fixed income asset allocation. Immediate fixed annuities make fixed payments until your death, and the death of your spouse, in a dual life policy.

While fixed annuities should never be your only source of retirement cash flow, they can be a source of comfort during

down stock markets, since they are not subject to market fluctuations. In many ways, a fixed annuity can be seen as a substitute for a defined benefit pension plan, since both provide a stream of fixed payments throughout your life.

If you are in good health and anticipate a long retirement, you may want to consider an inflation-adjusted annuity. This product is similar to having a fixed annuity with an annual cost of living adjustment (COLA) benefit. With this approach, you get less initial income, but your annuity payment will keep increasing at the rate of inflation.

If you buy a fixed annuity, be sure to comparison shop. Only buy an annuity that has low expenses and is backed by a highly rated insurance company.

An alternative to a commercial annuity is a Charitable Gift Annuity or a Charitable Remainder Annuity Trust. As shown in Chapter 5., these annuities often offer better after-tax returns than commercial annuities.

The Problem with Deferred Annuities

If you are not yet at retirement age, you may find that an investment advisor is trying to sell you a fixed or variable deferred annuity. These are investment devices with tax-deferred growth characteristics similar to retirement savings accounts such as IRAs. However, you receive no tax deduction when you buy the deferred annuity and you pay ordinary income taxes upon fund withdrawal.

Deferred annuities can be a great investment for the sales person, earning them as much as a 10 percent commission on the sale, but they are often a poor investment for you.

If you are being encouraged to buy a deferred annuity and you believe that a deferred annuity is the right product for you to buy, compare prices and benefits of other deferred annuities that are only offered by noncommissioned brokers at such

companies as Schwab or Fidelity. You might find that the deferred annuity from a noncommissioned broker costs less and has more benefits than the one that you are being sold.

You may also find that you can accomplish your investment objectives using a different approach than deferred annuities, which often have high sales commissions and a fairly high life insurance cost built into them.

If you are over 50 and still working, consider a deferred Charitable Gift Annuity or a Charitable Remainder Trust. You will be giving a substantial charitable gift as well as receiving an after-tax return that may be as high as the return you will get with a commercial deferred annuity. See Chapter 5. for more information on charitable annuities.

Reverse Mortgage

You may have considerable equity in your home, but need cash for your retirement living expenses. If you are age 62 or older, with a reverse mortgage you can receive a monthly income stream for as long as you live. Your payments are tax free and do not affect Social Security benefits.

If you are "house rich" and have exhausted your other retirement savings, a reverse mortgage may be a method of obtaining needed cash, while allowing you to stay in your home. However, a reverse mortgage is expensive to set up and should only be looked upon as a last resort in retirement funding.

Diversification

Your primary consideration with any investment strategy is to avoid having so many assets in any one investment that your life style would change if the investment suffers a dramatic decline.

This is especially true of your company's stock, as employees of Enron found. If your company faces serious financial difficulties, you could suffer from a significant drop in the price of your stock and you might lose your job.

If you have more than 10 percent of your total investment portfolio in any one investment, including your company's stock, consider reducing that investment and diversifying your portfolio.

Chapter 9 Summary

1. To approximate what your expenses will be in retirement, reduce your "current expenses" by costs that you will not have in retirement, such as having your mortgage paid off. Increase your "current expenses" by additional costs that you expect to have, such as increased travel. This will give you an approximation of your "current retirement expenses" in today's dollars.
2. Retirement income will come from Social Security benefits, employer-sponsored pension plan distributions and retirement savings and other investment income.
3. Social Security payments can begin with reduced benefits when you are 62. After determining your full retirement age (FRA), the age at which full retirement benefits are available, you can calculate the reduced benefits of taking Social Security before your FRA.
4. If you take Social Security benefits before your FRA, the amount that you receive will be reduced for the remainder of your life, except for yearly inflation adjustments.

5. Until reaching your FRA year, Social Security benefits are reduced by $1 for every $2 in earned income over $12,960 (2007).
6. If your spouse's Social Security benefits are less than 50 percent of yours, your spouse can receive "spousal benefits" that are 50 percent of your Social Security retirement benefit at their FRA.
7. If your spouse is already receiving Social Security benefits and dies, you may elect to receive your deceased spouse's benefits, as long as you are at least 60 years old and were married for at least 9 months. If you take these benefits prior to age 65, they will be at a reduced amount of your spouse's full benefit.
8. Defined benefit pension plans provide a fixed benefit from the time you retire until the time that you and your spouse die. Your HR department can tell you what your current pension benefit would be at retirement.
9. Save the maximum amount possible in tax-deductible retirement accounts and your Roth IRA before investing in taxable income sources. Most retirement accounts provide an immediate tax benefit and all retirement accounts are allowed to grow income tax free until the funds are withdrawn.
10. The earlier you start your retirement savings the less you will have to save annually to meet your retirement goals.
11. Determine, in today's dollars, how much of your expected retirement expenses will be covered by projected Social Security Benefits.
12. Real rate of return is the percentage that your after-tax investment returns exceed the rate of inflation. At a 4 percent real rate of return, for each $1,000 of annual

retirement income that you require, you will need about $17,500 of retirement savings.

13. "Tax-inefficient" investments are those that generate dividends and capital gains that are taxed at ordinary income-tax rates. Keep your most "tax-inefficient" investments in a tax-deferred or Roth IRA retirement account.
14. Assets in taxable accounts can be managed to lessen their tax impact when sold.
15. Roth IRAs should generally be the last assets that you consume. These tax-free accounts are excellent assets to leave to younger heirs.
16. Other investments that may be appropriate for retirement income include immediate annuities, where you get a fixed income for one or two life times.
17. Be cautious of investment advisors who sell deferred annuities. These investments often have high sales commissions and may only be beneficial to the commissioned sales person. Consider a deferred Charitable Gift Annuity or Charitable Remainder Trust.
18. If you are over 62 with significant equity in your house, you may consider a reverse mortgage that provides you with monthly income while allowing you to remain in your home. This approach has high initial fees and could lead to your losing your home. It is recommended that you consider this only as a last resort for retirement income.
19. Diversification is critical to successful retirement savings. If you have more than 10 percent of your total investment portfolio in any one investment, including your company's stock, reduce that investment and diversify your portfolio.

