

FINANCIAL GUIDANCE FOR EVERY AMERICAN:

TAX PLANNING

HOME OWNERSHIP AND FINANCING

ACCUMULATING RETIREMENT WEALTH

EDUCATIONAL SAVINGS AND FINANCIAL AID

NECESSARY LEGAL PROTECTIONS

LIFE INSURANCE PLANNING

(SECOND EDITION)

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To this combination of professional education and certification, Mark Altieri adds decades of experience as a practitioner, proficiency as a highly acknowledged teacher and widely published academic, and the practical knowledge that comes with raising and educating six children. In this publication, Professor Altieri has combined all of his talents in a highly readable and easy to understand format that will provide thousands of dollars worth of savings to the typical American reader who invests a few hours in this book.

FINANCIAL GUIDANCE FOR EVERY AMERICAN:

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INTRODUCTION

Poll after poll finds that fear of financial instability ranks at the top of the "Concern List" for the typical American. In today's overly complex world, coming to grips with what we need to know and do now and in the future often seems an impossible task. Part of the stress and anxiety that we experience is no doubt a function of the large amount of information with which we are bombarded continually.

With so much information available, could there be relatively simple guidelines and answers to our tax, legal, insurance and financial planning issues? This is, in fact, the theme of the book. If you implement the simple steps outlined in this publication, you will have taken a large step in solidifying your financial security. Indeed, I will strongly advise you to make a conscious effort to keep things simple and not let concern or planning for various financial goals consume you. Believe me, if you take the suggested, simple steps in this book, you will be a long way ahead of not just your neighbor but most well-to-do people in this country.

The maxim and direction I've given myself, "Keep It Simple Stupid", is perhaps a more appropriate guideline now than ever before. When I first went into teaching from a highly technical practice, I was forced to renew my knowledge of basic legal and tax concepts. It was

amazing how many of the basics I had forgotten or set aside in my all-consuming practice that largely focused on specialized tax planning techniques. I rediscovered that without a strong foundation, more elaborate planning could often be unsuccessful. Moreover, most of us don't need the highly technical stuff. A strong foundation, like the proverbial house made of bricks, will serve us very well and will relieve us of the need to consume our precious time chasing more detailed remedies for basic problems.

Thus, I have not simply provided you with a primer on the various subjects addressed in the title. I truly believe that for most of us my planning tips are all that we need to implement meaningful financial security. Therefore, take a few hours to study this book. Get a good feel for the general concepts that I am talking about. Then follow through on implementing them via the information I provide you.

If you do these things, you will have taken the necessary steps to fundamentally protect yourself legally. Similarly, you will have implemented fundamental, though effective, devices to legally reduce your tax liability. Additionally, you will have protected your family in the event of your death in a cost-effective way and you will have implemented steps that will provide for your, your spouse's, your children's and your grandchildren's retirement and educational needs.

All of us can do these things. This is not the playground of the rich by any stretch of the imagination. Your right as an American citizen is to participate in the so-called American Dream. But you have to do it – not someone else or the federal or state government. Do the things suggested in this book and you will have locked up your share of that American Dream.

NOTE: From time-to-time I will point out certain schemes that are being heavily marketed to the middle and lower class citizens of this country that I consider at least grossly inappropriate or, in some cases, first-rate scams. These hustles take various forms, usually under the guise of tax or financial planning. I will differentiate them from legitimate (and relatively simple) planning techniques that I will focus you on in this book. In that process you will see that there are no "get rich quick" schemes – your financial stability will require long-term and serious planning.

You can read this book and obtain an excellent functional grasp of all of the topics. However, to greatly expand your use of the book, I have provided World Wide Web ("Web") links keyed to each discussion topic in the book. These Web links will enable you to obtain great amounts of additional, free information to fine-tune the educational process. Additionally, there has been a great deal of time spent assuring that the Web links provided to you are user friendly and specific to the topic at hand.

BUDGETING YOUR RESOURCES
AND STOPPING THE HEMORRHAGING

Virtually everything discussed in this book will directly or indirectly flow out of your ability to basically budget your resources. It is impossible to properly plan out the topics addressed here if you have no handle on where your wealth is coming from and where it is going.

Whether you are rich, poor or somewhere in the middle, the inability to properly organize your assets is an almost universal problem. It is extremely easy to let things get out of control: running up credit card debt (we will discuss rectifying this problem in the Miscellaneous section of the book), not properly reconciling your checkbook, and not properly prefunding for big-ticket items that you know are coming such as vacation, Holiday, and educational expense. You MUST budget for many of the things discussed in this book such as your home and retirement investments. Without a basic budget covering not only these items but also our regular expenses, no viable, long-term plan is possible. So the big question then becomes how do I, who has never been able to manage my funds, now implement a viable budget? Here are some basic techniques that work.

NOTE: If you are married, you must involve your spouse in this process. Without both spouses reading from the same hymnbook, your budget is doomed.

Approach One: The Computerized Approach.

There are many excellent computer programs available that allow for fundamental budgeting. For example, Quicken Basic, which is a powerful tool that does everything from keeping a computerized reconciliation of your personal checkbook, to charting the remaining mortgage amount on your home, to keeping a tally of how your investments are performing. This and other budgeting programs not only will keep a running tab on things but also will store necessary records for tax purposes and provide charts and graphs illustrating to what extent you are under-or over-budgeting for specific items. Thus, if you are somewhat computer adept you will want to thoroughly explore maintaining your budget via your computer. Go to my Web site

(<http://www.personal.kent.edu/~maltieri/web/guide/home.htm>), click on Budgeting Programs and then Quicken Basic to review this program or preview Quicken Basic at virtually any store that sells computer programs.

Here is the hitch. You must diligently input all of your budget data, typically on a daily basis. For those of us who work long hours, have major family commitments and/or are not computer adept (or do not have a computer adept spouse), the efficiency of the computerized budget quickly begins to break down. Although it is highly recommended that you at least attempt to maintain a budget through a computerized program, many of you (like me) will default to budgeting on a manual basis. The following describes how I maintain my non-computerized manual budget.

Approach Two: A Manually Maintained Budget.

As with the computerized budgeting approach, your first step will be to determine your inflow, that is, your revenue stream. If you are an employee, this will be your take-home pay. If your tax withholding amounts have been computed properly, your take-home pay is your after-tax revenue. Federal, state and local income tax and social security taxes have already been withheld. In addition to your tax withholding, if you are making pre-tax contributions to your company's Section 401(k) plan or to a Section 403(b) annuity (both of which are discussed in detail under the Retirement Planning section of this book) or are required to contribute toward the cost of your health coverage, those contributions will also have been deducted from your paycheck in arriving at your net take-home pay.

Figuring your after-tax revenue is the easy part. Now you have to determine your outflow (your expenses). Sit down with your spouse and write down all your recurring monthly expenses. For example, with regard to monthly recurring expenses my wife and I have noted the following items: home mortgage, utilities (electric, gas, phones, water), TV cable access, normal credit card charges, food, and general miscellaneous. By the way, a very convenient device to help you in the monthly budgeting process is generally available through your utility companies. If you call up your water or electric or natural gas utility and talk to the people in the Billing Department, they will be able to assist you in estimating your utility costs over the year by

looking at your past usage history. They will then bill you on a level monthly basis in the future. If the usage estimate proves to be too high or low, an appropriate adjustment will be made going into next year.

Now that we have attended to your recurring monthly expenses, you will also have to compute significant expenses that you incur during the year but that do not recur every month. For example, under this non-recurring category, my wife and I have isolated the following expenses: home property taxes, car insurance, home insurance, and life insurance (all of which we pay semi-annually), Christmas, vacations, birthdays, and an emergency (rainy day) fund.

By dividing the non-recurring expenses by twelve, you will arrive at a rough monthly estimate of these non-recurring expenses. The recurring monthly expenses should be paid from your primary checking account. With regard to your other expenses (the non-recurring ones) recall that you and your spouse have estimated those expenses for the year and divided that annual expense number by twelve. Each month you should deposit the monthly amount you need to accommodate these non-recurring expenses in a second interest bearing checking account (TIAA-CREF, noted in the Retirement Planning section of the book at page 94, has an excellent interest-bearing money market account on which free checks of \$250 or more may be written). In this way, you will be building up a fund in the second checking account out of which you will accommodate these non-recurring expenses as they come due. By utilizing a second checking account for these non-recurring expenses you will keep them segregated and will be better able to determine if you are properly funding for them.

Now you are in a position to establish your inflow (your after-tax take-home pay) and subtract from that number your expenses (both the monthly and non-monthly expenses). In this manner, you can get a handle on how much money is coming in and where it is going. To the extent you are over or under estimating your expenses, you will make adjustments when necessary. If your revenue exceeds your expenses, you have additional wealth to increase your educational or retirement savings (discussed in detail later in the book) or to add to the "Rainy Day" emergency fund (mentioned above and discussed further in the Miscellaneous section of the end of the book). If your expenses exceed your revenues, you are either going to have to increase your regular revenue stream or decrease your expenses. Borrowing money to

accommodate your recurring and non-recurring expenses is a formula for disaster that we will discuss in further detail in the Miscellaneous section of the book.

This budgeting system will allow you (perhaps for the first time in a long time) to track where your money is coming from and where it is going. Again, it is necessary that you do this if you desire to systematically live within your means and accommodate the many planning devices discussed in this book.

TAX PLANNING

"Unquestionably, there is progress. The average American now pays out twice as much in taxes as he formerly got in wages." H. L. Mencken, early 20th century journalist.

The above quote by Mencken is really an understatement. Toward the end of April the average American reaches what has been publicized as the "Tax Freedom Day." This is the date at which the typical American taxpayer stops working to pay combined federal, state and local government tax liabilities and starts working for his or her own self and family. The world has seen many revolutions started over lesser levels of wealth confiscation.

In our parents' day, the Tax Freedom Day was in late March. The extraordinary growth has, of course, paralleled the growth in the size of federal, state and local governments. Since most of us are neither politicians nor revolutionaries, we are compelled as law-abiding citizens to absorb this ever-increasing tax liability number. Dropping out and joining some radical tax protester group is not the answer (see my discussion of this topic at [page 42](#)). The solution is two-fold: get involved at some political level in changing the size and cost of government and/or take whatever steps are available to legally avoid the payment of taxes. We will focus on the second possibility.

It is relatively difficult to manipulate income taxed by state and local (municipal) governments. This is because state and local governments tax us largely on our total or gross income. Our federal income tax liability, however, is based not on gross but on "Taxable Income." We reach Taxable Income after subtracting deductions from gross income. Thus, to the extent we can increase our deductions, we can lower the Taxable Income number that is the tax base for federal income tax purposes.

Understanding Deductions

More precisely, federal Taxable Income is computed as noted in [Exhibit 1](#).

Exhibit 1

Gross Income

- Above-the-Line Deductions
- = Adjusted Gross Income
- Below-the-Line Itemized Deductions or the Standard Deduction Amount (whichever of the two is the greater)
- Personal and Dependency Exemptions
- = Taxable Income

The ultimate tax liability number is then determined by multiplying the applicable tax percentage rate against the Taxable Income number (we will look at computing the actual tax liability in just a moment).

Note that the base number on which federal income taxes is computed, Taxable Income, is reduced as we increase our deductions. However, as noted in the Exhibit, there are two types of deductions: Above the-Line Deductions and Below-the-Line Itemized Deductions. If you look at **Exhibit 1**, you will see that an Above-the-Line Deduction will always yield a tax benefit in that it will always reduce your Taxable Income number. Above-the-Line Deductions are generally business-related expenses. For example, if you are a sole proprietor, the legitimate expenses of your proprietorship constitute Above-the-Line Deductions. If you are not self-employed but rather work as an employee, Above-the-Line Deductions are rare because few personal expenditures are deductible Above-the-Line. A few notable exceptions are the contributions to a traditional Individual Retirement Account (discussed under the Retirement Planning section), any alimony you might pay to your ex-spouse, and interest you pay on certain student loans (discussed later under Educational Savings).

By again referencing **Exhibit 1**, you see that the Below-the-Line Itemized Deductions may or may not yield a tax benefit in that they are only deductible to the extent they exceed the

standard deduction amount. In 2006, the general standard deduction amount was \$5,150 for a single taxpayer, \$7,550 for a single taxpayer who is the head of a household with dependents, and \$10,300 for married taxpayers filing jointly. Thus, if you are married, you and your spouse got no advantage from your Itemized Deductions in 2006 until all available Itemized Deductions for the year exceeded \$10,300. The deduction for a personal or dependency exemption was \$3,300 for the 2006 tax year. The standard deduction and exemption amounts go up a little each year by a cost of living adjustment.

NOTE: Throughout this book, I will primarily reference 2006 tax numbers. This will allow you to compare the illustrated results with your own 2006 tax return. Where particularly relevant, I will refer to 2007 tax law changes.

EXAMPLE: In 2006 Mark and Debbie have gross income of \$125,000, make a \$3,000 contribution to an Individual Retirement Account, have total Itemized Deductions of \$20,000 and exhaustively attend the needs of their six dependent children. Per the Exhibit 1 formula we would determine their Taxable Income as follows:

$$\begin{aligned} & \$125,000 \text{ (Gross Income)} \\ - & \quad \$3,000 \text{ (Above-the-Line Deduction to IRA)} \\ = & \quad \$122,000 \text{ (Adjusted Gross Income)} \\ - & \quad \$20,000 \text{ (the greater of their total Itemized Deductions for the year or their} \\ & \quad \$10,300 \text{ standard deduction for married taxpayers)} \\ - & \quad \$26,400 \text{ of Exemptions } (\$3,300 \times 8 \text{ (2 jointly filing taxpayers and 6} \\ & \quad \text{dependents)}) \\ = & \quad \$75,600 \text{ (Taxable Income)} \end{aligned}$$

We will determine their ultimate tax liability on this amount of Taxable Income in the next Example.

Since most of us are not self-employed and since the few personal expenses that are otherwise allowed as Above-the-Line Deductions cannot generally be counted on, the trick here is to expand the more reliable and predictable Below-the-Line Itemized Deductions to the point that they exceed the standard deduction amount. The first step in our tax planning, therefore, is to make an itemizer out of you (if you are not already deducting your Itemized Deductions) or better optimize your Itemized Deductions (if you already are an itemizer). But first you need to understand another fundamental concept.

Understanding Your Marginal Tax Bracket

I have titled **Exhibit 2 "Your Tax Liability and Marginal Tax Bracket."** By looking at Exhibit 2, you see that the percentage rate of taxation goes up as your Taxable Income goes up (this is known as a "progressive" rate structure). Your marginal tax bracket is the highest rate of taxation your Taxable Income is being taxed at. The relevance of this is that we need to know our marginal tax bracket to determine the value of an additional dollar of deduction or the tax cost of an additional dollar of income. Look at the rates below. If I am in the 28% marginal tax bracket and I increase my deductions by one dollar, I reduce my Taxable Income that would be subject to that 28% rate of taxation by a dollar, thus saving 28 cents in tax payable. Conversely, if I increase my income by a dollar, I add a dollar to my Taxable Income subject to the 28% rate, thus increasing my tax liability by 28 cents.

Using the information from your last tax return, determine what your Taxable Income number was last year or estimate what it will be this year. Now go to the **Exhibit 2** tax rate schedules and plug your Taxable Income number into the appropriate tax rate schedule. Again, the highest percentage rate of taxation that your Taxable Income is subject to is your marginal rate of taxation.