CHAPTER 9 ABUNDANCE STRATEGIES

1. From your annual Social Security statements, calculate the percentage of your "current retirement expenses" that your Social Security payments will cover.
2. If you expect to receive fixed benefit pension plan income upon retirement, use no more than 66% of the expected benefit amount in your retirement planning. At 3% inflation, the purchasing power of your fixed benefit pension will be cut in half in 26 years.
3. Using the "inflation multiplier," calculate how much you will need in the future for "retirement expenses" that are not covered by Social Security and pension plans. Three percent is the average annual inflation rate for the past 100 years.
4. Multiply the amount, calculated in 3. (above), by $17,500 to calculate your required "retirement savings." This assumes a 4 percent real rate return for your retirement savings.
5. If you plan to continue employment between age 62 and your Social Security Full Retirement Age (FRA), wait until your FRA before taking Social Security benefits. Taking Social Security benefits before your FRA reduces your benefits for the remainder of your life. Benefits are further reduced by 50 percent of every dollar you earn above $12,960, before you reach your FRA year (2007).
6. Tax-advantaged accounts, such as defined contribution plans, individual retirement accounts, HSAs, etc., should be funded to the maximum extent possible, before funding taxable accounts.
7. "Tax-inefficient" investments generate income taxed at ordinary income tax rates. Examples of this include

Real Estate Investment Trusts (REITs), which generate nonqualified dividends, and actively traded mutual funds, which generate short-term capital gains.

8. Put "tax-inefficient" investments into your tax-deferred or Roth IRA retirement accounts. "Tax-efficient" investments, such as municipal bonds, should be kept in your taxable savings accounts.
9. In your retirement years, keep up to 50 percent of your investments in equities.
10. Keep enough cash investments and short-term bond funds to cover at least 24 months of retirement expenditures. By doing so, you may not be required to sell equities during a market decline.
11. In your retirement years, make withdrawals first from your taxable accounts. Taxable assets can be managed to lessen their tax impact, plus funds in your tax-deferred accounts can continue their tax-deferred growth.
12. An exception to 11. (above) is when your taxable income is below the 15 percent federal income tax limit. If you are over 59½, and have significant savings in your tax-deferred retirement accounts, withdraw funds from your tax-deferred accounts up to the 15 percent federal income tax limit.
13. When you reach 70½, take only the required annual amounts from your tax-deferred accounts, if you have taxable accounts to supplement your expenditures.
14. Use Roth IRA account funds only when your taxable accounts and your tax-deferred accounts are depleted. Roth IRA funds are excellent assets to pass on to younger heirs.

CHAPTER 10

Leave an Abundant Estate

"The only thing you take with you when you're gone is what you leave behind."

–John Allston

Estate Planning is a complex task, requiring the help and support of a lawyer who specializes in estate planning. Proper estate planning will allow your abundant financial resources to provide for your loved ones after you are gone. You may also want to give a portion of your estate to your favorite philanthropic causes.

Wills and Will Substitutes

Upon death, your property is transferred to other people or legal entities through a process called probate. In probate, your property is transferred according to the provisions in your will. A will assures that your remaining property goes to the people or charities you choose.

You may also transfer property outside of probate through a "will substitute," which allows property to be transferred outside of the probate process. Some states have complex and expensive probate procedures while for other states the process

is simple. The laws of your state will influence your decision about whether or not to use will substitutes.

Wills

A will is a legally enforceable declaration of how your probate property is to be distributed upon your death. Wills are revocable and can be changed until the time of your death. A new will should specifically revoke the applicability of any previous will.

You may modify your will through a legal document known as a codicil. When you add a codicil to your will, the original will remains in effect, except that it is now altered by the contents of the codicil. Your will and all codicils should be kept together in a secure place outside of your home.

Probate

The court-supervised process for administering your estate is called probate.

Probate serves the following purposes:

1. Probate is the process of validating a will.
2. Probate provides for the appointment of your "personal representative" who will administer your probate estate.
3. Probate provides a process by which your creditors can be paid as well as a process for your final tax obligations to be met.

As with any legal process, there are always some disadvantages. The primary disadvantages of transferring property through probate include:

1. Probate is a public process.
2. Probate is a legal proceeding. The paperwork and

various steps in the probate process can require a significant amount of time to complete.

3. Probate can be costly, especially if your estate must pay for your personal representative and/or attorney to complete all of the steps in the process.

Dying Intestate

When you die intestate (without having a will), only specific blood relatives who are the state-specified heirs are entitled to receive your property. Friends and charities get nothing.

Typically all of your property will go to your spouse and/or your children, when you die intestate. If you wish for your spouse to receive everything, that wish may not be consistent with your state's intestate laws.

Will Substitutes

Legal methods for transferring property outside of the probate process are called "will substitutes." Will substitutes include:

1. Joint tenancy or joint tenancy with right of survivorship (JTROS)
2. Life Insurance
3. Individual retirement plans, profit-sharing plans and defined contribution plans that pay the account proceeds directly to the named beneficiary
4. Transferring property to a trust to give the trust legal title to the property
5. Payable on Death (P.O.D.) and Transfer on Death (T.O.D.) accounts that allow funds to be passed at death outside of the probate process
6. Series EE and Series HH government savings bonds

Joint Tenancy

If you and your spouse own your home in joint tenancy or joint tenancy with right of survivorship, your house would pass immediately to the survivor if either of you should die. You own an undivided equal interest in the property with the other joint tenant(s). When you die, the surviving joint tenant(s) will own equal interests in 100 percent of the property.

However, be careful about using joint tenancy as a "cure all" in order to move all of your property outside of probate.

Paul and Denise decided to add their son Roger as a joint tenant to their house so that when they were both gone, Roger would inherit their house without it going through probate.

Two years ago, Roger started a small business and took out a $200,000 loan, backed by his personal assets. Roger's business ran into severe financial difficulties and was forced to close.

The bank that loaned Roger the money to start his business has placed a $200,000 lien on Paul and Denise's house, since Roger is a joint tenant, and the house is Roger's only personal asset with any remaining value.

Paul and Denise must now find a way to "bail out" their grown son or face the prospect of losing their house.

After selling his construction business, Carlos invested his proceeds with a trusted financial advisor. The brokerage account has continued to grow and is the main financial asset that Carlos

> wishes to leave to his four children.
>
> When Carlos' wife died, he decided to name his oldest son, Juan, as a joint tenant in his brokerage account. By doing this, Carlos knew that if he was ever incapacitated, Juan could pay his bills and take care of his financial affairs.
>
> Carlos had a massive heart attack and died last year. Even though his will specified that the brokerage account would be shared equally between his four children, Juan, as the only joint tenant of the brokerage account, received 100 percent of the account.

In certain situations, joint tenancy can even be problematic with a spouse!

> Bobby and Billie Jean have been married for five years. Bobby has been a successful investor and has built up his brokerage account to over $1 million.
>
> When they were first married, Bobby and Billie Jean decided to put all of their assets, including the brokerage account, into joint tenancy.
>
> Unknown to Bobby, Billie Jean has decided to leave him and travel around the world. Since the brokerage account is held in joint tenancy, Billie Jean is able to sell the stocks and empty the account to pursue her dreams.

To avoid the problem shown above, see if your state has a special type of joint tenancy, existing only between spouses, called "tenancy by the entirety." Tenancy by the entirety does not allow either tenant to sell or gift his or her interest in the property without the consent of the other tenant.

Life Insurance

Properly executed, life insurance can provide cash to your beneficiary, avoid probate and avoid estate and inheritance taxes. To have the insurance proceeds pass outside of your estate, the policy should be purchased so that the owner of the policy is also the beneficiary.

You can provide cash gifts to your beneficiary so they can pay the premiums. Your beneficiary will receive the proceeds of the insurance policy income tax free and the proceeds of the policy will pass outside of your estate, subject to no estate taxes.

An Irrevocable Life Insurance Trust (ILIT) for the benefit of the beneficiary is another method of accomplishing the same result. With this approach, the irrevocable trust is the owner of the insurance policy.

With both approaches you eliminate probate. The insurance proceeds will not be subject to estate, inheritance or income taxes.

Payable on Death and Transfer on Death

Payable on death or P.O.D. statutes allow bank accounts, certificates of deposit (CDs) and money market funds to be passed, outside of the probate process, at death.

A transfer on death (T.O.D.) account is usually limited to the registration of publicly traded securities and debt obligations, but can include real estate deeds in some states.

In states where P.O.D. and T.O.D. accounts are allowed, they provide a simple means of transferring cash-equivalent assets to your spouse, children and charitable institutions outside probate, while allowing you complete control over your funds, including the right to change the beneficiary.

Series EE and Series HH Government Savings Bonds

These bonds normally are issued either in "co-ownership" or in a "beneficiary" format. With "co-ownership," if either owner dies, the survivor is the sole owner of the bond(s). With the "beneficiary" format, when the primary bondholder dies, the beneficiary is entitled to any payments. The primary holder controls the bond payments and has the right to substitute another beneficiary at any time.

Community Property is NOT a Will Substitute

Louisiana, Texas, New Mexico, Arizona, Nevada, California, Washington, Wisconsin and Idaho are community property states. Under the community property concept, property acquired during marriage is owned one-half by the husband and one-half by the wife, regardless of whose name is on the title and who actually put up the money to purchase the property.

Community property is not a will substitute. When you die, your half of the community property does not automatically go to your surviving spouse. Instead, it is distributed through the probate process to the beneficiary designated in your will.

If the designated beneficiary is not your surviving spouse, your surviving spouse will end up with only half of the family house, half of an automobile and half ownership of the bank accounts. To protect your spouse, make sure that your house and other vital assets are titled in joint tenancy with right of survivorship.

Some community property states have passed statutes recognizing a form of community property known as "community property with right of survivorship." This type of

property will pass outside of the probate process, since a decedent's interest in such property passes automatically to the surviving spouse, similar to joint tenancy.

Federal Estate and Gift Taxes

In 1977, the estate tax and the gift tax were integrated, using a common tax rate table and common combined amounts of property that could be transferred by gifts during life or with your estate at death, without incurring any estate tax. This threshold amount is called the *applicable exclusion amount*.

Applicable Exclusion Amount: The amount of an individual's net estate that can be passed on without paying any estate tax.

Since 2004, the federal gift and estate tax applicable exclusion amounts are no longer the same. The gift tax applicable exclusion amount is $1 million and is not expected to increase.

The estate tax applicable exclusion amount has increased to $2 million in 2007 and is scheduled to be totally repealed in 2010. This repeal is only for one year, after which the applicable exclusion amount will revert back to $1 million.

Before 2010, it is expected that Congress will modify the estate tax laws to set an estate tax applicable exclusion amount that is higher than $1 million and lower than unlimited.

It is likely that Congress will set the estate tax applicable exclusion amount between $2 million and $5 million. Until Congress takes action, do not plan for more than the present $2 million estate tax applicable exclusion amount, with the gift tax applicable exclusion amount remaining at $1 million.

Gift Taxes

Inter Vivos Trust: A trust created during the lifetime of the trust creator.

The federal gift tax applies to *inter vivos* property transfers made while

you are still alive. The "gift" occurs when you give someone property and receive back less than the full value of the property. This is only considered a "completed gift" if you also give up all control over the property.

In 2007, you may gift up to $12,000 to as many people as you wish. These gifts receive the annual gift tax exclusion and will not incur any gift tax. If your annual gift to any individual is no more than $12,000, you have no gift tax liability. If you are married, you may double the tax-free gift by having your spouse consent to "*gift splitting*."

Gift Splitting: If you are married, your spouse may elect to give half of all gifts that you make. When this occurs, the gift tax exclusion amount is doubled.

For the annual gift tax exclusion to apply, the recipient of your gift must be able to immediately use and enjoy the property.

If your spouse is a U.S. citizen, you have an *unlimited marital deduction*, enabling you to transfer an unlimited amount of your property to your spouse without any gift or estate tax liability. If your spouse is not a U.S. citizen, there is a *super annual exclusion*, which allows an annual transfer of up to $125,000 (2007) to your spouse without any gift tax liability.

Unlimited Marital Deduction: The process by which spouses can give an unlimited amount of their assets to their U.S. citizen spouses.

Super Annual Exclusion: The amount that a spouse can give each year to their non-U.S. citizen spouse, without the gift being subject to the federal gift tax.

Charitable deductions allow you to transfer an unlimited amount of property to a qualified charity without incurring any gift tax liability. To qualify for this deduction, the gifts must be either outright gifts of cash or property to a qualified charity or a gift of a partial interest in property to a qualified charity.

You may also make gifts to defray tuition or medical

expenses for a relative or friend. As long as the payment is made directly to the educational institution or health-care provider, the entire amount you pay is excluded from gift taxes. This is a very useful method of transferring assets out of your estate for the benefit of your loved ones.

All taxable gifts, as well as the election to split gifts, must be reported on IRS Form 709 on or before April 15 of the year following the year in which you made the gift. If any gift tax is due, that tax must also be paid at the same time.