Exhibit 2

Your Tax Liability and Marginal Tax Bracket

2006 Tax Rate Schedules									
Single – Schedule X					Head of household – Schedule Z				
If taxable		The tax is:		<i>of the</i>	If taxable		The tax is:		<i>of the</i>
Income is:	<i>But not</i>			<i>amount</i>	Income is:	<i>But not</i>			<i>amount</i>
Over --	<i>over --</i>			<i>over --</i>	Over --	<i>over --</i>			<i>over --</i>
\$0	\$7,550	.....	10%	\$0	\$0	\$10,750	.....	10%	\$0
7,550	30,650	\$755.00 +	15%	7,550	10,750	41,050	\$1,075.00 +	15%	10,750
30,650	74,200	4,220.00 +	25%	30,650	41,050	106,000	5,620.00 +	25%	41,050
74,200	154,800	15,107.50 +	28%	74,200	106,000	171,650	21,857.50 +	28%	106,000
154,800	336,550	37,675.50 +	33%	154,800	171,650	336,550	40,239.50 +	33%	171,650
336,550	.....	97,653.00 +	35%	336,550	336,550	.....	94,656.50 +	35%	336,550
Married filing jointly or Qualifying Widow(er) – Schedule Y-1					Married filing separately – Schedule Y-2				
If taxable		The tax is:		<i>of the</i>	If taxable		The tax is:		<i>of the</i>
Income is:	<i>But not</i>			<i>amount</i>	Income is:	<i>But not</i>			<i>amount</i>
Over --	<i>over --</i>			<i>over --</i>	Over --	<i>over --</i>			<i>over --</i>
\$0	\$15,100	.....	10%	\$0	\$0	\$7,550	.....	10%	\$0
15,100	61,300	\$1,510.00 +	15%	15,100	7,550	30,650	\$755.00 +	15%	7,550
61,300	123,700	8,440.00 +	25%	61,300	30,650	61,850	4,220.00 +	25%	30,650
123,700	188,450	24,040.00 +	28%	123,700	61,850	94,225	12,020.00 +	28%	61,850
188,450	336,550	42,170.00 +	33%	188,450	94,225	168,275	21,085.00 +	33%	94,225
336,550	.....	91,043.00 +	35%	336,550	168,275	.....	45,521.50 +	35%	168,275

EXAMPLE: In the prior Example, Mark and Debbie (married, filing jointly) have Taxable Income of \$75,600 in 2006. Using the tax rates noted in **Exhibit 2**, we see that their actual federal income tax liability for the year is \$12,015 (the first \$15,100 of taxable income x 10% (\$1,510) and the next \$46,200 x 15% (\$6,930) and then the last \$14,300 x 25% (\$3,575)). Mark and Debbie are in the 25% marginal income tax bracket as that is the highest rate of taxation to which any of their Taxable Income is subjected.

Optimizing Your Itemized Deductions

So back to pumping up your Itemized Deductions or making an itemizer out of you if you are not already itemizing your deductions. The single event that will make an itemizer out of you is home ownership. Later in this book, we will study in detail the necessary financial planning incident to home ownership. Here and elsewhere in this Tax Planning section, we will explore the tax advantages of home ownership.

Look at **Exhibit 1** again. Remember that in order to be an itemizing taxpayer, all of your Itemized Deductions for the year must exceed the standard deduction amount. To the extent your total Itemized Deductions exceed your standard deduction amount, you will reduce your Taxable Income number. Under our "Keep It Simple Stupid" (KISS) philosophy, we are trying to optimize our Itemized Deductions in the simplest manner. Home ownership gets us there.

Two of the most common Itemized Deductions are interest expense on a home mortgage and the property taxes paid on the home. We will discuss these two Itemized Deductions, as well as others, in detail later on. These two items alone, even on a fairly modestly priced home, will frequently push us over the standard deduction threshold and make an itemizer out of us. Here is an example of how this would work and also how we can use the leverage of home ownership to catapult us from a renter to a homeowner at little or no additional after-tax cost.

EXAMPLE: In 2006, John and Jane Smith rent their apartment at a cost of \$875 per month. Their utilities cost \$100 per month but are paid for by the landlord. Additionally, the Smiths pay \$3,000 in state income taxes, \$1,500 in local income taxes and donate \$500 a year to their church. In the tax year being analyzed, the Smiths are in a marginal tax bracket of 28%. They purchase a new home and mortgage finance \$100,000 of the purchase price. Their monthly mortgage payment is \$700 a month or \$8,400 for the year. Additionally, they will pay \$200 a month (\$2,400 for the year) in property taxes. Their utility expense, which they will now pay after the home purchase, is a non-deductible personal expense and will remain at \$100 per month (\$1,200 for the year).

Before the purchase of their home, the Smiths had \$5,000 in Itemized Deductions (the state and local income taxes and the church donations) but were not itemizers since their basic standard deduction of \$10,300 exceeded their Itemized Deductions. After the home purchase, they are able to add to their pre-existing \$5,000 of Itemized Deductions the property taxes (\$2,400 per year) and their mortgage interest expense. As I will explain in great detail later in this section and in the Home Ownership and Financing section of the book, in the early years of a mortgage, almost all the mortgage payment is interest. In our Example, say \$650 per month of the \$700 monthly mortgage payment or \$7,800 for the year is mortgage interest expense. Because of their home ownership, the Smiths have increased their Itemized Deductions by \$10,200 to \$15,200.

The Smiths have generated \$4,900 of new deductions (the \$15,200 of new Itemized Deductions minus their \$10,300 standard deduction that they had before owning the home). How much does the additional \$4,900 of deductions save the Smiths on their tax return? As we noted under the Exhibit 2 analysis, we would multiply \$4,900 by their marginal tax rate of 28% and find that they will reduce their federal income tax liability by \$1,372.

Now let's do a reconciliation to see how the Smith's transition to home ownership and the leverage from the additional tax deductions will actually put them in a better cash position than they were in before (let alone the fact that they now own a home that is hopefully appreciating in value each year):

Pre-ownership annual housing cost $\$875 \times 12 = \$10,500$

After-ownership housing costs:

Housing mortgage payments $\$700 \times 12 = \$8,400$

Property taxes = \$2,400

Utilities = \$1,200

Minus Additional tax savings from increased Itemized Deductions =
(\$1,372)

After-tax annual cost of their home = \$10,628 (\$8,400 + \$2,400 + \$1,200 -
\$1,372).

Thus, in our Example we see that the Smiths have virtually the same housing costs after purchasing the home in terms of after-tax cash outlay (\$10,628 versus \$10,500). Although there are many incidental expenses of home ownership, hopefully these are more than outweighed by the pride of ownership and the increase in the home's net value over the years as the mortgage is repaid and the home otherwise appreciates in value. Also, there is the down payment and other closing costs incurred when purchasing a home. In the Home Ownership and Financing section of this book I will talk about all the elements of making home ownership work – selecting the best and cheapest mortgage, selecting a good city to live in, and purchasing the home with an optimum amount of cash down.

The Big Three Itemized Deductions – Interest Expense, State and Local Taxes, and Charitable Contributions

I call these Itemized Deductions the "Big Three" because virtually every itemizing taxpayer will have significant deductions in each of these three categories. For reasons mentioned later in this section, other possible Itemized Deductions are generally not available to the typical itemizer.

The **Example I** just gave you on the tax advantages of home ownership has already generally discussed two of the "Big Three" of Itemized Deductions. As I illustrated for you in the Example, the mortgage interest expense and local property taxes alone are often enough to make an itemizer out of the typical American. Anything else we can add to our Itemized Deductions is icing on the cake. Let's look a little more closely at the Big Three to make sure we are optimizing everything legally available.

Later in this Tax Planning section, we will look at the actual tax form for computing Itemized Deductions (the Schedule A to the Form 1040). Initially, however, I want to make sure

you understand the underlying concepts – the theory – of the major Itemized Deduction categories.

The First of the "Big Three" of Itemized Deductions —
Mortgage Interest Expense

We have focused on the fact that interest expense on the mortgage indebtedness on our home is an Itemized Deduction. It is not the entire mortgage payment that constitutes an Itemized Deduction, just the interest expense. When we mortgage finance the purchase of our home over 15 or 30 years, the mortgage payments are broken into two component parts: the principal amount borrowed and an interest expense on that principal.

I will explain this next point in greater detail under the Home Ownership section of the book, but we will generally pay our mortgage payments on a monthly basis and the monthly payment will be exactly the same (in the case of a fixed rate mortgage) or approximately the same (in the case of an adjustable rate mortgage) over the 15 or 30-year term of the mortgage. In the earlier years of the mortgage, because there is more unpaid principal outstanding, more of your monthly mortgage payment will be interest and less will be principal. In the later years of the mortgage, when there is less unpaid principal outstanding, more of your monthly mortgage payment will be non-deductible principal and less of it will be deductible interest expense.

EXAMPLE: Mark and Debbie take out a 30-year mortgage to finance the purchase of their home. The principal amount borrowed from the Bank is \$100,000 and the rate of interest is fixed at 7% over the life of the mortgage. The monthly payments will always be \$665. Although \$100,000 was borrowed, approximately \$239,400 (\$665 times 12 months times 30 years) will be repaid to the Bank. Thus, there will be a total of \$100,000 of principal repaid to the Bank and \$139,400 of interest paid to the Bank over the life of the mortgage.

In the first year of the loan, the couple would make total payments of \$7,980 (\$665 times 12 months). Of those first year payments, approximately \$7,000 of the \$7,980 will be interest and \$980 will go to pay down principal. In

the final year of the 30-year mortgage, the situation will have reversed itself. Of the final 12 monthly payments of \$7,980, about \$300 will be interest expense with approximately \$7,680 being non-deductible principal repayment (go to my Web site at <http://www.personal.kent.edu/~maltieri/web/guide/home.htm>, click on Home Ownership and Financing and then Mortgage Tools to fine-tune this analysis).

Therefore, every year the amount of your deductible mortgage interest expense will vary. The Bank from which you have obtained the mortgage will send you a Form 1098 that will specify how much of your total mortgage payment for the year constituted mortgage interest expense. So each year the Bank will give you the exact number of your mortgage interest expense that you can deduct if you are an itemizer.

NOTE: Additional information may be necessary for you to more fully understand the tax law and competently file your federal tax return. Luckily there is plenty of easy to understand information enabling just that. If you are an itemizer, you must file the regular Form 1040. The Instructions to the Form 1040 are very helpful, providing examples, worksheets and clear directions in a simple language format. Additionally, the Instructions frequently reference IRS Publications. IRS Publications are small booklets dealing with specific tax topics. For example, Publication 530, *Tax Information for First-Time Homeowners* and Publication 936, *Home Mortgage Interest Deduction*, provide more detail than I will give you on the mortgage interest expense deduction. The IRS Publications are comprehensive, well written and readily understandable. They are not overly technical and have been written so as to make complex tax concepts understandable to non-tax savvy readers. As an additional bonus, the Publications generally are well-indexed and are full of helpful examples. You can find all of the IRS Publications on-line at [my Web site](#) (click on Tax Planning and then IRS Publications). Also, many IRS Publications are available at your local library.

Frequently you will want to print documents off the Web. With larger documents like the IRS Publications, you may need a free computer program called Adobe Acrobat. If you don't already have Adobe Acrobat on your computer, go to my Web site, click on Miscellaneous and then Adobe Acrobat and follow the download instructions.

Points.

Another element of deductible mortgage interest expense that may be available to you is your payment of "points." If you pay points on your mortgage, you only pay them in the first year of the mortgage. Points are prepaid interest expense and any points you pay will be noted on the Form 1098 you get from your Bank for the first year of the mortgage. To the extent that you pay points on the home mortgage you use to first purchase your home (or points paid on a home improvement loan), you may deduct those points as home mortgage interest expense in the year that you pay them. One point equals one percentage point, so if the mortgage loan is for \$100,000 and there are three points paid by the borrower to get that mortgage loan, the borrower pays \$3,000 (3% times \$100,000) once only in the first year of the loan.

EXAMPLE: Mark and Debbie purchase a home and mortgage finance \$100,000 of the purchase price. The mortgage is a three-point loan on which they pay \$3,000 of points once at the inception of the loan. Mark and Debbie are itemizers. They may deduct the \$3,000 for the tax year in which those points are paid in addition to the other mortgage interest expense they pay that year on the mortgage.

Although I will discuss this further in the Home Ownership section of the book, different mortgage loans have different levels of points paid on them. If you look at your Saturday or Sunday newspaper, the Home Section should list mortgages available from local mortgage lenders. The list will show a variety of things including the type of mortgage, the rate of interest charged on the mortgage and the points, if any, charged in the first year of the mortgage.

You will note that some mortgages don't charge any points. Why would you pay points at the inception of the mortgage if you don't have to? If you study the mortgage listings, you will note that the more points you pay at the inception of the loan, the lesser the rate of interest you will be charged over the entire term of the mortgage. Thus, you can "buy-down" the mortgage interest rate by paying more points at the inception of the mortgage. Is this a good idea? It depends on how long you plan on staying in the home. The longer you plan to stay in your home, the more sense it makes to buy-down the interest rate for the entire mortgage term by paying points up-front.

EXAMPLE: Mark and Debbie, from the prior Example, again are mortgage financing the purchase of their home. The amount of the mortgage loan will be \$100,000 and the rate of interest is 7% if no points are paid. If Mark and Debbie pay three points, they can obtain the same \$100,000 loan with an interest rate of 6.25%. The couple is quite sure that they will be moving after living in the home for about three years. Which mortgage should they take out? The 7% mortgage would require monthly payments of \$665 whereas the 6.25% mortgage would require monthly payments of \$615, a savings of \$50. Over a three-year period, the \$50 savings a month will save them approximately \$1,800 over the 7% mortgage. However, to get the 6.25% mortgage, remember they had to pay \$3,000 of points up-front. Thus, the zero point 7% loan makes more sense if the couple will indeed be moving after about three years.

Points Paid When Refinancing a Home Mortgage.

Under the Home Ownership section of the book we will talk some more about shopping for a mortgage and the logic of refinancing an existing first mortgage on your home. But we must also broach the subject under our tax analysis for the following reason. We have just noted that points that you pay on a home mortgage are generally deductible. However, read the rule again a little more slowly. It is points on a home mortgage used to purchase or improve your home that are deductible. If interest rates have been going down and you have already purchased and taken out a mortgage loan of the fixed rate variety (discussed in detail under the Home Ownership section of the book), you may find yourself in a situation where you have

locked yourself into a rate of interest that is substantially higher than what you could now obtain on a new home mortgage. In this situation it may be highly advisable to refinance your home mortgage.

As is the case with any home mortgage, you can "buy down" the interest rate by paying points on the refinanced home mortgage. However, now (unlike the mortgage you incurred on the initial purchase of your home) the points you pay on the refinanced mortgage will not be currently deductible. Any points you pay on the refinanced mortgage are deductible but only in equal increments over the entire term of the loan.

EXAMPLE: Mark and Debbie refinance their old mortgage because interest rates have gone down and they no longer want to be locked into the higher rates of interest payable on their original home mortgage. The refinanced mortgage is \$100,000 repayable over 30 years. Mark and Debbie can pay no points and obtain a 7% rate or pay three points and obtain a 6.25% rate. However, if they select the 6.25% mortgage and pay \$3,000 in points, they can only deduct \$100 in the current year (\$3,000 divided by 30 years) and \$100 a year for each of the next 29 years.

You see in the Example that the points paid on the refinanced mortgage are deductible but it will take 30 years (in the case of a 30 year mortgage) to fully deduct them. We get so little immediate deductible bang for the buck – in addition to the fact that we will probably forget to deduct the allowable amount in the future – that it usually makes much more sense to refinance with a low or zero point loan.

Home Equity Loans and Second Mortgages.

A home equity loan (sometimes called an equity line of credit) constitutes a loan from a Bank that is also secured by a mortgage on your home. A loan that is properly labeled a home equity loan looks a lot like the principle mortgage loan on your home. That is, there is set term to the home equity loan with amortized (equal) payments, typically made monthly, for the duration of that term. A true equity line of credit loan (as opposed to a home equity loan) would

operate more like your standard Master Card or Visa—you could draw on it as needed, would not have to repay a set monthly payment, and would pay an interest charge on any unpaid principle outstanding for each billing (typically monthly). For purposes of this tax analysis, I will initially refer to both types as home equity loans.

Since the home equity loan is a loan made in addition to the primary mortgage on your home, it is a "second mortgage" loan (your primary mortgage being the "first" mortgage loan). The difference between a first and second mortgage is a matter of security on the lending Bank's part—if you default on your mortgage payments and your home is sold off to satisfy the debt, the first mortgage lender would be paid-in-full before the second mortgage lender would be paid a penny.

The great thing about home equity loans from a tax-planning standpoint is that the interest expense paid on them is generally an Itemized Deduction along with the interest expense on the primary first mortgage. This is true no matter what the home equity loan proceeds are used for. More precisely, the tax laws allow for the interest expense on a home equity loan to be deductible to the extent it does not exceed the lesser of 1) the fair market value of the home minus the principal amount of the first mortgage (this is the equity in the home), or 2) \$100,000. We had better look at an Example to see how this would work.

EXAMPLE: Mark and Debbie own a home with a fair market value of \$200,000. The principal amount outstanding on their first mortgage is \$150,000. Therefore, the couple has equity in their home of \$50,000 (\$200,000 minus \$150,000). Mark takes out a home equity loan for \$25,000 from the Bank and secures it with a second mortgage on their home. The purpose of the home equity loan is to provide funds for the purchase of a family automobile, to provide for the educational expenses of their children, or for some other personal purpose. Normally the interest expense on a loan to finance personal expenses is nondeductible consumer interest expense (as noted below). Here, however, the interest on both the first mortgage and the home equity loan is deductible by Mark and Debbie as an Itemized Deduction on their federal income tax return.

Another advantage of the home equity loan is that the Bank will charge you a significantly lesser rate of interest than it charges on your unsecured Master Card or Visa. This is because of the security that the second mortgage on the home provides to the lender.

What are the risks? If you are not a very disciplined borrower and you run up your home equity loan to the point of defaulting on it, the consequences are extreme. Because of the security embodied in the second mortgage, the Bank could compel the sale of your house to satisfy the debt. Conversely, if you default on your unsecured Master Card or Visa you may ruin your credit rating but you won't have your home taken away. I feel that people might be more subconsciously inclined to run up a home equity loan (particularly of the revolving equity line of credit variety) because they know that the interest expense is tax deductible. This is a very foolish example of letting the tax tail wag the dog. Such tendencies could lead you to lose your home as I just mentioned.

What is my suggestion? If you are in legitimate need of a large additional sum of money and you have plenty of equity in your home, I would consider refinancing the first mortgage at a higher amount so that the desired excess borrowing can be distributed to you in cash. This is particularly advisable if it makes sense to refinance your first mortgage anyway (see the discussion under the Home Ownership section at [page 62](#) as to when it makes sense to refinance). If refinancing the first mortgage doesn't make sense, I would next recommend a true home equity loan, with set amortized (equal) monthly payments over a reasonable term of years. Lastly, I suggest staying away from the equity line of credit type home equity loan unless you know for a fact that you are a well disciplined borrower who will not run up a significant balance on the account.

Consumer Interest Expense.

In the Miscellaneous section of the book, I more completely detail problems and solutions relating to consumer debt. Consumer debt is indebtedness that is incurred to purchase non-business, personal-use items. Thus, when we finance the purchase of a family automobile through GMAC, that is consumer debt. When we finance a refrigerator or television set purchased from Sears or some other vendor, the underlying debt is consumer debt. Last, but

certainly not least, the balance we run up on our personal MasterCard, Visa or Discover cards is consumer debt.

There are many obvious problems with running up excessive amounts of consumer debt other than the tax implications (again, I discuss these issues in the Miscellaneous section of the book). With regard to our tax analysis, adding insult to injury is the fact that the interest expense on consumer debt (which often is at a very high rate because the underlying debt is frequently unsecured) is not tax deductible.

The Second of the "Big Three" of Itemized Deductions – State and Local Taxes You Pay

This category primarily deals with state and local income taxes and real estate property taxes. Most other state and local taxes, like sales and excise taxes, are generally not deductible.

Even if you are lucky enough to live in a state like Alaska or Nevada where there is no state income tax, the municipality in which you live and/or work may well be income taxing you under a local income tax. Thus, very few of us are exempt from paying either state or local income tax. A much more common situation is like mine in the state of Ohio. Not only do I pay a federal income tax, I also pay an income tax to the state of Ohio. Moreover, I also pay a local income tax to the city where I live and an additional local income tax in the city where I work.

For many middle-class Americans, depending on the state and municipality in which we live, this combined state and local income tax liability may be many thousands of dollars. Indeed, probably a majority of Americans find themselves paying more in combined state and local income taxes than they pay in federal income taxes. Lessening the blow of this triple income tax hit a bit is the fact that the state and local income taxes (but not federal income taxes) are deductible as Itemized Deductions on our federal income tax return. Therefore, we almost universally find that the state and local income tax number is a big hit and a big addition in computing our total Itemized Deductions.

But it is not just state and local income taxes that are deductible as an Itemized Deduction in this category. Additionally, we can pad this state and local tax number with any real estate

property taxes we pay. If you are a homeowner of even a modestly priced home, you are probably paying a local county government a few thousand dollars a year in real estate property taxes (go back to [page 13](#) and re-read my Example of the effect of home ownership on state and local tax payments).

Let's start our detailed analysis with real estate property taxes and then we will look at state and local income tax Examples.

Real Estate Property Taxes.

How do you assure that you are optimizing your ability to pump up your Itemized Deductions in this category? Again, if you own the home in which you are living, you are paying a significant amount of real estate property taxes. As I mentioned earlier, even in the case of a \$100,000 valued home, the property tax liability may be \$2,000 to \$3,000 per year.

Most people budget their property tax liability through the Bank from which they have their mortgage. In this case, each month when you make your mortgage payment to the Bank, you are really making three different payments: 1) a repayment of some of the principal of the loan, 2) an interest payment on the unpaid principal of the mortgage loan, and 3) a prepayment of your property tax liability. With regard to the third type of payment (the property tax liability), the Bank will set up a property tax account for you and will pay your property tax on your behalf as it comes due. This technique, by the way, is a very good way to budget for your property tax liability in that it is a "forced savings" arrangement that will assure that there are sufficient funds to pay your property taxes as they come due.

EXAMPLE: Mark and Debbie have a mortgage loan with their Bank. Each month they pay the Bank a total of \$1,000. \$750 of the \$1,000 goes to pay the principal and interest expense on the mortgage itself. \$250 of the \$1,000 is credited to their property tax account. Every six months, Mark and Debbie's property tax bill is sent directly to the Bank and the Bank pays \$1,500 twice a year to the taxing authority on their behalf. Thus, by paying the \$1,000 each

month to the Bank, Mark and Debbie have attended to both their debt service on the mortgage and their property tax liability.

If you are in this situation, since the Bank is paying these property taxes on your behalf, you may claim them as real estate property taxes you paid in the computation of your Itemized Deductions. Remember that every year the Bank sends you the Form 1098 on which is noted the interest expense paid that year on your mortgage. The Form 1098 will also note any property taxes the Bank has paid on your behalf.

You get your property tax deduction in the year in which you (or the Bank on your behalf) actually pays the property taxes. As I just mentioned, the advantage of having the Bank pay your property taxes for you is that you are forced to budget for and prepay this liability. The disadvantage is that you may lose some timing flexibility and you usually will not earn any interest on that account. If the Bank is making the payments, they will work on their timetable but not necessarily yours. For example, the Bank may not pay your real property taxes for the second half of this year until January of next year thus deferring the deductibility of that payment until next tax year.

If you are billed directly for your property taxes and make the payments yourself, we need to talk about possibly manipulating this timing point. Property taxes generally are billed every six months. If you are making these payments yourself, in November or December of each year, you will receive a bill for your property taxes. The bill will typically give you until the end of the following January to make the required semi-annual payment. Additionally, the bill will give the property owner an optional ability to prepay a second six month's worth of property tax liability in addition to the required payment.

What should the property owner do in this situation? He or she should at least assure that the required semi-annual payment is made by the end of December so that it can be added to the Itemized Deductions for the current year (again, as noted a moment ago, you might lose the ability to do this if the Bank is paying property taxes on your behalf). Additionally, if the property owner has the money and could better use the deduction this year than next, pre-paying the second six-month optional payment might be a wise thing to do.

EXAMPLE: Mark and Debbie anticipate being in a 25% marginal tax bracket (see **page 12** to determine your marginal tax bracket) this year due to unexpected high income. In the next tax year, they anticipate being in a 15% marginal tax bracket. Therefore, any deductions they can accelerate from next year into the current year would be better utilized against higher taxed income. In December of the current year, Mark and Debbie received their property tax bill requiring them to pay \$1,500 by next January and optionally allowing them to pre-pay a second six month's worth of property taxes of an additional \$1,500. Mark and Debbie will assure that they at least pay the required \$1,500 by the end of December. Additionally, since they have the available cash and desire to optimize the current year's Itemized Deductions, they pre-pay the second \$1,500.

Focusing just on the second \$1,500 of property tax liability, Mark and Debbie reduce their current year's tax liability by \$375 ($\$1,500 \times 25\%$ marginal tax bracket). If they had waited until next year to pay the second \$1,500 of property tax liability, they would have reduced their taxes by \$225 ($\$1,500 \times 15\%$ marginal tax bracket). Thus, accelerating the deductibility of the second \$1,500 saves them \$150 of tax liability ($\$375 - \225) over the two years and they get it more quickly, thus yielding a time value of money benefit.

Property Tax in the Year Your Home is Sold.

Note that this particular analysis is applicable only if you have sold your home this tax year. When you receive your property tax bill, you will be billed six months in arrears. That is, you will be paying a liability that has already accrued over the last six months and that you have already incurred. So if you sell your home, one of the things that you are going to have to attend to prior to transferring title to the new owner is to pay your property taxes that have accrued through the date of sale but which you have not yet paid.

As we will discuss in the Home Ownership section of the book, a person called an escrow agent is usually used as an intermediary between the buyer and seller of a home. One of the

functions of the escrow agent will be to assure that the seller's property taxes are paid up through the date of transfer of title. The escrow agent will retain enough of the sale proceeds from the home to pay the seller's final property tax liability.

When the dust settles after the sale of a home, the escrow agent will give the seller a reconciliation sheet that will note a number of items including the final payment of property taxes on the sold home made by the escrow agent on behalf of the seller. This last item can be a large number, maybe a few thousand dollars. It is treated as property taxes paid by the seller in the year of sale of the home and can be added to the other property taxes paid by the seller that year in computing his or her Itemized Deductions. Remember this if you are selling your home.

State and Local Income Taxes.

Now let's look at optimizing the deductibility of our state and local income tax liability. If you are an employee, you have no doubt noted that there is a great difference between your gross wages and your net take home pay. Not only is your employer legally required to withhold your federal income tax and social security tax liability from your paycheck, your employer is also obligated to withhold your estimated state and local tax liability and pay them over to the state and municipal government where you work. The amounts withheld from your paycheck and paid over by your employer are considered paid by you in the year in which they are withheld from your pay. The Form W-2 that your employer gives you each January will note how much state and local income tax was withheld on your behalf and considered paid by you in the prior year.

Additionally, you may directly make certain state and local income tax payments during the relevant tax year. For example, many of us pay two local income taxes, one in the municipality in which we work and a second in the different municipality where we live. As just discussed, employer withholding will attend to the local income tax liability for the municipality in which you work. However, you will have to pay directly the local income tax liability for the municipality in which you live. Typically, you will do this by making quarterly estimated payments.

Also, if you have not prepaid directly or through withholding enough state and local income tax, when you actually file your return you will have to pay any shortfall. This amount that you pay to the state and/or local government when filing the return is also a payment of state and local income tax in the year in which it is paid. Let's look at an Example of this, focusing on state income taxes, to make sure that you have a handle on it.

EXAMPLE: For the 2006 tax year, Mark and Debbie paid \$6,000 of total state income tax. The couple made these payments in three different ways. On April 15, 2006, they filed their 2005 state income tax return. Because they did not prepay enough of their 2005 state income tax liability, they paid \$500 when they filed the tax return on April 15, 2006. Additionally, through employer withholding on each of his paychecks for the 2006 tax year, Mark's employer withheld and paid over to the state income tax department a total of \$4,500 of tax on Mark's behalf. Lastly, in order to assure that they prepaid enough state income tax for the 2006 tax year, Mark and Debbie made a direct tax payment of \$1,000 on December 15, 2006. Thus, for purposes of computing how much state income tax they paid in 2006, they are considered to have paid \$6,000: the \$500 paid on April 15, 2006, the \$4,500 of total employer state income tax withholding for 2006, and the \$1,000 they directly paid on December 15, 2006. Mark and Debbie may add \$6,000 of Itemized Deductions to their 2006 federal income tax return due to these payments.

Now that you understand how to compute what state and local income taxes you are considered to have paid in a given tax year, let's explore a tax planning angle. As just noted, we get to add to our Itemized Deductions state and local income tax payments in the year in which they are paid by us or by our employer. If we had the money and wanted to pump up our Itemized Deductions in a given year, let's explore the effect of overpaying (not underpaying) our state or local income taxes. Within reason, we can intentionally overpay our state or local income tax liability to take advantage of this technique.

Let's say that you anticipate your state income tax liability to be \$2,000 this tax year. Through employer withholding and direct payments, you figure you will accommodate \$1,500 of

that liability. The first thing you should do is increase your employer withholding or make direct payments to your state by the end of the year to assure that you prepay at least the remaining \$500 that you anticipate owing for the year.

Now let's say that you do that but because you anticipate being in an unusually high marginal tax bracket this year, you prepay a total of not just \$2,000 but \$3,000. What happens? You will deduct the full \$3,000 this tax year when the payments are made. However, you have overpaid your state income tax by \$1,000. Next year, the state will send you a refund of \$1,000 for the overpaid amount.

Since the refund in the second year relates to a payment that reduced your tax liability in the prior year, the \$1,000 refund will be included in your federal Gross Income (see [page 9](#)) in the second year when the refund is received. This is known as the "Tax Benefit Rule" – a descriptive title. Again, the refund is income because it relates to a payment that yielded you a tax benefit (deduction) in an earlier year and that tax benefit is now being reversed out by including it in income in the current year. Incidentally, the same result would pertain whether you had the \$1,000 refund mailed to you or credited against your next year's state income tax liability.

Why would you want to increase your Itemized Deduction in this manner by \$1,000 in the earlier year if you would suffer a reversing \$1,000 income inclusion in the next year? I alluded to the answer above. If you anticipate being in a significantly higher marginal tax bracket this year than next, this technique will be valuable (study again the discussion on determining your marginal income tax bracket on [page 11](#), then the following Example).

EXAMPLE: The facts are the same as in the prior Example except that Mark and Debbie are in the 25% marginal tax bracket in 2006 and anticipate being in the 15% marginal tax bracket in 2007. Let's say their actual state income tax liability for 2006 is only \$4,500. As they have prepaid \$5,500 of their 2006 liability (the \$4,500 employer withholding and the \$1,000 direct payment noted in the prior Example) the couple has overpaid their 2006 state income tax liability by \$1,000. Early in 2007, Mark and Debbie receive a \$1,000 refund check from the State.