Estate Taxes

Estate tax must be paid on your gross estate, which is calculated by summing the fair market value of all the property that you own at death. All property in the probate estate is included in your gross estate as well as all property that passes through will substitutes.

For property held with your spouse as tenants by the entirety or joint tenants with right of survivorship (JTWROS), half of the property value will be included in your gross estate.

If property is held in JTWROS with someone who is not your spouse, the full value of the property will be included in your gross estate, unless it can be proven that the other person contributed to the purchase of the property.

Any amounts that your survivors will receive from your IRAs, qualified retirement plans and annuities will also be included in your gross estate.

Your gross estate may be reduced by deductions for funeral and estate administrative expenses, uninsured casualty and theft losses, claims against the estate, debts, death taxes paid to a state and any other indebtedness included in the gross estate. Charitable gifts will also be given a charitable deduction. The portion of your estate that is passed to your spouse, if a U.S. citizen, will receive the unlimited marital deduction.

Your taxable estate is your gross estate reduced by all deductions. If you have any taxable gifts, made since 1976, these are added to your taxable estate to determine your estate tax rate. Once your estate tax liability is calculated, the estate tax *applicable credit amount* is applied. Any remaining estate tax liability must be paid within nine months of death.

> **Applicable Credit Amount:** A credit against the Federal Estate Tax that allows you to bequeath property free of the Federal Estate Tax. The amount of property that can be passed on tax free is the estate tax exclusion amount.

The estate tax should be minimized or avoided when legally possible. The remainder of this chapter will focus on strategies to help you eliminate or minimize your estate tax liabilities.

Estate Planning Strategies

If you and your spouse's combined estate will not exceed the estate tax applicable exclusion amount, $2 million in 2007, you will likely have no estate tax liability. You may transfer your entire estate to your spouse, since the surviving spouse's applicable exclusion amount will protect the entire estate from estate tax.

If your combined estate exceeds $2 million (in 2007), you may not want to leave everything to your spouse. Doing so may waste one of your applicable credit amounts, creating an estate tax liability at the death of your spouse.

To keep this from occurring, there are two strategies:

1. An applicable exclusion amount "bypass plan" allows you to use each spouse's applicable credit amount to reduce or eliminate estate tax at the death of the second spouse.
2. An "estate equalization plan" in which the wealthier spouse makes lifetime gifts to the poorer spouse, so that the poorer spouse's estate is equal to the estate tax

applicable exclusion amount of $2 million in 2007.

Bypass Trusts

Trusts can be used as a “bypass device” to provide income, gift and estate tax savings. A “bypass trust” is an irrevocable trust created for the benefit of your spouse. Since the trust assets do not qualify for a marital deduction, the assets will use your estate tax applicable credit amount. By doing this, they will not be included in your spouse’s estate. You also get to specify who will receive the remainder interest in the trust after the death of your spouse.

Eldad and Valerie have been married for 35 years. Through diligent savings and investment success, they have accumulated assets valued at over $3 million. They wish to leave their entire estate to their two grown children, upon the death of the second spouse.

Talking to their estate planning attorney, they discover that with their current wills, leaving everything to their spouse, the second spouse to die will probably leave an estate that will be subject to federal estate taxes. Both Eldad and Valerie would prefer to give their assets to their children, instead of the federal government.

Their attorney recommends that Valerie and Eldad each set up a “bypass trust.” When the first spouse dies, a portion of their estate, up to the estate tax applicable exclusion amount ($2 million in 2007), can be put in the bypass trust.

Each bypass trust is structured so the surviving spouse will receive all income from the trust and they can invade (withdraw) the trust principal as

> required. When the second spouse dies, all of the assets remaining in the trust will pass to Eldad and Valerie's children.
>
> Using a "bypass trust" allows Valerie and Eldad to pass up to $4 million (2007) to their children without paying any estate tax.

A "marital trust" is often used in conjunction with a bypass trust. With a marital trust, the trust assets qualify for the unlimited marital deduction, with all remaining assets included in your spouse's estate. The trust is required to pay all income to your spouse. Your spouse has complete control in appointing the beneficiary of any remaining trust assets.

Another estate planning trust is called the "*Qualified Terminable Interest Property* (QTIP) Trust." Like the marital trust, the QTIP trust pays all income exclusively to your spouse for life.

> **Qualified Terminal Interest Trust (QTIP)**: An estate planning trust, often used in second marriages, to assure that your spouse will receive all trust income, during his or her lifetime, with any remaining trust assets passing to your children.

With a QTIP trust, you are able to name the beneficiaries who will receive any remaining trust assets upon the death of your spouse. The assets in the trust are treated the same as a marital trust and will be included in your spouse's estate. Assets not included in the QTIP trust are put into a bypass trust and included in your estate.

> Jon and Elisabeth have been married for 21 years. They have been married previously and each has two children from their previous marriages. Elisabeth has had a very successful investment-banking career and has a net worth of over $3 million.

If she dies before Jon, she wants to be sure that Jon can continue to lead the abundant life that they share. However, when Jon dies, she wants her children to receive the remaining assets that she accumulated.

Their lawyer recommends that Elisabeth set up QTIP trust combined with a bypass trust. When she dies, her assets, up to the estate tax applicable exclusion amount ($2 million in 2007) can be placed in a "bypass trust." Her remaining assets will be placed in the QTIP trust. Jon will be the income beneficiary of both trusts and will be able to invade trust principal as needed.

Elisabeth names her children as the beneficiaries of both the QTIP trust and the bypass trust. When Jon dies, all assets in the bypass trust will pass to Elisabeth's children, estate tax free. If the remaining QTIP trust assets are below the estate tax applicable exclusion amount, all of these assets will also pass to her children, estate tax free.

Living Trusts

A revocable "living trust" may be terminated or modified by the trust creator at any time. Living trusts are often used to avoid probate, with the grantor able to add or remove property from the trust at any time. Earnings generated by the trust are recognized as income to the grantor. All of the trust assets are included in the grantor's gross estate.

Contingent/ Standby Trusts

"Contingent" or "Standby" Trusts are revocable trusts providing for management of your assets when you are no longer able to manage your assets, due to mental or physical incapacity. If you become incapacitated, your agent transfers

your property interests to the trust and manages these assets on your behalf.

Spendthrift Trust

A "spendthrift" trust can be created if you feel that the trust beneficiary is incapable of managing his or her financial affairs. The terms of the trust limit the rights of the beneficiary to dispose of his or her interest in the trust. This keeps the beneficiary from assigning any portion of the trust's assets to another party. It also protects the assets in the trust from the beneficiary's creditors.