They will include this \$1,000 refund in their 2006 income because it is a recovery of the excess \$1,000 payment that they deducted from their Federal income taxes in 2006. The net result of this is to the couple's benefit. They deducted \$1,000 too much in 2006 and realized savings of \$250 of taxes that year (\$1,000 times then 25% marginal tax bracket). In 2007, they will include the refund in their Federal income tax increasing their tax liability by \$150 (\$1,000 times 15% margin tax bracket for 2007). The net tax savings between both years relative to the \$1,000 extra state income tax payment will be \$100 (\$250 minus \$150).

For more information and examples on the deductibility of state and local taxes you pay, go to my Web site, click on Tax Planning, then IRS Publications, then IRS Publication 17, *Your Federal Income Tax* (you can picture the IRS official who thought up that one). Chapter 24 of that Publication provides you with more detail and examples relative to deductibility of taxes that you pay.

The Third of the "Big Three" of Itemized Deductions – Charitable Contributions

One of the major things that distinguish us as a great people is the generosity and philanthropy of Americans. We are, very simply, the most generous people in the world (go to my Web site, click on News and then Charitable Gifting).

Although not the leading factor in our generosity, certainly the tax benefits afforded charitable contributions under the Internal Revenue Code are a contributing factor. Here are the basics on optimizing your Itemized Deductions for your charitable contributions.

Most of us make our gifts to our church, synagogue, mosque and other charitable organizations in cash. Always make your cash gifts to these charities by check so that you have your cancelled check to document the gift. The cancelled check will constitute the required bank record of the gift. Without it, you will need to get a written statement from the charity verifying the gift. Additionally, to the extent that you make a single gift of cash or non-cash property to a

charity that is \$250 or more in amount, you will need a written substantiation of the gift from the charity documenting the purpose, amount and description of it.

EXAMPLE: Mark and Debbie contribute \$10 per week to their church. In addition, they make a one-time gift of \$500 to the church as part of a fundraiser to add on a church building. When Mark and Debbie compute their Itemized Deductions for the year, they may add a total of \$1,020 (\$10 times 52 weeks plus \$500) as charitable contributions in the computation of their Itemized Deductions. No written substantiation from the church is necessary with regard to the weekly gifts (their cancelled checks will suffice) as no single contribution equaled or exceeded \$250. However, with regard to the single \$500 gift, the couple will need to obtain written substantiation from the church that it indeed was a gift to the church and not a payment for some other purpose (for example, private school tuition that is not deductible).

How about non-cash charitable contributions? Many of us regularly contribute clothing and other non-cash property to charitable organizations like Goodwill and the St. Vincent De Paul Society. You may count the fair market value of this property at the time of the gift as part of your charitable contributions in computing your Itemized Deductions. A recently added requirement is that such property be in good condition or better. You will need a receipt from the entity to which you are gifting the property. The charitable donee will provide some measurement of fair market value of the property. Frequently, however, you will have to reasonably estimate the fair market value of the property on your own. Remember it is the value at the time of the gift - not the original purchase price for the property – that is the correct number.

If all of your non-cash property gifts for the year in total exceed \$500, you additionally will have to file a Form 8283. The information requested is detailed, including a description of the property, the date of original purchase of it, and the original cost of it (go to [Web site](#), click on Tax Planning then Forms and Instructions to see it). This Form 8283 is something we would rather not file if we do not have to. Why? For a lot of reasons, the less information we give the government the better. A humorous example of one reason involves President and Mrs. Clinton.

Some political enemies got hold of an old tax return of the Clintons' pursuant to the Freedom of Information Act. The Form 8283 filed by the Clintons that year detailed the fact that they were taking a charitable contribution deduction for gifts of used clothing – including underwear!

EXAMPLE: In addition to the \$1,020 cash gifts that Mark and Debbie made in the prior Example, they additionally make gifts of clothing to the St. Vincent DePaul Society. They received receipts from St. Vincent DePaul and the reasonable estimate of the fair market value of the clothing at the time they gifted it to the charity to be \$400. In computing their Itemized Deductions for the year, Mark and Debbie note gifts of \$1,420. No Form 8283 needs to be filed with their Federal income tax return as their non-cash gifts (\$400) are less than \$500.

The charitable contribution deduction is a good one to utilize if we are trying to pump up our Itemized Deductions at the end of the year. By making gifts late in the tax year, we can manipulate our Itemized Deductions right at year-end. However, in this regard be aware of a few things. Simply making a pledge or promise to make a gift to a charity is not enough. You must deliver your check or non-cash property to the charity on or before December 31. Actually making a gift with your credit card on or before December 31 will suffice. Making a payment by credit card is not a promise to pay—it is an actual, immediate payment with borrowed funds.

EXAMPLE: Referring to the Example on page 30, the \$500 one-time gift that Mark and Debbie contribute to their church fundraiser is not made by check but rather by credit card. Their \$500 contribution is made the year the credit card is charged, not when Mark and Debbie actually pay that credit card balance off. Again, as before, we have a single gift equaling or exceeding \$250, so written substantiation from the church documenting the payment as a gift is necessary.

There is a limit on how much of your charitable gifts you can deduct as an Itemized Deduction in a given tax year. If you are making gifts of cash, you can currently deduct that cash gift to the extent it does not exceed 50% of your Adjusted Gross Income (see pages 9-10). Any excess of your charitable contribution over 50% of your AGI may be carried forward for up to five tax years until used up (subject to the same 50% of AGI limitation).

EXAMPLE: Mark and Debbie make a cash gift of \$60,000 to their church. Their Adjusted Gross Income in the year the gift is made is \$100,000. In computing their Itemized Deductions that year, the couple may deduct \$50,000 attributable to this gift (50% of their \$100,000 AGI). The excess \$10,000 that is not currently deducted may be carried forward for up to five years until it is deducted subject to the 50% of AGI limitation in those future years.

If you own appreciated stocks or bonds that you have held for more than one year, Congress has provided a great tax break to encourage charitable giving. Here it is. Say you own stock that you bought for \$100 five years ago that is now worth \$1,000. If you sold (rather than gifted) that appreciated stock, you will be taxed at long-term capital gain rates. Even though the LTCG rate is very favorable (a maximum rate of 15%), it is still a tax we would like to avoid if we could. If instead of selling that appreciated stock, you gifted it to your Church or another legitimate charitable donee, you would get gift credit based on the full fair market value of the stock even though you have never been taxed on the gain.

EXAMPLE: Years ago Mark bought Acme stock for \$10,000. It is now worth \$40,000. Mark wants to make a gift of \$40,000 to his Church and fund the gift through the Acme stock. One approach would be to sell the Acme stock for \$40,000 and gift the \$40,000 cash sales proceeds to the Church. This approach would give Mark a \$40,000 charitable contribution for the year, but he would also be taxed on a \$30,000 (\$40,000 selling price minus \$10,000 cost) long-term capital gain. Another approach would be for Mark to gift ownership of the stock to his Church without selling it. Mark still gets credit for having made a \$40,000 gift (the stock's full fair market value), but now he will not incur any capital gain. This more favorable result would apply even if the Church, shortly after being gifted ownership of the stock, sold it in the Church's own name.

Remember if you take advantage of this wonderful tax planning opportunity, you will have to file the Form 8283 (if the property's value exceeded \$500) and provide the details on the stock you are gifting. Hopefully, you won't be trying to deduct any used underwear at the same time.

One possible hitch with this technique is the AGI limitation on the current deductibility of the gift. Remember that we just noted a 50% of AGI limitation on the current deductibility of a cash gift. When long-term capital gain property is gifted, the AGI limitation is reduced to 30%. As with a cash gift, any excess gift may be carried forward up to five tax years and deducted in those future years subject to the same 30% of AGI limitations.

EXAMPLE: Say in the previous Example, Mark's AGI for the year is \$100,000. Although he has made a gift of \$40,000, only \$30,000 of it (30% of his AGI) is currently deductible. The non-deductible \$10,000 is not lost – Mark will be able to carry it forward for up to five years subject to the same 30% of AGI limitation on deductibility in those carry forward years.

For more details and examples of appropriate charitable contributions go to my Web site (<http://www.personal.kent.edu/~maltieri/web/guide/home.htm>), click on Tax Planning then IRS Publication 17, Chapter 26. Also review Publication 526, *Charitable Contributions*.

NOTE: A tax-oriented scam that appears to be growing in popularity is to incorporate yourself as a tax-exempt charitable entity. The promoters of this hustle will provide you with step-by-step instructions on obtaining your tax-exempt status for a fat fee. This is a con of the first order, and you are strongly advised to avoid this scheme like the plague.

Another variation on this theme, which is slightly more legitimate, involves the use of a charitable remainder trust or other forms of charitable "trusts." This is slightly more legitimate in that the use of a charitable trust is a very legitimate estate-planning tool with certain high wealth individuals. However, some "financial planners" are promoting the use of the charitable remainder trust for use by middle and lower-income Americans. This is **TOTALLY INAPPROPRIATE** for the vast majority of Americans.

Remember, if we are talking about taxes (or financial matters generally) and the scheme being promoted sounds too good to be true, 999 times out of

1,000 it's a hustle. I've heard some of these con artists on TV and on tape making their case. They can be VERY good – looking like the boy or girl next door or maybe out of the church choir, intelligent sounding and so, so convincing.

Stay away from these people! If it sounds too good to be true, IT IS! Use your common sense in these situations. Stay away from any form of "tax shelter" promotion. Save the significant amounts of money you would end up paying to the promoters of these scams and invest it pursuant to the Retirement Planning or Educational Savings sections of this book. You will be immeasurably better off. Also, read the more detailed discussion of tax protester groups at [page 42](#).

Other Itemized Deductions

Although most Americans will not avail themselves of these other Itemized Deductions, you may be an exception. If so (or if you just want a copy of the Schedule A — where we figure our Itemized Deductions — to follow along with the analysis), go to my [Web site](#) (<http://www.personal.kent.edu/~maltieri/web/guide/home.htm>), click on Tax Planning, then Forms and Instructions and download a copy of Schedule A and Instructions to it. If you do think you can take advantage of these other Itemized Deductions, read the Instructions very carefully. Often, the Instructions for the other Itemized Deductions make reference to IRS Publications, which are also accessible through my Web site and will be referenced below.

We put the total Itemized Deductions that we compute for the year on Schedule A to the Form 1040. We have just focused on optimizing the "Big Three" Itemized Deductions: state and local taxes (lines 5 through 9 on the Schedule A), interest expense you pay, (lines 10 through 14) and charitable gifts (lines 15 through 18). How about the other categories of Itemized Deductions on the Schedule A? Here is why the typical itemizer will have little or no entries in the other Schedule A categories.

Medical Expenses.

With regard to deductible medical and dental expenses, you will need a large uninsured expense in order to avail yourself of this Itemized Deduction. Why? There are two reasons.

The first is that to the extent you have insurance coverage or are reimbursed for your medical or dental expenses by your employer, they may not be deducted on the Schedule A. The second obstacle is that there is a large 7 1/2% of Adjusted Gross Income (see pages 9-10) hurdle that needs to be surpassed. Only the excess over the 7 1/2% floor may be taken as an Itemized Deduction. Since most Americans have good health insurance or employer health coverage and/or do not assemble enough uninsured medical expenses to get over the AGI floor, most itemizers have no entry in this category.

EXAMPLE: Mark and Debbie have Adjusted Gross Income of \$50,000. Mark has comprehensive family health care coverage through his employer. Mark and Debbie and their children's uninsured health care expenses for the year (deductibles and co-pays for which they are liable) amount to \$1,500 for the year. Since the couple's uninsured healthcare expense for the year of \$1,500 is less than 7 1/2% of their AGI (\$3,750), they have no Itemized Deductions for medical expenses this year.

What we are looking for in this medical expense category is a large, uninsured medical expense. Nursing home expenses, for example, are frequently uninsured or underinsured. The entire nursing home expense (room and board as well as medical expenses) is a potentially deductible expense if the primary reason for the patient being in the nursing home is to attend to his or her health care needs.

EXAMPLE: Let's continue the prior Example. Audrey is Mark's dependent mother. Since she is his dependent, Mark may add her uninsured medical expenses that he pays to his and Debbie's in computing the couple's Itemized Deductions for the year. Audrey is a resident at a local nursing home. Audrey's doctor had recommended that she be put in this particular skilled nursing home facility to attend to a chronic heart condition. Mark pays the uninsured nursing home expenses that amount to \$15,000 for room and board and an additional \$5,000 for medical treatment. Because Audrey's stay in the nursing home is necessitated principally because of her medical condition, the entire \$20,000 is to be accounted for and Mark and Debbie can add an additional \$17,750 [\$20,000

plus \$1,500 (from the prior Example) minus \$3,750 (7 1/2% of their AGI)] to their Itemized Deductions for the year.

For more information in this area, go to my Web site, click on IRS Publications and view Publication 502, *Medical and Dental Expenses*.

Casualty and Theft Losses.

How about if you suffer a casualty (fire, hurricane, tornado) or theft damage to your property? An Itemized Deduction is possible here, but again it is severely limited. What are the limitations? Only uninsured losses are potentially deductible and now we have a 10% of AGI hurdle to get over.

EXAMPLE: Mark and Debbie's house was broken into. The fair market value of what was stolen was \$5,000. After the applicable deductibles, the insurance agent paid Debbie \$4,500 for their loss. The couple's AGI is \$50,000. Nothing from this occurrence increases Mark and Debbie's Itemized Deductions. The net loss of \$500 is not in excess of 10% of their AGI (\$5,000).

If you think you qualify, go to my Web site, click on Tax Planning, then IRS Publications to access IRS Publication 547, *Casualty and Theft Losses*.

Job Expenses and Miscellaneous Deductions.

With regard to the job expenses in this category (job travel, union dues, job education, etc.), it is only unreimbursed employee expenses that are potentially deductible. If you are paying these expenses with your own money, most employers maintain a reimbursement plan to pay the employee back for these out-of-pocket expenses incurred by the employee on behalf of the employer. In that case, the reimbursement typically is not included in your income and you can't deduct the expense (the reimbursement has put you back into the same economic position you were in before paying the expense). Another big item in this category is tax preparation fees you pay to a tax advisor. After adding up your unreimbursed employee expenses, union dues

and tax preparation fees, you have to get over another Adjusted Gross Income floor before you have any actual Itemized Deduction in this category. Now the floor is 2% of your AGI number.

EXAMPLE: Mike and Lisa have Adjusted Gross Income of \$60,000. Mike incurs \$1,000 of unreimbursed automobile expenses directly related to his employment activities. In addition, Lisa paid \$500 for tax preparation and investment advisory fees. The couple may add \$300 to their Itemized Deductions for the year [\$1,500 minus \$1,200 (2% of their AGI)].

If you think you qualify for an Itemized Deduction in this category, I have another excellent IRS Publication for you to view. Go to my Web site, click on Tax Planning, then click IRS Publications to obtain Publication 529, *Miscellaneous Deductions*.

Tax Credits

NOTE: You DO NOT need to be an itemizer to take advantage of tax credits.

Tax credits are different from deductions. Tax credits don't reduce Taxable Income (see [pages 9-10](#)), but rather reduce actual tax liability. \$1 of tax credit reduces your tax liability number by \$1, whereas a dollar of deduction reduces the base Taxable Income number by \$1. \$1 of tax credit will save you \$1 of tax payable regardless of your marginal tax bracket. \$1 of deduction will reduce your tax liability number as a function of your marginal tax bracket. We touched on this in [Exhibit 2 on page 12](#). If I am in the 28% marginal tax bracket, \$1 of deduction will save me 28 cents in taxes payable.

EXAMPLE: Look again at the Example on page 10. There, Mark and Debbie had \$75,600 of Taxable Income and were in the 25% marginal income tax bracket. If the couple had one more dollar of Taxable Income, they would pay \$0.25 more in taxes that year (the last additional dollar of Taxable Income times their 25% marginal rate). Conversely, if the couple were able to increase their tax deductions by \$1, they would have \$1 less of Taxable Income and would pay \$0.25 less in tax for the year.

How about the effect of tax credits? Look at the page 12 Example. Mark and Debbie have an actual income tax liability for the year of \$12,015. If they had \$1 of tax credit available to them for the year, it would reduce the tax liability number by a full \$1 to \$12,014. The couple's marginal tax bracket would have no affect on the tax credit allowance.

So you see, \$1 of tax credit is much more valuable than \$1 of tax deduction. Therefore, it is very important that we do not miss taking any available tax credits on the Form 1040. Starting in the 1998 tax year, there are a number of new tax credits available to the middle class in addition to the more popular pre-existing credits. I will describe the more typical credits for you, but review the Form 1040 Instructions (go to my Web site, click on Tax Planning, then click on IRS Forms and Instructions) to make sure there aren't any less typical credits you may also be entitled to. Additionally, I will refer you to the right IRS Publications below.

Refundable vs. Non-Refundable Tax Credits.

There is one more thing that I need to tell you about tax credits before we start looking at the different ones available. Some tax credits are "refundable" and some tax credits are "non-refundable."

A refundable tax credit acts exactly like the federal income taxes that your employer withholds from your paycheck - a refundable tax credit is first available to wipe out your tax liability for the year and to the extent the refundable tax credit exceeds your tax liability for the year, the excess is actually refunded to you in the form of a check from the government.

A non-refundable credit is one that is only available to offset that year's tax liability. If it exceeds the tax liability number, it does not generate a refund nor is it otherwise useable (although it may additionally be available to offset social security you paid that year, as I will note below). In applying a non-refundable credit against your tax liability for the year, you will use it prior to applying federal income taxes withheld by your employer.

EXAMPLE: Mark and Debbie have a \$1,000 non-refundable tax credit this tax year. Mark's employer has additionally withheld \$1,500 of federal income tax

from his paychecks throughout the year. The couple's income tax liability for the year proves to be \$1,400. The first \$1,000 of the \$1,400 tax liability is absorbed by the \$1,000 non-refundable credit. The last \$400 of the tax liability for the year is accommodated out of Mark's federal income tax withholding. The couple receives an \$1,100 refund check from the government attributable to the over-withheld taxes.

Child Care Credit.

If you are a single parent, or married and both spouses work outside the home, you are typically eligible for a nonrefundable credit based on the child care expenses you pay to a caregiver. If you have two or more children under the age of 13 and pay \$6,000 or more in child care expenses your credit could be as high as \$2,100. If you only have one child under the age of 13 and pay \$3,000 or more in child care expenses your maximum credit will be \$1,050. If you spend less on child care expenses than the limits noted, you will still be eligible for a credit but of less amount.

There are no Adjusted Gross Income (see pages 9-10) limitations on the availability of the Child Care Credit. However, as your AGI goes up, your maximum credit goes down. You will compute the Child Care Credit on Form 2441. Look at that Form and the Instructions to it in order to establish the exact dollar amount of your Child Care Credit. Go to my Web site, click on Tax Planning then Forms and Instructions. Also look at IRS Publication 17, Chapter 33 and Publication 503, Child Dependent Care.

Child Tax Credit.

The Child Tax Credit is different from the Child Care Credit we just looked at. The amount of the credit is \$1,000 per child if the child is under the age of 17, a U.S. citizen, and is claimed as a dependent on your tax return. The credit is fully available for married taxpayers with Adjusted Gross Income (pages 9-10) under \$110,000 (\$75,000 for single taxpayers). If one's AGI exceeds those threshold amounts, the child tax credit is quickly phased out. The Child Tax Credit may be available to you even if you do not owe any federal income tax. The credit is

refundable to the extent of the lesser of (i) the unused portion of the credit, or (ii) 15% of a taxpayer's earned income in excess of \$11,300 for 2006 and \$11,750 for 2007. Families with 3 or more children are permitted to calculate the credit even more liberally since this credit is available to reduce (and generate a refund from) Social Security taxes such families paid in addition to income taxes for the year.

EXAMPLE: Mike and Suzie have 4 dependent children under the age of 17. The couple's combined income tax liability for the year is \$1,500. The couple paid \$3,000 in Social Security taxes through withholding. Mike's employer additionally withheld \$1,000 of federal income taxes from Mike's paycheck. The child credit is available to offset both income tax liability and Social Security tax liability for the year. The child tax credit of \$4,000 (4 children times \$1,000) is applied first to wipe out the \$1,500 income tax liability for the year. Additionally, the last \$2,500 of the child credit is available to reduce the couple's \$3,000 Social Security tax liability for the year to \$500. The couple will get a refund check of \$3,500 (the \$2,500 of over-paid Social Security tax and the \$1,000 of over-withheld federal income tax).

Carefully follow the Form 1040 Instructions and IRS Publication 17, Chapter 36, as you work through this great tax credit for families.

Earned Income Credit.

This credit was designed to provide an incentive to less well-to-do citizens to go out and earn wages rather than overly rely on some form of welfare. If you have two or more dependent children and your Adjusted Gross Income (see pages 9-10) for tax year 2006 is less than \$38,348, you may be eligible for the full Earned Income Credit (it quickly phases out thereafter). If you have only one dependent child, you may be eligible for the full Earned Income Credit if your AGI is less than \$34,001. Furthermore, if you are age 25 through 64 and are not claimed as a dependent on another person's tax return, you may be eligible for a reduced earned income credit even though you have no children if your AGI is less than \$14,120.

This is a very valuable type of credit in that it is a fully refundable credit (see page 39). That is, it is available not only to wipe out your income tax liability for the year but also may generate a refund check back from the government. This is another situation where you want to read the Form 1040 Instructions and IRS Publication 17, Chapter 33 and Publication 596, the Earned Income Credit, very carefully. Take your time working through the Earned Income Credit worksheet provided in the Instructions. Be careful here: there are penalties imposed if you negligently or fraudulently take advantage of the Earned Income Credit and it is the major reason why lower income taxpayers are audited.

Education Tax Credits.

There are two very significant tax credits available when you pay college tuition expenses for yourself, your spouse, or your dependents. I will talk in more detail about these Education Tax Credits under the Education Savings section of the book.

Constitutionality of the Income Tax and Tax Avoidance Promoters

As you use this book and become more familiar with the Web, you will undoubtedly run into books and Web sites where promoters will tell you that you legally do not have to pay your Federal income tax liability. Typically the logic of these tax-avoidance promoters is that the Federal income tax is unconstitutional and/or the Federal income tax, as Congress has enacted it, allows us to voluntarily pay or not pay our income tax liability.

DO NOT get sucked into one of these tax-avoidance/tax protester groups. I am telling you flat out, without any doubt or equivocation, that the income tax is constitutional and legal. If you buy into one of these wacky tax-avoidance groups, you will either be intentionally or unintentionally breaking the law. Tax fraud is potentially a criminal offense, and the fact that you were duped into engaging in tax fraud is generally no defense against your being prosecuted. The people who promote these tax-avoidance schemes are either woefully ignorant of the law, con artists or simply nut cases. Avoid them like the plague.

Why am I so emphatic about this? Because the law with regard to the constitutionality of the income tax is so crystal clear. Let me give you a quick history lesson. Prior to 1913, it was a

fact that the Federal government could not tax us the way it now does. The Founding Fathers (in their wisdom) provided in Article I, Section 7 of the Constitution that if the Federal government was to levy a direct tax (like an income tax) on its citizens, the amount of the tax would have to be the same citizen by citizen. In other words, the Founding Fathers were saying that all of us, as U.S. citizens, have the same constitutional rights and obligations. If the government is to extract an obligation from us in the form of a tax, that tax should also be equal in amount. Therefore, the U.S. Constitution, as originally written, did not authorize the Federal government to tax us on variable factors such as our income.

We literally had to amend the Constitution to permit the Federal government to income tax us as they now do. In 1913, more than two-thirds of the States and Congress voted into law the Sixteenth Amendment to the U.S. Constitution. The Sixteenth Amendment authorizes the Federal government to tax "income from any source derived." In light of the incredibly broad breath of the Sixteenth Amendment (that we were stupid enough as a people to authorize), it is hard to give any credence to tax protester groups who claim the income tax is unconstitutional.

Incidentally, a fascinating footnote to this discussion is the fact that the promoters of the Sixteenth Amendment got it through the state ratification process with the following "class envy" pitch: the Federal income tax will only tax the extremely rich and not the middle-class. As always happens, this "nail the rich guys" angle has backfired on the common man and woman with the result that the original 1913 income tax has grown from 9 to over 7,000 pages of statutory law and has significantly gotten into the back pockets of a majority of Americans.

There are scores of tax cases further confirming the constitutionality of the income tax. The courts have been very harsh with the illegal tax avoiders and have readily doled out heavy civil and criminal penalties. If you don't like the income tax the way it is, your only legal recourse is to vote for congressional representatives and a president who will be serious about tax simplification and who will ultimately "rip the income tax code out by its roots." Unfortunately, in order to accomplish the last-quoted goal of the influential (now retired) Texas Congressman Bill Archer, we would have to repeal the Sixteenth Amendment-not an easy task in modern America.

If you are interested in further educating yourself on legal ways of reforming the tax laws of this country, link to my Web site, click on Tax Planning and click on Tax Reform.

NOTE: Remember what I told you earlier about deals that sound too good to be true. Whether it's tax planning, purchasing commodity futures, investing in foreign businesses, lending money at 100% interest to foreign dignitaries or diplomats who you heard about through a chain letter, or anything else that sounds too good to be true-STAY ALERT. These good looking and well dressed hucksters will sound like the most intelligent people you've ever heard and generally will appeal to you as honest types who really want to help you. Some of these people may be hawking their snake oil at otherwise reputable gatherings. People promoting things who you know from church, synagogue or mosque should likewise be approached cautiously. You will naturally let down your guard since your religious affiliation with these people may have already influenced you that they are good folks.

Stay away from all of these people! Use your common sense in these situations – there are no get rich quick schemes out there (unless you were born a Kennedy or a Rockefeller). If it sounds too good to be true, IT IS!

Self-Employed Individuals

All the information that is noted in this book is relevant to individual taxpayers no matter what their work relationship. Still, I am primarily focusing on the typical American who is an individual who works for an employer in an employee relationship. How about special tax issues relevant to the taxation of proprietors and small business entities? This latter analysis is beyond the scope of the book. However, I won't completely ignore you small business folks. For further instruction on how to conduct your small business as a proprietorship or partnership or as an incorporated business go to my Web site, click on Tax Planning, then IRS Publications and download Publication 334 (Tax Guide for Small Business). This Publication details not only the income tax rules but also the federal excise and employment tax rules for proprietorships. For those small business owners conducting their business as a partnership, click on IRS

Publication 541 (Tax Information on Partnerships), or if as a corporation, see IRS Publication 542 (Tax Information on Corporations).

Other Relevant Tax Information

Tax-Exempt Income.

Generally, whenever individuals receive wealth they also have a Gross Income inclusion for tax purposes (see Exhibit 1 on page 9). However, Congress long ago determined that certain forms of wealth increase would not be income for tax purposes. Some of these tax-exempt receipts can be very significant and you need to be generally aware of the exempted categories of income. Some of the more common categories for typical Americans are listed below. Remember, it is the person who is the recipient of these payments that gets them income tax free under the Federal tax laws:

- Life insurance proceeds but only if paid by reason of the death of the insured (we will discuss this category in greater detail under the Life Insurance Planning section of the book),
- Lifetime gifts (the donor may be liable for gift tax on gifts over \$12,000, but the donee receives them income-tax free),
- At-death gifts-bequests and inheritance (the decedent's estate may be liable for estate taxes),
- Health insurance benefits or employer reimbursements for health care,
- A legal recovery of damages for physical (bodily) injury,
- Scholarship grants applied toward tuition, fees, and books - but not room and board (we will analyze this category in detail under the Educational Savings section of the book),
- Social Security benefits to a limited extent – if married taxpayers, with less than \$32,000 of Adjusted Gross Income (\$25,000 of AGI for single taxpayers),

- The sale of your home (see page 50).

There are other categories of tax-exempt income as well that are less commonly encountered. Study the Form 1040 Instructions (go to my Web site, click on Tax Planning and then Forms and Instructions, as well as Publication 17, Your Income Tax, Chapter 13 – Other Income).

Gifts of Highly Appreciated Stock or Other Property to Children.

In the Retirement Planning section of the book, I strongly advise you to not invest significantly in stock of a single company. What I do advise you to do is invest in stock ownership of many companies through diversified stock mutual funds.

Let's say that despite my advice, you own through purchase or inheritance highly appreciated stock or other investment property (like land). By highly appreciated, I mean that the fair market value of this property is significantly higher than its tax basis (your cost if you purchased it or its fair market value on the date of death of the decedent if you inherited the property).

If you sell this highly appreciated property, it will trigger a long-term capital gain to the extent of the difference between that fair market value and tax basis. Long-term capital gains are taxed at favorable rates of taxation relative to ordinary income. If your normal marginal rate of taxation (see Exhibit 2 on page 12) is 25% or greater on ordinary income, your maximum rate of taxation on long-term capital gains is 15%. If your normal marginal rate of taxation on ordinary income is 10 or 15%, your maximum rate of taxation on long-term capital gains is only 5%. This favorable rate of taxation on long-term capital gains relative to ordinary income is great and, by the way, provides a strong incentive to invest in our economy.

Apart from these general rules, where am I going here? Your children or grandchildren may be in a significantly lower rate of taxation than you are. Is there a way to shift wealth to the children to accommodate their needs and have the inherent income taxed at their lower rates? Sometimes.

You cannot shift your wage income to anyone. It is a long and hallowed tax rule that personal service income is taxed to the taxpayer who earned that income. Capital gain income, however, is a different story. We can shift that built-up income to another taxpayer by transferring legal ownership of the underlying property to the other taxpayer. This form of tax planning is known as "income splitting" and it can be an extremely effective way of keeping wealth within the family unit while substantially lowering the overall tax hit. You can study an Example of income splitting under the Educational Savings section of the book at [page 115](#).

There are some significant hitches in this tax planning technique:

- The child/new owner of the property must be age 18 or older (14 or older prior to 2006) in the year the property is sold. Otherwise, the effective tax rate is usually the parents' not the child's;
- The child is now the owner of the property and any after-tax cash proceeds once the property is sold. In other words, for this technique to work there must be a true and effective gift of the underlying property from parent to child. As long as the child is a minor, the parents can act as custodian over the child's wealth but must use the wealth as if it were the child's not the parents'.
- If the child's wealth is used to satisfy a parental support obligation, income is taxed back to the parents. Things like food, shelter, medical care and elementary and high school educational expenses are generally considered parental support obligations. Non-necessary items like college expenses, a child's automobile, vacations, music, and acting lessons are generally not considered to be parental support obligations and may be satisfied out of the child's wealth without a taxable event to the parents.
- Increasing your child's wealth may have a detrimental effect on obtaining financial aid for that child's college education ([see page 115](#)).

Obviously, if you are going to dabble in this area to a great extent, it would be sound wisdom to retain the services of a competent Certified Public Accountant in your area. Look in

your yellow pages or go to my Web site, click on Tax Planning, and then click on State Societies of CPAs. Each State Societies of CPAs noted on my Web site has a referral service to assist you in retaining a competent CPA near where you live.