Transferring Business Interests

If you are a business owner, you will eventually need to decide whether to sell your business or to pass your business along to your heirs through the process of business succession. We will consider several methods that can be used to pass your business on to your heirs.

You may decide to give your business to family members through gifts. If you begin this process early enough, you may be able to use the annual gift tax exclusion to transfer a significant amount of the value of your business, while also significantly reducing the size of your estate.

Kent and Gretchen own a successful office supply company with an appraised value of $2.5 million. Their three children have grown up helping in the business and all are now working for their parents.

When Kent and Gretchen retire in 20 years, they plan to leave their business to their children.

> By using gift splitting, they can give each child $24,000 per year (in 2007) of stock in their company with no gift tax liability. Each year they can gift a total of $72,000 tax free. In 20 years, they will have transferred $1,440,000 of their business to their children, with no gift or estate taxes due on this transfer.

You may decide to sell your business to your heirs through an "installment sale," in which your children agree to buy your business through a series of installment payments.

> When they retire, Kent and Gretchen find that the stock that they still own in their business is worth $2 million. Their children agree to buy this remaining stock through an installment sale. Every year, for 20 years, the children pay Gretchen and Kent $100,000 that they use to help fund their retirement. Gretchen and Kent only pay capital gains taxes on $100,000 each year.
>
> If either Gretchen or Kent live 20 years, none of the business will remain in their estate. If they both were to die within 10 years, half of the selling price ($1 million) will be included in their estate.

Family Limited Partnership (FLP)

The family limited partnership (FLP) is a method to assure the orderly transfer of your business ownership. When the partnership is created, you transfer the business to a limited partnership, retaining a general partnership interest.

The limited partner family members will only have liability up to the level of their investments. As the general partner, you are fully liable for the debts of the partnership and you have

management control over the business.

Irene owns a commercial real estate business. Both of her grown sons work with her in the business. Irene is planning to retire in 15 years and would like to pass the business to her sons, while minimizing income and estate taxes.

With her lawyer's help and advice, Irene puts her business into an FLP. Since limited partnership shares have little marketable value, she can gift a significant amount of ownership to her children each year using her $12,000 (2007) annual gift tax exclusion.

Irene maintains her general partnership role and full business control until she retires. When she retires, her two sons are made the general partners. They agree to pay Irene partnership dividends of $100,000 per year for the rest of her life in return for her remaining partnership interests.

Limited Liability Company (LLC)

Another possible business entity for passing along a family business is the limited liability company (LLC). No member of an LLC is personally liable for the debts of the business, as is the general partner of an FLP.

The operating agreement can be set up to allow only one or more named members to be in charge of the management of the LLC. Membership shares of an LLC owner, who does not have management rights, can be discounted in value, similar to the discounting methods used for limited partners in an FLP.

Each type of business entity has positives and negatives and

the differences can be both subtle and complex. Consult with competent financial and legal counsel before making any decision on the best entity to use to accomplish your estate planning objectives.

Medical Care Decisions

It is important that your wishes for certain medical care be carried out, even if your ability to provide informed consent to a course of medical treatment has been impaired.

Advanced Medical Directives

To avoid being subjected to intrusive and expensive life-sustaining procedures, you may provide "Advanced Medical Directives." These are written statements detailing what medical treatments should or should not be used on you and under what circumstances.

Advanced Medical Directives may give your agent the authority to make health-care related decisions that have nothing to do with your specific health-care treatments. An example of an Advanced Medical Directive is giving your medical proxy the ability to file a malpractice suit on your behalf.

It is important to know what Advanced Medical Directives are available in your state and to carefully consider each one before you include it in your medical proxy.

Medical directives are typically provided in either a living will and/or a medical proxy.

Living Will

With a "living will" you state what life-sustaining medical measures related to hydration, respiration and nutrition should

or should not be taken by a health-care provider, if you are incapable of understanding and/or consenting to treatment. A living will is a revocable document that must be signed and witnessed by persons who are not your heirs or beneficiaries of your estate.

Usually, a living will is usable only if you are terminal and death is imminent. Because of this provision, a living will can be difficult to enforce. If your family and the attending physicians do not agree on whether the injury or illness is terminal or whether death is imminent, you may be subjected to treatment that you would not want to occur.

Medical Proxy

A "durable power of attorney for health care," commonly called a "Medical Proxy," is a revocable document in which you (the principal) authorize your agent (the health care attorney-in-fact) to make health-care decisions on your behalf.

This is much broader in scope than a living will and includes decisions in all health-care situations, when you are unable to give informed consent. With a Medical Proxy in place, your agent, not your attending physician, will be able to make all of your health-care decisions. This applies even when you are not terminally ill.

Springing Power of Attorney for Health Care

Your agent may have immediate authorization to make medical decisions on your behalf or you may provide for a "springing durable power of attorney for health care." With "springing power," your agent's authority to make health-care decisions only "springs forth" when you are no longer able to understand or communicate effectively with your medical providers.

If there is any question about your ability to fully understand and communicate with your medical providers, it will typically take the concurrence of two physicians before the springing medical proxy is accepted.

Accurate Records

As with your taxes, a key part of successful estate planning is keeping accurate records. Put together a folder or notebook that provides information on the location of all of your financial assets, the location of your will, information on any insurance policies in force and your wishes concerning funeral and/or burial instructions. Typically this information will be kept with your estate planning attorney or a trusted friend or advisor.

My goal has been to provide you with an overview of estate planning, including topics you should address when you develop your estate plan. Nothing in this chapter should be considered legal advice. When you are ready to implement your estate plan, seek counsel from a qualified estate planning attorney who will be able to help you successfully implement all of the estate planning ideas that will best suit you and your family's needs and goals.

CHAPTER 10 SUMMARY

1. A will is a legally enforceable declaration of how your probate property is to be distributed upon your death. It can designate who administers your will, who will care for your children, what funeral arrangements you wish, how your debts should be paid and what amounts and from which sources shall come funds for charitable giving.
2. Dying without a will is called dying intestate. Your state has an intestate succession statute that specifies who inherits your property. Only specific blood relatives are entitled to receive your property.
3. Probate is the court-supervised process for administering your estate. Probate is a public process that can be both lengthy and costly, especially if an attorney is used to complete the process.
4. "Will substitutes" are legal methods for transferring estate assets outside of the probate process.
5. Joint tenancy ownership, where you own an equal interest in the property with other person(s), is one type of will substitute. When you die, the surviving joint tenant(s) will own equal interests in 100 percent of the property.
6. Life Insurance is both a will substitute and an estate-planning tool. You can have the life insurance proceeds pass completely outside of your estate as long as you have no ownership rights in the policy.
7. "Payable on Death" or P.O.D. accounts, "Transfer on Death" or T.O.D. accounts, as well as Series EE and Series HH government savings bonds can all be used as

forms of will substitutes.