Also, a competent investment company and/or stockbroker will be needed to assist in the legal transfer of stock ownership to the child. If the highly appreciated property is non-stock property, a lawyer should be retained to assist in the legal transfer of ownership of land or other property (see page 127 - Locating a Lawyer, and Obtaining The Services of a Professional Financial Advisor at page 96).

Computerized Tax Software

Absent the advent of true tax simplification (something that probably will not happen in any meaningful way during our lifetimes), the Federal income tax law will continue to grow in size and complexity. Despite my best efforts to simplify the concepts for you, federal taxation will continue to be a complicated and ornery bear to live with. Is there any computer solution to this problem? One of the coolest things to come down the pike is the advent of incredibly user-friendly tax preparation software and computerized programs.

The one I have always personally used is TurboTax. Go to my Web site, click on Tax Planning and then Tax Preparation Software. TurboTax is relatively cheap, \$40 or \$50 depending on where you purchase it. It is exceptionally powerful yet extraordinarily easy to use. One of the many good things about TurboTax is the way it slowly walks tax-confused users through the return. Also, the wave of the future is filing online even if you're an average taxpayer. The TurboTax software program allows you to easily file online. The final useful thing about a computerized tax preparation program is that a lot of the information will carryover from year to year (information on you, your spouse and your dependents as well as employer information). Repetitive information can simply be uploaded from last year's return.

NOTE: Purchasing Goods and Services over the Internet. Frequently you may want to purchase things you come across on the Internet, like the tax preparation software I just described. Over time my thinking on this subject has changed.

When I first began to surf the Web and desired to purchase things I saw on it, I would not give my credit card information over the Web but would rather manually order things via any phone number given or by writing to any mailing address given by the vendor. This can be very time consuming and actually a more complicated process than simply ordering items directly off of a Web site.

I now use a particular credit card only for my Web site orders. Thus, I have a little "control device" to assure that there is no fraudulent use of my credit card. In the past three years that I have used this credit card for my Web purchases, I have never seen anything out of the ordinary on the credit card bill (most Web vendors have secure services that assure the competent and safe use of credit card information). If you use this technique and do notice something out of the ordinary, you can cut off any liability at \$50 (or \$0 if done promptly with many card issuers) by calling the customer service number on the credit card.

HOME OWNERSHIP AND FINANCING

Whether you are buying your first home, or moving or upgrading to a new home, this section of the book will be invaluable to you. We will start by quickly commenting on some additional tax information relevant to home ownership and then swing into the non-tax material.

More on the Tax Benefits of Home Ownership

As we have already discussed in the Tax Planning section, home ownership is the single biggest factor that will make an itemizing taxpayer out of you. Your home will open up the availability of a whole menu of Itemized Deductions in addition to the two big deductions associated with home ownership: mortgage interest expense and real estate property taxes.

For the vast majority of Americans, home ownership is our one true "tax shelter." Look again at the Example on **page 13** of how the tax savings associated with home ownership can catapult you from being a home renter to a homeowner. That Example gives you an excellent illustration of the year-to-year tax benefits afforded homeowners.

Not only are there current "front-end" tax benefits of home ownership (noted in the Example), there are also "back-end" tax benefits to home ownership – relating to the sale of the home – that are as significant and pro-taxpayer.

The rules are oriented around the fact that when homeowners sell their home, there frequently is a large amount of inflationary gain recognized on the sale. Additionally, Congress recognized that the value of the home is the single most important asset (along with private retirement plan benefits) for the vast majority of Americans. Therefore, the new rules allow for a significant tax holiday on the sale of the home. How much? Up to \$250,000 of gain is excluded from taxation if the homeowner is single and the exclusion is doubled to \$500,000 if the homeowner is married. The rules require that the home must have been owned and used by the taxpayer as his or her principal residence for at least two years during the five-year period preceding the sale of the home. If the taxpayer is married, at least one of the spouses must meet the two out of last five-year ownership requirement and both spouses must meet the two out of last five-year use requirement.

It is not the selling price alone that measures the gain on the sale of the home. It is the selling price (minus selling expenses) less the "tax basis" in the home that measures gain. The tax basis of the home is generally the cost of the home being sold plus significant improvements.

EXAMPLE: Lisa sells her principal residence in which she had a tax basis of \$100,000 for \$600,000. She has owned and lived in the home as her principal residence for the last 10 years. Her selling expenses (primarily real estate brokerage fees) are \$50,000. Although the home is in Lisa's name only, she is married to Mike and the couple files a joint return. Mike has lived in the home since he married Lisa four years ago. The realized and recognized gain on the home sale is computed as follows:

Selling Price	\$600,000
Minus Selling Expenses:	(\$ 50,000)
Minus Tax Basis:	(\$ <u>100,000</u>)
Realized Gain	\$450,000

How much of this realized gain is recognized and taxed? None – up to a \$500,000 gain is insulated from taxation. Both spouses meet the two out of five year use requirements and Lisa meets the two out of five-year ownership requirement.

Some Basic Non-Tax Information

Now that I have illustrated for you the significant tax benefits that flow out of home ownership, let's explore certain issues relevant to your owning a home, whether you are a first-time homeowner or a repeat buyer.

In your own mind, you have a dollar range for a home you think you can afford. Exactly how much home you can actually buy will be affected less by the actual dollar purchase price of the home and more by the following two factors: (1) closing costs (the actual costs you will incur

in the year when you purchase the home, including your cash down payment to the seller and other costs paid to the Bank through which you are mortgage finance the purchase of the home), and (2) the type of mortgage you get and the interest expense charged on that mortgage. Until you have a handle on these two things you will not be able to analyze how much home you can actually afford.

Since few of us have the wealth reserves to purchase a home outright, we must borrow money from a Bank in order to purchase our home. This form of loan is called a mortgage. The Bank (lender) takes a mortgage security interest in the home. If the borrower defaults on the mortgage, the Bank can compel the sale of the home to satisfy the debt.

Because the Bank does not want to get caught short in a default situation, the general rule of thumb is that it will lend 80% of the purchase price. Thus, in a standard situation, the new homeowner will come up with 20% or more of the purchase price and borrow the balance from the Bank.

What if we do not have the 20% down payment? Here are a few solutions. Your Bank of choice probably participates in a FHA (Federal Housing Authority) or VA (Veterans Administration) insured home loan program. Under these programs the purchaser might come up with only 5% of the purchase price and finance the 95% balance. However, under these programs the borrower must purchase "mortgage insurance" until he or she pays down the mortgage to the 80% equity level.

In my own situation, my wife and I bought our first house in 1983 and financed it with an FHA/VA mortgage. I put 5% of the purchase price down and financed the 95% balance. It took me about 4 or 5 years to pay off enough of the mortgage principal to get the remaining balance to the 80% threshold that allowed me to drop the mortgage insurance.

NOTE: In many cases the Bank will not clearly notify you when the mortgage insurance is no longer necessary, so it is prudent that you keep tabs on this mortgage insurance point if you go this route.

Another approach with regard to funding the ideal 20% down payment would be to borrow against your account balance if you participate in a company sponsored retirement plan like a pension, profit-sharing or Section 401(k) plan (discussed under the Retirement Planning section of the book). If you look at my discussion on Consumer Interest Expense on [page 147](#) in the Miscellaneous section of the book, I detail for you how to effect such borrowing against your plan and, in many cases, making the interest expense on such a loan tax deductible.

When you sell or buy a home, a person called an escrow agent acts as an intermediary for the buyer and the seller. Your Bank or the real estate agent can advise you on an appropriate escrow agent. The function of the escrow agent is to accommodate the transfer of funds and the deed and other necessary documentation on the home between the buyer and the seller.

Concepts Applicable to All Mortgages

As we have already noted, most Americans will rely heavily on mortgage financing to affect the purchase of their home. Having acknowledged that fact, we now have to study the different types of home mortgages that are available. There are many different types of home mortgages and the short-term and long-term cost differentials on these different mortgage types can be extreme. Whether you are a new or repeat homeowner, taking the time to make yourself aware of these different types of home mortgages could save you hundreds—maybe thousands—of dollars annually with regard to your mortgage payments.

Closing Costs.

Any mortgage loan will have "closing costs" attached to it. Closing costs entail the required down payment on the home, "points" charged at the inception of the loan (recall our discussion of points and the special tax treatment afforded them on [page 18](#)), loan origination charges and a variety of miscellaneous additional expenses. The loan origination fee is that amount charged by the Bank acting as the mortgage lender to process the mortgage. The loan origination fee is typically a large expense and it is distinct from any points charged on the mortgage. The only closing costs that are tax deductible in the year of payment are your points.

By law, the mortgage lender must provide you with a line item breakdown of your various closing costs. This is significant, as these closing costs will vary greatly lender-by-lender. Therefore, when you shop for your home mortgage (detailed below), a clear knowledge of the amount of your closing costs will be almost as important as determining the interest charge and the type of your mortgage.

We have just discussed options for funding the down payment on your home. Your down payment will almost always be the most significant closing costs that you incur. Recall that you should strive to mortgage finance 80% or less of the total purchase price of your home in order to avoid the need for home mortgage insurance and to get the best rates.

Interest Expense.

Interest expense charged on a mortgage (or any other type of loan) is the expense the lender charges the borrower for the use of the lender's money. Think about that fact for a moment. If you were in the lender's shoes and were about to make a long-term loan (15 or 30 years) would you charge more or less interest expense if you were unable to change the terms of the loan? You would charge a higher rate of interest due to the uncertainty of what interest rates would be in the future. If you as the lender had the ability to change the loan terms every year so as to readjust interest expense to conform to then-current market rates for interest, you could initially charge a lesser rate of interest at the inception of the loan. This reality about interest expense is the basis for the difference between our two major types of home mortgages: fixed rate and adjustable rate mortgages.

Fixed Rate Mortgages

Fixed rate mortgages usually have a term of thirty (30) or fifteen (15) years. Throughout the entire term of the mortgage, the interest rate charged will be fixed and will not vary. Also, each monthly loan repayment will be the same dollar amount throughout the term of the loan. As we have noted earlier, a loan repayment has two (2) component parts: principal repayment and payment of interest for borrowed principal not yet repaid. Therefore, in the earlier years of the loan when the outstanding borrowed principal is greatest most of your monthly mortgage

payment will be interest expense (which is deductible for income tax purposes as an Itemized Deduction – see page 16) and very little of the monthly mortgage payment will be nondeductible principal. Conversely, in the later years of the mortgage, when most of the principal on the loan has been repaid, much less of the monthly mortgage payment will constitute interest and more will be principal. Restudy the Example in the Tax Planning section of the book on page 16 that illustrates this phenomenon with regard to a fixed rate mortgage.

The fixed rate mortgage just described has traditionally been the preferred choice for home mortgages for a couple of reasons. The big reason is that the monthly mortgage expense will never vary over the term of the loan. The monthly mortgage amount can be locked in because the interest expense charged on the loan will never vary. Thus, from a budgeting standpoint, the fixed rate loan is great as we're locking in our monthly mortgage expense over the long-term.

What are the downsides to the fixed rate mortgage? As we also just noted, because the interest expense is fixed, the mortgage lender will charge a higher rate of interest to compensate it for the risk that market rates of interest will go up in the future. If, in fact, market rates of interest do significantly rise in the future, the homeowner who financed the purchase of his or her home with a fixed rate mortgage looks like a genius. Historically speaking, this situation was generally the case in the 1970's and early 1980's when inflation was fairly pronounced.

EXAMPLE: Mark and Debbie take out a 30-year mortgage to finance the purchase of their home. The principal amount borrowed from the Bank is \$100,000 and the rate of interest is fixed at 7% over the life of the mortgage. The monthly payments will always be \$665. Although \$100,000 was borrowed, approximately \$239,400 (\$665 times 12 months times 30 years) will be repaid to the Bank. This amount comprises the total of \$100,000 of principal repaid to the Bank and \$139,400 of interest paid to the Bank over the life of the mortgage.

Two years later, the market rate of interest on a comparable loan rises to 10%. Another couple, John and Kelly, take out a 30 year mortgage to finance the purchase of their home. As with Mark and Debbie, the principal amount

borrowed from the Bank is \$100,000 but the rate of interest is now fixed at 10% over the life of the mortgage. John and Kelly's monthly payments will always be \$878. Their total payments over 30 years will be slightly more than \$316,000 with about \$216,000 of total interest payments.

The Bank would like to get rid of Mark and Debbie's mortgage at this point in time because market rates of interest have gone up, but Mark and Debbie are more than happy to sit tight with their 7% mortgage loan. There will be no reason for Mark and Debbie to consider refinancing their existing mortgage as they enjoy a locked-in rate that is significantly lower than current market rates of interest.

If market rates of interest are trending downward (as generally has been the case since the early 1980's) the homeowner who took out a fixed rate home mortgage might wish that he or she hadn't and may be compelled to refinance the home with a new lower rate mortgage (and a new round of closing costs).

EXAMPLE: Mark and Debbie in the prior Example take out the \$100,000, 7% mortgage loan that was noted. Five years later, market rates of interest have declined from 7% to 5% on comparable loans. If Mark and Debbie refinance their mortgage at 5% for a term of 25 years, they would find their monthly payments reducing from \$665 per month to \$585 per month, a savings of \$80 per month or over \$960 per year. The couple has a significant incentive to refinance the old loan. If they do so, the Bank on the original mortgage loan loses one of its more profitable mortgage loans.

You might think that this sword cuts both ways. For example, if the homeowner takes out a fixed rate mortgage and market interest rates go down in the future, won't Banks make out since the fixed rate mortgage is charging a mortgage expense in excess of what is then a market rate of interest? Yes, if the homeowner maintains that high rate mortgage and doesn't refinance, which is what he or she will almost always do as illustrated in the prior Example.

Adjustable Rate Mortgages

With an adjustable rate mortgage (an "ARM"), the mortgage interest expense is typically recomputed annually. On recalculation, the interest expense is recomputed so as to conform to the then current market rate of interest. Because the interest expense will typically be recomputed annually, the Bank is not on the hook (as it is in the case of a fixed rate mortgage) if market rates of interest increase in the future. Therefore, the Bank will not need to hedge its bet when setting the initial interest rate at the inception of the loan. This is why ARMs almost always have a significantly lower beginning rate of interest than do fixed rate mortgages. As the interest expense is recomputed annually the monthly mortgage payment will change somewhat each year.

EXAMPLE: If Mark and Debbie in the last Example had initially taken out an ARM as opposed to a fixed rate mortgage, they would not have to refinance to obtain the lower rates. The ARM would automatically adjust downward – if market rates of interest were trending downward – without the need to refinance and incur the associated closing costs, miscellaneous expenses and time that go along with refinancing a significant debt obligation like a mortgage loan.

Thus, if market rates of interest are stable or trending downward, the ARM trumps the fixed rate mortgage. Conversely, if market rates of interest rise significantly in the future, the ARM would be less attractive as compared to the fixed rate mortgage.

How the Variable Rate of Interest on an ARM Is Computed.

All ARMs are not created equal. Apart from the "teaser rate" issue that I will address below, the critical factor with an ARM is the interest index that it employs. Remember that the interest rate on the ARM will typically be readjusted up or down each year as the market rate of interest varies. How is this change in market rates of interest determined? It would be a function of the interest rate "index," which will be fully disclosed to you at the inception of the ARM. The most common index employed nationwide on ARMs is the Federal Reserve Funds Index. This index very accurately measures variations in market rates of interest as it measures

the interest expense the Federal Reserve charges on monetary loans to member banks. A less commonly used (and less volatile) index is the average interest expense charged on all home mortgages. This latter index is produced by the National Average Contract Interest Rate for Major Lenders on the Purchase of Previously Occupied Homes – quite a mouthful. Both of these indices are noted in the Wall Street Journal, Monday real estate section. The Federal Reserve Funds Index might be noted in your local paper as well.

Teaser Rates of Interest on ARMs.

The analysis we went through earlier on properly analyzing and calculating our closing costs is equally applicable to both fixed rate mortgages and ARMS. However, in our analysis of the ongoing cost and ongoing interest expense of the ARM, there is another very significant point that needs to be understood and analyzed. As I have already pointed out, all things being equal, the Bank will charge less interest at the inception of an ARM than it will on a fixed rate mortgage. Again, this is due to the fact that the Bank will not be locked into a below market interest rate on the ARM if market rates of interest increase in the future as it would on the fixed rate mortgage. However, some ARM lenders provide an even lower "teaser rate" of interest in the first year or two of the ARM. If you go the ARM route, you want to make sure that after a year or two a higher "fully-indexed" rate of interest doesn't pop the annual recomputed rate significantly higher than what you anticipated.

EXAMPLE: Mark and Debbie take out a \$100,000 mortgage to finance the purchase of their home. After careful analysis, Mark and Debbie decide to take out an ARM rather than a fixed rate mortgage. The ARM is indexed to the Federal Reserve Funds Index. At the inception of the loan, the Index is at a 5% rate. One year from now, the interest rate will readjust to the Index rate plus 1½% points. The initial year's rate of interest, however, is not set at 6½% (the 5% rate plus one and one-half a percentage point) but rather is set at 5%. The Bank uses this extra-low first year rate to attract ARM customers. One year from now, if the Index rate is still at 5%, Mark and Debbie will find that their second year of mortgage payments are readjusted using a 6½% rate of interest even though the underlying Index has not changed.

To avoid this problem you want to be fully aware of what the fully-indexed rate will be once the teaser rate falls off after a year or two. These facts must be disclosed to you in writing and, if you ask, verbally. But you must be aware of what a teaser rate of interest is versus a fully-indexed rate in order to be aware of the issue and ask the right questions. Now you are!

Which is Better, a Fixed Rate Mortgage or an Arm?

It depends on your risk tolerance. If you are the type of person who wants, in essence, to buy insurance to assure that your home mortgage expense will not spike upward because of an inflationary surge, then borrow via a fixed rate mortgage. This will protect you to the extent that the market rate of interest increases significantly in the future. As discussed earlier, you will pay for this protection because the fixed rate of interest established at the inception of the loan will be significantly higher than that established at the inception of an ARM of comparable term.

What do I think? In the past I have leaned slightly more toward the ARM and have used ARM mortgages on the two homes I have purchased. In economic cycles, the higher the inflation rate, generally the higher the market rate of interest. Since the mid-1980's, when the Reagan Administration and Federal Reserve policy checked prior high inflationary trends, inflation has been held in check and has been virtually non-existent. Similarly, market rates of interest have been stable or trended downward over that period of time. Since I strongly believe that the Federal Reserve has established an infrastructure to prevent significant inflation, I am not fearful of significant rises in the market rate of interest in the future.

Let's look at me as an Example. My wife and I purchased the house we now live in 1989. We financed the purchase price through an ARM indexed to the less volatile, National Average Contract Interest Rate for Mortgage Lenders on the Purchase of Previously Occupied Homes, mentioned earlier. Although hindsight is 20/20, I still think it is a useful exercise to look at how much money my wife and I saved using an ARM over a fixed rate mortgage with regard to our home.

EXAMPLE: In my and my wife's case, the interest rate at the inception of our ARM was 9.5% when the interest rate on a fixed rate mortgage of comparable

term was 11%. Since 1989 the interest rate has readjusted every year in a generally downward trend. For example, the annual readjustment of the interest rate saw the initial 9.5% rate drop to 5.0% level a few years ago. Each year that the interest rate dropped by 1%, my wife and I saved approximately \$1,500 in our annual mortgage payments. If we had originally taken out a fixed rate mortgage and never refinanced it, our cumulative mortgage payments over the last 12 years or so would have been tens of thousands of dollars greater.

The market sometimes changes relative to fixed rate mortgages. Historically, fixed rate mortgages have been priced at one and a half to two percentage points of interest above a fully-indexed ARM. A few years ago, fixed rate mortgages were priced as low as one-half a percentage point above some fully-indexed ARMs. If you can get a fixed rate mortgage priced that close to an ARM, you should go in that direction.

What you need to do is run the numbers both ways, making sure you factor in all variables and closing costs, and then make an informed decision based on your risk tolerance.

Shopping for a Mortgage

If you live in a larger urban area, your local weekend newspaper probably has a Home Section. Somewhere in that Home Section there is most likely a description of home mortgage loans charted out for you. The chart will illustrate various loans available from area lenders and mortgage brokers. Both fixed rate and ARMs will be illustrated. Many of these charts will get into a breakdown of the variable costs such as the interest rates relative to points charged at the inception of the mortgage. Recall from our discussion in the Tax Planning section of the book on [page 18](#) that the more points you pay at the inception of the loan, the more you can buy down the interest rate charged over the entire term of the mortgage. Ideally, the illustrated ARMs will show the initial rate of interest and what that rate of interest would be if it were "fully indexed" after any teaser rate drops off. Here is a link to a representative example using a solid lender, Dollar Bank:

<http://www.dollarbankmortgage.com> (click on current rates)

At this point you will have a rough idea of the terms and conditions of mortgages available from area lenders. You should carve out a few hours and call the mortgage loan departments of each and every lender in your area. Specifically ask the loan officer about all of the things we have reviewed. In order to compare apples and apples with different lenders, ask your questions based on a hypothetical loan of the same amount. At that point you will be able to ask the loan officers at the various mortgage lending institutions what the loan origination fees and other closing costs would be on, say, a \$100,000 mortgage. If you are inquiring about ARMs, make sure you have a firm handle on what index is being used, if there is an initial teaser rate, and what the rate would adjust to (based on current information) if the loan jumped to the fully-indexed rate (like in the Example on page 58).

In going through this exercise you will be shocked at the variation in costs from lender to lender. For example, I remember that when I went shopping in 1989 for the mortgage I just described to you in the prior Example, the ARM mortgage lender I ultimately went with-compared to the one I almost went with-saved me about \$150 per month. In 1989 dollars that differential was enough to finance the purchase of an automobile. Comparable savings are available today. You merely have to keep everything we have talked about in mind and do your shopping.

Another fabulous resource available to us is, of course, the Web. I have provided you with a great link, which will allow you to scan the entire country for the best mortgage lenders (go to my Web site at <http://www.personal.kent.edu/altieri-online.com>, click on Home Ownership and then Mortgage Tools). Don't presume that these Web-accessible mortgage lenders will necessarily provide you with the best deal as compared to your local Bank. As with all things, however, the more competition there is, generally the better off we are as consumers and the Web certainly opens the competitive field. Still do the same rigorous shopping and analysis that we just talked about if you are mortgage shopping on the Web. All of the Web-based mortgage vendors will have 800 numbers where you can call and talk to a human being with regard to these questions.

Refinancing an Existing Home Mortgage

As we discussed above, if you have purchased a home and financed it through a fixed rate mortgage, you are in a dilemma if the market rate of interest has declined since you locked in your higher fixed rate. A very common resolution of this dilemma is to refinance the mortgage at the then lower market rate of interest. Recall that on page 19 of the Tax Planning section of the book we noted the fact that points paid on a refinanced home mortgage are not fully deductible in the year in which they are paid. Therefore, as you shop the mortgage market for an appropriate refinancing loan, you will want to strongly consider a low or no point mortgage since the points are not currently deductible.

Where to Live

We have just run through the parameters for determining how much home you can afford, how to come up with the necessary closing costs, and how to best finance the balance of the purchase price through a mortgage loan. We are not quite through with our analysis. Selecting the community in which you will purchase your new home includes many tangible and intangible factors.

You may desire, for example, to move back to the community in which you were raised. In such a case, the factors I am going to talk about now are of secondary importance. Take some advice from my wife (and you husbands who don't-watch out), live where you want to live and where you want to raise your family. This is of primary importance.

But for many other homeowners (perhaps a majority) one community appears to be as good as the next. For example, I live in the Greater Cleveland, Ohio area. I may have a preference to live on the West Side of Cleveland, but beyond that general preference, Rocky River seems as good a place to live as Bay Village as does Avon Lake. Now we want to sit down and give our decision some more thought. There may be such an after-tax cost difference between living in these communities that it could effect the value of the home you are able to purchase.

EXAMPLE: You and your spouse have isolated two suburban communities where you would like to purchase your new home. One, Oldtown, is where you currently live and the other, Newtown, is nearby. The school systems in both of these communities are very good and historic student testing data (which you have obtained through the community's school district) are virtually identical. Having moved beyond the schooling issue, you and your spouse now start exploring other elements in your decision to stay in your current community or move to Newtown. On closer examination, you discover some huge differences.

Newtown is geographically larger than Oldtown and supports more business activity than does Oldtown. Because of this business activity, you realize (after making a call to the County Recorder's office) that the property tax rate in Newtown is significantly less than in Oldtown. You realize that on a \$150,000 home, you would pay \$1,000 more in property tax in Oldtown than you would on a comparably priced house in Newtown. Even though real estate property taxes are an Itemized Deduction on the federal income tax return (see page 24), the value of the tax deduction won't come close to making you whole on this out-of-pocket cost differential (for example, for the extra \$1,000 cost you save \$280 in tax payable if you are a 28% marginal rate taxpayer).

Also, on closer examination, you and your spouse discover another startling fact relating to your local income tax liability. Like most of us, you are currently paying a municipal income tax liability in the town in which you work and an additional income tax liability to the town in which you live, Oldtown. You have long known that in computing your Oldtown income tax liability you are allowed a 50% credit setoff for the income tax you pay to the municipality in which you work. However, when you examine the municipal income tax structure in Newtown, you discover that Newtown residents are given a 100% credit in computing Newtown income tax liability for local income taxes paid to the municipality in which the resident works. This difference provides you with another \$500 a year savings in the net local income taxes you pay.

Anything else? How about differences in sewer assessments and water costs. Again, you and your spouse are surprised to learn that Newtown has its own water facility and that your total water and sewer costs in Newtown, for the amount of water use you anticipate for your family, saves you another \$400 per year of out-of-pocket expense. This last category of water and sewer expense savings is relatively more valuable than the property tax and local income differential. The water and sewer expense is not deductible as an Itemized Deduction on the federal return whereas property taxes and local income taxes are.

After examining all of these differences, you and your spouse discover an amazing thing. You realize that you could support the down payment and mortgage debt service on a \$150,000 house in Oldtown but that you could purchase a \$180,000 house in Newtown at the same out-of-pocket, after-tax monthly expense.

Note that in the Example, you have immediately increased the investment value of your home by \$30,000 at the same monthly cost. Such an occurrence might be worth you and your spouse spending a few hours thinking about these differences before you purchase your new home. This is a hugely beneficial exercise and could significantly change the inherent value of your home ownership.

RETIREMENT PLANNING

In General

Which would you rather have, a \$1,000,000 or a penny doubled every day for a month? If you picked the \$1,000,000, you would have short-changed yourself by over \$9,000,000. This simple example profoundly illustrates the miracle of compounding interest: that is, a principal amount of money earns interest, thus growing the principal on which more interest will later be earned. If we have enough cycles in which the principal amount doubles in value, the miracle of compounding interest becomes more and more pronounced as noted in the above Example.

The rule of 72's gives us an excellent standard to determine the doubling period. For example, if a principal sum is earning a fixed rate of interest of 6%, that sum will double in value in approximately 12 years (72 divided by 6 equals 12). If the principal sum is earning interest at a rate of 12%, it will take only 6 years for the principal sum to double in value (72 divided by 12 equals 6). Divide other interest rates into 72 and observe the time required to double your initial principal.

Historically, those who have invested in well-diversified stock mutual funds (described below) have had an average rate of return in the 12% range. The longer the investor has before retirement, the more assured he or she is of attaining or exceeding that historic average. Conversely, a 6% rate of return would be closer to an historic average for a class of investments traditionally deemed safer, such as well-rated corporate bonds, certificates of deposit and U.S. bonds and notes.

If I am a 24-year-old worker who desires to retire at age 60 and I invest in stock funds, per the earlier analysis, a dollar I invest at age 24 that averages a 12% rate of return will double six times by the time I reach age 60. That dollar thus becomes \$64 (\$1 becomes \$2 becomes \$4 becomes \$8 becomes \$16 becomes \$32 becomes \$64). Conversely, the investor putting his or her money in a safer form of investment earning a 6% rate of return will find that same dollar invested at age 24 doubling about three times to \$8 (\$1 becomes \$2 becomes \$4 become \$8).

You see from these illustrations a few fundamentally important concepts in our retirement planning: Concept One - the earlier in life you begin your retirement planning the vastly better off you are, and, Concept Two - the higher the average rate of return, the more powerful the compounding interest effect. We will talk about the trade-off between higher rates of return and the risk inherent in the investment later on in this section of the book, but let's leave it for now by stating that the younger you are and the more time you have until retirement, the more risk you should take in your investments. Why? Because the highs and lows average out over time on riskier investments and the younger investor optimizes the two concepts I just mentioned.

But what I've just illustrated for you presupposes that you've already made the decision to invest and the only question is the form of investment. What if you are like the person I was, always making excuses for not beginning to fund a retirement plan. I had plenty of excuses such as six children, a wife who was at home with the kids and not generating an income, etc. I did not begin meaningfully funding my own retirement plan until just a few years ago, when I was in my early 40's. Late is certainly better than never, but I cut my own throat by not optimizing two decades of the most powerful compounding years by not beginning to invest in my 20's. And by the way, I realized an amazing thing when I did start my investment program: I didn't really notice the absence of the money I was investing in terms of it degrading my lifestyle. That has been the case even though what I have and will sock away will hopefully grow to about a million dollars by the time I retire in 15 or 20 years.

One other very important point that you'll see illustrated. Taxation will gut our investment's rate of return if it is a currently taxable investment. All the investment options that I will focus on, however, are tax-favored forms of investment where the taxes generally are not due until you retire and start drawing on the wealth, or in a more limited situation, are never taxed at all.

Social Security Versus Private Retirement Plans

If you look at your pay stub you will see a significant deduction for FICA. This FICA contribution (which stands for the Federal Insurance Contribution Act) is the tax paid to fund

your Social Security and Medicare benefits. Let's focus on our governmental pension program, Social Security, even though I could take up a chapter discussing the flaws in the Medicare program as well.

For most working Americans the FICA tax is the single most significant federal tax paid. It is a flat tax levied on every dollar of wage income up to approximately \$88,000 per year. The rate of tax is a flat 7.65% – with 6.2% going toward the Social Security part and 1.45% going toward the Medicare part. Let's look at the Social Security element. If your wage income for the year were \$50,000, your Social Security tax would be \$3,100 ($\$50,000 \times 6.2\%$). But the picture is worse still. Your employer pays a matching 6.2% contribution. Most people probably think this is a great deal until they scrutinize things a little closer. The employer isn't making a gift here. The employer is paying its 6.2% contribution out of your gross wages. Like your regular wages, it is simply another cost of doing business from the employer's viewpoint. Therefore, in a very real sense, the entire 12.4% combined employer and employee Social Security tax is coming out of your gross wage income. Thus, your real Social Security tax if you make \$50,000 of wage income a year is more in the neighborhood of \$6,200 ($\$50,000 \times 12.4\%$).

What does this very high pension cost get you? Depending on which poll is consulted, younger Americans are more likely to either believe Elvis is still alive or to believe in UFOs than that they will reap a meaningful benefit from the Social Security program.