8. Community property is not a will substitute. Your half of community property does not automatically go to your surviving spouse. It is distributed through the probate process to the person(s) designated in your will. If the designated beneficiary is not your surviving spouse, the surviving spouse will end up with only half of the family house, half of an automobile and half ownership of the bank accounts.
9. The federal gift tax applies to property transfers while you are alive. Each year, you receive an annual gift tax exclusion of $12,000 (2007) for gifts that will not incur any gift tax. If you are married, you may double the tax-free gift as long as your spouse consents to gift splitting.
10. The unlimited marital deduction allows an unlimited transfer of your property to your spouse without any gift or estate tax liability. If your spouse is not a U.S. citizen, the maximum annual amount that you can transfer without any gift tax liability is $125,000 in 2007.
11. You may transfer an unlimited amount of property to a qualified charity without incurring any gift tax liability. When you pay tuition or medical expenses directly to the educational institution or health-care provider for a relative or friend, you also incur no gift tax liability.
12. When you die, estate taxes may be due on your taxable estate. Your taxable estate is your gross estate, reduced by all applicable deductions. If your taxable estate is less than the estate tax applicable exclusion amount of $2 million (2007), no estate taxes will be due.
13. With a "bypass trust," the trust assets do not qualify for

a marital deduction, allowing you to take advantage of your estate tax applicable credit amount. You also get to decide who will get the trust's remainder interests. With a "marital trust," the trust property qualifies for the unlimited marital deduction and is included in your spouse's estate. Your spouse gets to decide who will receive the remainder property.

14. With a Qualified Terminable Interest Property (QTIP) Trust, some assets go into a bypass trust, to take advantage of your estate tax applicable credit amount, while the other assets go into a marital trust. You get to decide who receives the remainder property in both trusts, upon the death of your spouse.
15. A closely held business can be transferred within a family by annual gifts, installment sales, family limited partnerships (FLP) or a limited liability company (LLC).
16. If you become incapacitated, two ways to provide for the management of your property are a trust or a springing durable power of attorney, which begins at the time that you become incapacitated. You may use either a revocable living trust or a contingent/standby trust.
17. Advanced Medical Directives are the authority to make health care related decisions, even ones that have nothing to do with your specific health care treatments.
18. To assure that your wishes for medical care are followed when your ability to provide informed consent is impaired, you can use a "durable power of attorney for health care" or a "medical proxy." This is a revocable document in which you authorize your agent to make health-care decisions on your behalf. You can set this up with a "springing power" as well as give your agent Advanced Medical Directives.

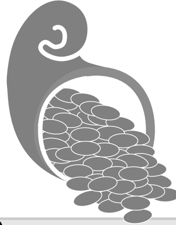
CHAPTER 10 ABUNDANCE STRATEGIES

1. Even if you are planning to leave everything to your spouse and your accounts and house are all held in joint tenancy with rights of survivorship (JTROS), you need a will that leaves all remaining property to your spouse. In some states, intestate laws divide property between a surviving spouse and surviving children. This could potentially leave your spouse owning only half of the family silverware.
2. Be careful when using joint tenancy with rights of survivorship (JTROS) to avoid probate. Each joint tenant owns equal interests in 100 percent of the property. That means that one joint tenant can take all of the funds out of a JTROS account, creditors of one joint tenant can attach the total JTROS asset and your will can provide no instructions concerning a JTROS property.
3. If your state allows it, "tenancy by the entirety" is often a better form of ownership than JTROS. Tenancy by the entirety is only for spouses. Neither spouse may sell or gift their interest in the property without the consent of the other spouse.
4. If you live in a community property state, your half of the community property does not automatically go to your spouse when you die.
5. If you live in a state that recognizes "community property with right of survivorship," this type of community property will pass outside of probate to the surviving spouse, similar to JTROS.
6. Yearly giving, up to the annual gift tax exclusion amount, is an excellent, tax-free way to remove property from

your estate. With gift splitting, you and your spouse can give away up to $24,000 annually (2007) to any person you choose, with no gift-tax liability.

7. If your total estate is over $2 million, you should develop an estate plan with a competent estate-planning attorney. With expert legal help you can minimize or avoid the complicated, cumbersome estate tax.
8. When you and your spouse's combined estate exceeds the estate tax applicable exclusion amount of $2 million (2007), by leaving everything to your spouse you may waste one of the exclusion credits. This may produce an estate tax liability at the death of the surviving spouse. To avoid this, create a "bypass trust" to utilize the estate tax applicable exclusion amount upon the death of the first spouse.
9. You may also do an estate equalization plan in which the wealthier spouse makes lifetime gifts to the poorer spouse, so the poorer spouse has assets equal to the estate tax applicable exclusion amount.
10. The Qualified Terminable Interest Property (QTIP) Trust is used in second marriage situations when you want the remainder assets to go to your children, instead of your spouse's children, yet you want your spouse to have full access to your assets until his or her death.
11. An Irrevocable Life Insurance Trust (ILIT) is a good method of assuring that your children get a guaranteed bequest upon your death. An unfunded ILIT contains an insurance policy in which you retain no rights of ownership. You may make tax-free gifts to the ILIT each year, up to the annual exclusion amount, to pay premiums on the life insurance. This completely removes the life insurance and proceeds from your estate.

12. If you want to pass your business to a relative, consider an "installment sale." With an installment sale, unpaid installments are included in your gross estate upon your death.
13. As the general partner in a family limited partnership (FLP), you retain complete control over the business. You can gift limited partnership interests to family members, typically with each gift at the annual gift tax exclusion limit. Limited partnership shares have little marketable value, allowing you to value the gifted business interests at a significant discount. When started early enough, this technique can entirely remove your business from your estate with no gift or estate taxes.



AFTERWORD

Scarcity or Abundance, It's Your Choice!

"Reflect upon your blessings, of which every man has plenty, not on your past misfortunes, of which all men have some."

–Charles Dickens

In the biblical story of the Exodus, Pharaoh, one of the richest individuals in the world, lived with a sense of scarcity. He used Joseph to secure all of his country's food and land so that he would be prepared for the coming famine. He spent his life in fear and scarcity.

Another biblical story relates to how Jesus took five loaves of bread and two fishes to feed five thousand people. Some biblical scholars believe that when the food was shared, people in the multitude took their own food and added that to the food that Jesus offered, providing more than enough food for all to eat. This interpretation demonstrates the "miracle" of shared abundance, where those who had enough made certain that all were fed.

Each of us is given the choice of living with a sense of abundance or living in fear from a belief in scarcity. Scarcity

and abundance are not a product of poverty and wealth but a product of our life views. To appreciate this, we only need to think of Mother Teresa. She was a woman, surrounded by poverty, who never lived in fear of scarcity.

For serenity, we are encouraged to accept the things that we cannot change and to have the courage to change the things we can. We cannot change the tax codes, the economy, the stock market or world events that may have a negative impact on our financial well-being. However, with the courage and commitment to do so, we can change our consumer-driven spending habits, prioritize saving funds for our family's future and plan for our financial health and well-being.

This guide is aimed at those who want to achieve the serenity that comes from a life that is filled with financial abundance. To achieve financial abundance, you must make a concerted effort in managing your assets. This guide provides ideas and strategies to help you with this effort.

Once you believe that you are living in abundance, fear of your financial future will be greatly reduced and you may wish to give generously to your favorite charitable organizations, as a way of acknowledging your financial abundance.

Glossary

A

Actively Managed Mutual Funds– A portfolio management strategy in which the manager takes an active role in making investments, with the goal of outperforming a specific equity index.

Adjusted Gross Income (AGI– A line on your Federal Income tax 1040 form which represents gross income less allowable deductions, such as individual retirement plans, HSA contributions, alimony payments, self-employment tax and student loan interest.

After-Tax Return– The total amount earned on an investment, reduced by any taxes paid on the earnings. For example: If a taxable bond pays 6 percent interest and you must pay 33 percent of the interest earned in federal and state income taxes, your after tax return is 4 percent.

AGI Phase-Out– Based on your AGI (or in some cases your MAGI), various tax benefits, including personal exemptions and itemized tax deductions, are reduced when your AGI reaches a specified lower limit. At the upper (phase-out) limit, the tax benefit is completely eliminated.

Alternative Minimum Tax– A parallel tax to the regular federal income tax, with different rates and definitions of income and deductions. This tax applies when certain tax benefits reduce your regular income tax below a specified level.

Annual Rate of Return– The total amount that an investment increases or decreases on an annual basis.

Applicable Credit Amount– A credit against the Federal Estate Tax that allows you to bequeath property free of the Federal Estate Tax. The amount of property that can be passed on tax free is the estate tax exclusion amount.

Applicable Exclusion Amount– The amount of an individual's net estate that can be passed on without paying any estate tax.

B

Basis– The amount that you paid for a property or investment.

Bond Maturity Date– The date upon which a bond will be redeemed by the bond issuer at it face (par) value.

C

Capital Assets– Property that is subject to capital gain/loss treatment for tax purposes. This includes most of your assets, except for certain business assets or works that you have created.

Capital Gain/Loss– The difference between the amount received and the cost, when a capital asset is sold.

Capital Improvements– Funds used to improve a capital asset, such as an apartment building, that are not deductible in the current year and that are added to the basis of the asset.

Capital Property– Property that is subject to capital gain/loss treatment. This includes most of your assets, except for certain business assets or items that you have personally created.

Cash Investments– Short-term investment devices that provide a return in the form of interest payments, such

as Certificates of Deposit that mature in one year or less and Money Market funds.

Catch-Up Contributions– Increased retirement plan contributions that are allowed for employees who are age 50 or over as of the last day of the year.

Certified Financial Analyst (CFA)– A professional designation, given by the Association for Investment Management and Research, that measures the competence and integrity of financial analysts. Candidates must pass three levels of exams covering accounting, economics, ethics, money management and security analysis.

Certified Financial Planner (CFP®)– A certification mark for financial planners conferred by the Certified Financial Planner Board of Standards. To use this designation, candidates must meet education, examination, experience and ethics requirements.

Consumer Price Index (CPI)– The weighted average of prices of a "basket" of consumer goods and services. CPI is calculated by taking price changes for each item in the predetermined "basket," weighted according to their importance, and averaging them. CPI is used to determine cost-of-living changes. The CPI-U is the Consumer Price Index for All Urban Consumers. The CPI-W is the Consumer Price Index for Urban Wage Earners and Clerical Workers

Cost of Living Adjustment (COLA)– An annual adjustment to offset a change in purchasing power, as measured by the Consumer Price Index.

D

Deferred Annuity– An insurance contract that is primarily a vehicle for accumulating tax-deferred

savings, with a view to eventually distributing the savings as either an immediate annuity or as a lump-sum payment.

Defined Benefit Pension Plan– A specific pension benefit, determined by a formula that can incorporate the employee's pay, years of employment, retirement age and other factors.

Defined Contribution Plan– A retirement plan providing for an individual account for each participant and for benefits based solely on the amount contributed to the account, plus income, gains, expenses and losses allocated to the account.

Depreciation– The cumulative decrease in value of a tangible asset over its useful life.

Depreciable Property– A business or income-producing asset with a useful life of more than one year. With this type of property, you may deduct from your taxes the cost of the property over a specified number of years.

Donor Advised Fund– An easy-to-establish charitable giving vehicle, set up under the tax umbrella of a public charity, that offers a low-cost, flexible alternative to direct giving or creating a private foundation.

E

Earned Income– All compensation received for performing personal services.

Elective Contribution– The amount of salary that you “elect” to have deferred and put into the account with a defined contribution retirement plan.

Emergency Fund– An account to help survive a short-

term financial set back, such as the loss of a job or a short-term disability. This account should have short-term investments and be adequate to cover six to 12 months of expenses.

Equity Investments– Investments in publicly traded stocks or stock funds that hold publicly traded stocks.

Equity Index– A performance measurement for a specific group of stocks. For example, the S&P 500 Index measures the stock performance of the top 500 U.S. companies, as chosen by Standard and Poor's.

Excess Earnings– The amount remaining when yearly expenses are subtracted from yearly income.

Exchange Traded Fund (ETF)– A mutual fund that can be traded like stocks at any time during the trading day.

F

Fair market value (FMV)– The price a willing buyer will pay a willing seller, when neither party is required to buy or sell the item or service.

Federal Insurance Contributions Act (FICA)– An employment tax imposed equally on employees and employers. It funds federal programs for retirees, the disabled and children of deceased workers. The FICA tax funds Social Security and Medicare.

Fixed-Benefit Pension Plan– A pension plan in which payments remain fixed throughout your lifetime. At 3 percent inflation, the purchasing power of a fixed benefit pension is cut in half every 24 years.

Fixed-Income Investments– Any type of investment that yields a regular or fixed return for the investment. Bonds and bond mutual funds are typical examples of fixed-income investments.

Full Retirement Age (FRA)– The age at which your full Social Security retirement benefits are available.

G

Gift Splitting– If you are married, your spouse may elect to give half of all gifts that you make. When this occurs, the gift tax exclusion amount is doubled.

Gift Tax Exclusion– A specified amount that can be given annually to any individual without the gift being subject to the federal gift tax. This annual amount can be given to as many people as you desire.

H

Home Equity Credit Line– A line of credit, secured by a principal residence or second home. The credit line is limited to the amount that the current appraised value exceeds all outstanding mortgages on the property.

I

Index Mutual Funds– A mutual fund that attempts to replicate the movements of the index of a specific financial market.

Inflation Adjusted Dollars– The purchasing power, in today's dollars, that a future amount of money will have, discounted by a specified inflation rate.

Immediate Annuity– An insurance contract, guaranteeing that the policy issuer will make a series of payments in exchange for a sum of money. These payments may be either level (fixed) or periodically increasing payments for a fixed term of years or until the end of one or two lives.

Insured Municipal Bonds– Tax-free bonds that are

insured against default by an outside insurance agency.

Inter Vivos Trust– A trust created during the lifetime of the trust creator.

Itemized Deductions– Items that can be claimed as deductions to your income on Schedule A of federal tax form 1040. The items include mortgage interest, state and local taxes, charitable contributions and medical expenses.

Irrevocable Trust– A trust that cannot be modified or terminated by the grantor without the permission of the beneficiary of the trust.

Irrevocable Life Insurance Trust (ILIT)– A trust that cannot be modified or terminated by the grantor without the permission of the beneficiary of the trust and contains a life insurance policy.

L

Liquid Assets– Property that can be quickly sold for cash, without a significant decrease in the value of the property.

Load Mutual Fund– A mutual fund that includes a sales charge. If the sales fee is included when you buy the shares, it is called a "front end load." If the sales fee is included when you sell the shares, it is called a "back end load." If the sales fee is included annually, it is called a "12-b1 fee."

M

Marginal Tax Rate– The percentage of income tax rate (tax bracket) that you will pay on each additional dollar of ordinary income that you earn.

Market Capitalization– The total dollar value of all outstanding shares in a company. It is calculated by multiplying the number of shares outstanding by the current market price of the company common stock.

Modified Adjusted Gross Income (MAGI)– Adjusted Gross Income (AGI) increased by items such as tax-free foreign earned income. For most people, MAGI is the same as AGI.

N

Noncallable Bonds– Bonds that may not be redeemed by the bond issuer before the stated bond maturity date.

Nonoperating Foundation– Usually incorporated as a nonprofit corporation or organized as a charitable trust, whose primary purpose is to make grants to charitable organizations

Nonqualified Distributions– Withdrawals from a retirement account that do not meet the withdrawal requirements of the plan. These withdrawals will often receive taxation and penalty payments that would not be imposed on a "qualified withdrawal."

Nonqualified Dividends– Dividends that are taxed at your ordinary income tax rate instead of the qualified dividend rate of 15 percent (maximum).

O

Ordinary Income– All income that is not capital gain income.

P

Par Value– The face value of a bond.

Present Value– The amount that funds, to be received in the future, are worth today, assuming a specified rate of return. As an example, an investment earning 8 percent per year that can be redeemed for $1,000 in five years has a present value of $680.

Pretax Funds– Funds upon which you are not required to pay income taxes. When you are able to purchase services with untaxed funds, the services are effectively purchased at a discount that is equal to your combined federal and state income tax rates.

Private Activity Municipal Bonds– Bonds that provide private developers and operators with access to tax-exempt interest rates for government projects. Income from these bonds is taxable under the Alternative Minimum Tax (AMT).

Q

Qualified Distributions– Retirement plan distributions that meet the specified requirements of the plan so as to avoid taxation and/or penalties.

Qualified Terminal Interest Property Trust (QTIP)– An estate planning trust, often used in second marriages, to assure that your spouse will receive all trust income, during his or her lifetime, with any remaining trust assets passing to your children.

R

Real Estate Investment Trusts (REITs)– A security that invests in real estate and sells like a stock on the major exchanges.

Real Rate of Return– The annual percentage return

realized on an investment, adjusted for changes in prices due to inflation or deflation. As an example, if you earn 8 percent on an investment, but inflation is 3 percent, your real rate of return is 5 percent.

Remainder Interest– The amount in a remainder trust that is left upon the conclusion of the income period.

Retained Interest– When the gift giver or trust grantor keeps any control over the gift or trust.

Rollover– A tax-free reinvestment of a distribution from a qualified retirement plan into an IRA or other qualified plan within 60 days.

S

Schedule A– The schedule on federal tax form 1040 where itemized deductions are listed. If Schedule A deductions exceed your "standard deduction" you may deduct the Schedule A amount.

Single Payment Annuity– Often called a life annuity, this will provide a series of future payments for a specified purchase price. Annuity payments continue until the death of the annuitant or the death of the second of two annuitants in a joint and survivor annuity.

Super Annual Exclusion– The amount that a spouse can give each year to their non-U.S. citizen spouse, without the gift being subject to the federal gift tax.

T

Tangible Property– Items such as machinery, computers and automobiles, that can be moved and are depreciated over a five- to seven -year time period.

Tax Advantaged Investments– Investments that either provide an immediate tax deduction of the investment

amount and/or provide tax-free withdrawals of both principal and interest/growth.

Tax Credit– Items that directly reduce income taxes owed. These are more valuable than deductions, since they reduce the amount of taxes you pay on a dollar-for-dollar basis.

Tax Deductions– Items that directly reduce income for federal tax purposes.

U

Unlimited Marital Deduction– The process by which spouses can give an unlimited amount of their assets to their U.S. citizen spouses.

V

Vesting Plan - The process by which employees receive complete ownership of employer contributions made to the employee's qualified retirement plan account.

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