For older Americans retiring nowadays who have 40 years or so of work history, Social Security provides approximately \$1,500 per month for life. This might also sound like a great deal if you don't think a little more deeply about what is actually going on. Most retirees would literally have hundreds of thousands of dollars more of wealth accumulated by retirement if they were allowed to put their FICA contribution into an Individual Retirement Account type investment (discussed below) rather than in the traditional Social Security program.

This concept is popularly referred to as "privatization." There are many reasons for doing this in modern America. The most significant is that it would allow Americans to obtain a stock market rate of return which has averaged almost 11% over the last four decades while being investing in relatively safe stock mutual funds. Even an absolutely safe U.S. Treasury

Bond or Note rate of return of 4.5% would significantly beat the current rate of return on Social Security benefits which is only about 1½%. Despite the fact that privatization is such a hot political issue, the current privatization proposals will only partially privatize Social Security (only about 15% of a worker's Social Security tax could optionally be privatized).

Maybe an even better reason, however, would be that such a privatized program would be self-funding like the private retirement system I will discuss below. By self-funding I mean that each retiree's benefits are funded out of his or her trustee account and reservoir of wealth. Even though most people think that under Social Security there is similarly a pot of money with their name on it, nothing could be further from the truth. Social Security is a pay-as-you-go system which means that the Social Security benefits being paid now to retirees are coming out of contributions that workers are currently making to the same system rather than from the retiree's Social Security account balance.

An additional extreme negative associated with the Social Security pension is that the benefits typically die with the retiree whereas with self-funded private retirement plans there will be a death benefit equal to the remaining account balance in the private plan. In other words, you could incur the significant Social Security tax each year for 40 to 45 years, die at the age of 65 and not have anything to leave to your family. In a private retirement plan situation where you were socking away comparable amounts of money each year, you might have an account balance of hundreds of thousands of dollars to leave to your family if you died at age 65.

A common argument against privatization is that the privatized Social Security benefits would not be guaranteed as they are under the current system. However, a privatized system could be structured in a way that allowed for a safety-net rate of return (higher than what the current system is now paying) at the cost of giving up a percentage point or two on the stock market rate of return yield. This would be a good compromise and, again, would assure that the whole system would be self-funding and safe.

Another extraordinary fact pertaining to this issue, and one that is relatively unknown by most Americans, is the fact that many federal and state employees already have fully-privatized retirement benefits. In other words, many federal and state employees have the equivalent of

their entire Social Security tax go into an individual account plan that can earn a real market rate of return like in a Section 401(k) and the other private retirement plans discussed below. So the politician who is telling you that privatizing a small portion (about 15%) of your Social Security contributions would be a risky scheme is himself participating in a 100% privatized plan (more hypocrisy from the status quo-and an excellent example of what happens when we let the government help us too much).

Despite all of the fundamentally sound arguments for privatizing the Social Security system, privatization is fought tooth and nail because it is such a political hot potato. Therefore, for purposes of this book, we simply cannot count significantly on Social Security to build our retirement nest egg. The only prudent thing to do is build our own retirement through the many tools available to us under the private retirement system discussed below. If Social Security is ever meaningfully reformed so as to provide a more significant source of retirement income, that will be welcome icing on the cake.

We need, therefore, to have a good understanding of what is available to us under the private retirement system. This private retirement system allows us various choices and different types of plans: pension, profit-sharing and Section 401(k) plans and Individual Retirement Accounts (IRAs). Another advantage to retirement benefits paid from private retirement plans (except those voluntarily contributed under Section 401(k) Plans or Individual Retirement Accounts (discussed below)) is that such benefits are never taxed under the Social Security FICA tax. That is, neither the contributions to such plans nor the distributions from such plan are subject to Social Security taxes. I will describe each of these private retirement plans below and then we will discuss strategies for investing the wealth we build-up in these plans.

Types of Tax-Favored Private Retirement Plans

Pension Plans.

A traditional pension plan (sometimes called a "defined benefit" pension plan) gives the plan participant a specific dollar benefit commencing at retirement and is payable over the post-

retirement life of the employee (or in a lesser amount over the joint lives of the employee and his or her spouse). I participate in a pension plan as a university faculty member.

Most pension plans provide a normal retirement age of 65 although earlier retirement at a reduced benefit level is frequently permitted. When I retire, I will receive a maximum benefit of 60% of my final annual compensation averaged over a three-year period prior to my retirement. This sounds like a very good deal and pension plans are still popular with large governmental employers like mine or with unionized groups of employees.

Although the pension plan is a desirable retirement plan, it suffers in a few respects. As noted, the ultimate pension benefit is not a function of how much money has been contributed to the plan over the working life of the employee but rather is a function of the compensation level at retirement and the number of years of service preceding that retirement. Thus, the pension plan participant does not directly benefit from robust economic times as participants in profit-sharing plans and Section 401(k) plans (discussed below) do. Additionally, once the pension benefit is annuitized on retirement, the monthly payment to the employee is often fixed in amount and may not keep pace with post-retirement inflation and buying power. More information on pension plans is available by going to my Website, clicking on Retirement Planning and then Types of Retirement Plans.

Profit-Sharing Plans.

Under a profit-sharing plan (sometimes referred to as a "defined contribution" plan), the employer will make a contribution to the participating employee's account that will be a percentage of the employee's compensation. Thus, if the employee's compensation level is \$40,000 and the employer is contributing 10% of compensation, that particular employee will have a \$4,000 contribution made to his or her account that year by the employer. Despite the name, the employer does not necessarily have to be in a profitable year to contribute to the plan.

A profit-sharing plan, as well as a Section 401(k) plan, is an individual account plan. An individual account plan receives a contribution that is directly credited to the individual account of the plan participant. Unlike the pension plan, the ultimate retirement benefit in an individual

account plan is not known. Whereas the employer assumed all investment risk in the pension plan, the employee assumes all investment risk in individual account plans. The ultimate retirement benefit will be equal to the dollar value of the participant's individual account at retirement. This benefit will consist of the contributions made on the participant's behalf plus (or minus) the investment return on those contributions.

Additionally, the plan participant will generally have the ability to direct the investment of his or her account. The participant will then have the ability to pursue different investment strategies as we discussed above when commenting on the miracle of compounding interest and the different rates of return depending on that investment strategy. More information on profit-sharing plans is available by going to my Website and clicking on Retirement Planning and then Types of Retirement Plans.

Section 401(k) Plans.

Section 401(k) of the Internal Revenue Code provides the rules governing the most popular form of employer-provided retirement plan in America, the Section 401(k) Plan (sometimes referred to as a “Cash or Deferred” Plan).

The Section 401(k) Plan is really a profit-sharing plan with a major twist. It is like a profit-sharing plan in that it is a defined contribution and individual account plan. That is, we know what is going into the Plan by way of contribution and whatever wealth accumulates is owned by the participant. As with profit-sharing plans, the ultimate retirement benefit will be a function of the total amount of contributions to the Plan participant's account, the rate of return on that account, and time .

The twist is in the method of funding the contributions to the Plan. Unlike a profit-sharing plan, where only the employer makes the contribution, in a Section 401(k) Plan the contribution to the participant's account is typically triggered by the employee/participant. The participant may contribute a percentage of his or her compensation for the year to the Section 401(k) Plan, often up to 15% of compensation (upper income Plan participants will not be able to elect to contribute more than a set amount — \$15,000 for the year 2006 and \$15,500 for

2007). The employer may then match the employee's contribution to the Plan. The employer may make an additional contribution of twenty-five or fifty cents for each dollar the employee has elected to contribute. If the employee contributes nothing for the year, the employer makes no matching contribution to that employee's account.

You MUST set up your budget (see page 4) so as to maximize your permitted contribution to the Section 401(k) Plan. Here are some simple Examples illustrating why you must optimize your contributions to your Section 401(k) Plan.

EXAMPLE 1: Jack is an employee of the Acme Company. Jack is eligible to participate in the Company's Section 401(k) Plan under which the Company makes a fifty-cent on the dollar matching contribution. Jack could have elected to contribute \$6,000 to the Plan but does not. The \$3,000 matching contribution that the Company would have made is thus never received by Jack. Additionally, the \$6,000 Jack takes as salary rather than contributing to the Plan is currently taxed. Say Jack is in the 28% federal income tax bracket and he incurs an additional 5% net income taxation under his state income tax. Jack ends up with \$4,000 after tax.

More likely than not, Jack will spend the \$4,000 and a year from now will have no recollection of what he spent it on. But let's say Jack decides to invest the \$4,000 in a mutual fund (discussed below) that one year later has generated a 15% rate of return. One year down the road Jack's mutual fund is worth \$4,600 (his \$4,000 investment plus one year's earnings of \$600). Since his mutual fund investment is not within a tax-deferred retirement plan, the \$600 of earnings will be currently taxed. Even if all the \$600 is taxed at the more favorable federal capital gain tax rate of 15%, Jack will have earned after tax only about \$500 after paying the federal capital gain tax and his state income tax. When the dust settles, after one year, Jack has accumulated about \$4,500 after tax.

EXAMPLE 2: Jane is a co-worker with Jack at the Acme Company. Jane is also eligible to contribute \$6,000 to the Company's Section 401(k) Plan, which she

does. The Company makes the \$3,000 matching contribution on top of Jane's \$6,000 contribution. Because these monies are contributed to a Section 401(k) Plan there is no current federal or state income taxation. Nor will there be any current taxation of the investment earnings. Jane will not be income taxed until she actually withdraws the money, for example, 30 years from now upon her retirement. Jane directs the Plan trustee to invest her \$9,000 in the same mutual fund that Jack invested in. One year down the road, Jane has accumulated \$10,350 of wealth in her account attributable to this year's transaction. Although Jane will eventually pay income tax on her plan accumulation when she retires, the effect of having so much more principal working for her over the next 30 years to retirement puts her in an immeasurably better position than Jack ends up with in **Example 1** (again presuming that Jack invests the money rather than spends it).

If your employer makes a Section 401(k) plan available to you, the exact amount the employee is allowed to elect to contribute, and the employer-matching contribution, are established under the Plan document and described in the Summary Plan Description for the Plan (the SPD has been distributed to you and is always available to you from your employer's human resources or benefits person). More information on Section 401(k) plans is available by going to my Website and clicking on Retirement Planning and then Types of Retirement Plans.

Also, if you are age 50 or over, you may be able to make an additional "catch-up" contribution to your Section 401(k) plan. These additional "catch-up" contributions are not effected by your current contribution limits. For 2006 and 2007, the catch-up contribution amount is \$5,000). Take advantage of this option, especially if you have not been fully participating in your Section 401(k) plan.

Individual Retirement Accounts –Traditional IRAs.

Probably the most common form of tax-favored retirement plan is the Individual Retirement Account. The traditional IRA that we will talk about now has been around for many

years. You, not an employer, will make contributions to the IRA. A traditional IRA is one that has its tax-advantage at the front-end rather than the back-end. You get to tax deduct your IRA contribution as an Above-the-Line Deduction - you can get your deduction even if you are not an itemizer (review Exhibit 1 in the Tax Planning section of the book on page 9).

How much can you contribute to an IRA? The lesser of \$4,000 per year for 2005-2007 (for 2008 - \$5,000) or 100% of your earned income for the year. Earned income must be worked for unlike unearned income like interest income from a savings account. Also, individuals age 50 and over are permitted to make additional annual "catch up" IRA contributions of \$1,000 for 2006 and thereafter.

Once your money goes into an IRA, it grows tax-deferred. This phenomena of tax-deferred growth is common with the other tax-qualified retirement plans that we just talked about – the pension, profit-sharing and Section 401(k) plans – as well as the IRA. In all these plans and the IRA, income generated off of the plan wealth is not currently taxed. Rather, the tax liability on the income growth, as well on the principal amounts contributed, are deferred until the wealth is paid out in the future.

NOTE: If withdrawals are taken from tax-qualified retirement plans prior to age 59½ (other than for death, disability and certain other limited events), not only is the taxpayer income taxed on the wealth withdrawn, there is an additional add-on 10% penalty tax to contend with. Why? The tax rules are designed to compel us to wait until we are at or near retirement to draw wealth from the plan.

What if your spouse is at home with the kids or otherwise not generating \$4,000 of earned income? A wonderful new pro-family development in the law now allows the stay-at-home spouse to fully fund his or her own IRA if the couple's joint Adjusted Gross Income (pages 9-10) is less than \$150,000 in 2006 (\$156,000 in 2007).

Can you still make a contribution to a traditional IRA if you are a participant in your company's pension, profit-sharing or Section 401(k) plan? The answer will depend on whether

you and your spouse are both participating in company sponsored retirement plans and on the amount of your Adjusted Gross Income. Let's look at the latter situation first.

If you are a participant in a company sponsored pension, profit-sharing or Section 401(k) plan and your AGI is less than \$75,000 in 2006 (\$83,000 in 2007), you may make a full \$4,000 tax-deductible contribution to your traditional IRA. Your ability to make a \$4,000 tax-deductible IRA contribution is phased out to zero dollars if your AGI goes from \$75,000 to \$85,000 (\$50,000 to \$60,000 for single taxpayers) for 2006.

Now on to the other rule- you are married, one spouse is working and participating in a company-sponsored pension, profit-sharing or Section 401(k) plan, but the other spouse is not. In this scenario, the second spouse can make a \$4,000 tax deductible contribution to his or her traditional IRA as long as the couple's joint income is less than \$150,000 (\$156,000 in 2007). The second spouse is not considered participating in a company plan because the first spouse does.

Roth IRAs.

Now for the new kid on the block – the Roth IRA. The Roth IRA is the hottest thing to come on the retirement planning scene since Section 401(k) plans became popular. The tax benefit afforded through the Roth IRA is exactly opposite from that of the traditional IRA and the other plans we have studied. As I already mentioned, these earlier analyzed plans provide an up-front tax benefit by way of a deduction for the IRA owner or company or employee contributing to the plan as well as tax-deferral on the invested funds (income taxation is not due and owing until wealth is tapped at retirement).

With the Roth, there is an opposite and (for many) much more potent tax benefit. When you make your contribution to the Roth IRA (up to \$4,000 per year as with the traditional IRA) you get no tax deduction. In other words, you are funding it with after-tax dollars. But after that up-front tax negative, things become beautiful. Why? You will never pay any income tax if you wait until retirement (or death, disability and some hardship withdrawals) to take your wealth

out. In addition, your actual contributions (not the earnings on the contribution, but the actual contribution itself) may be withdrawn from a Roth IRA at any age without penalty.

You can make a full \$4,000 contribution to a Roth even if you participate in a company sponsored retirement plan as long as your AGI is less than \$150,000 (\$95,000 if single) (\$156,000/\$99,000 in 2007). For taxpayers age 50 and older, a "catch-up" contribution of \$1,000 may be made to their Roth IRAs. The Roth makes most sense for people who will have a longer period until retirement and/or people who are in a lower marginal tax bracket (see page 11) when funding the Roth but who will be in a higher tax bracket when taking withdrawals.

EXAMPLE: Bryan is a 15-year-old High School student who makes \$2,000 each year working a summer job. Pursuant to his Dad's intelligent advice, Bryan (who is in the lowest 10% marginal tax bracket) makes a \$2,000 contribution to a Roth IRA beginning in 2006 for each of the four years he is in High School. Therefore, Bryan will currently be taxed \$200 ($\$2,000 \times 10\%$) in each of the four years with regard to his Roth contributions. After contributing \$8,000 in total to the Roth, Bryan never contributes another dollar to it and for 45 years keeps it invested in a stable stock mutual fund yielding an average of 12% over a 45 year period of time. Upon retirement at age 62, Bryan finds that his \$8,000 of principal invested years ago has grown to \$1,500,000, all of which he can withdraw from the Roth entirely income tax-free.

NOTE: The Example I just gave you is also a wonderful illustration of what would occur if Americans were allowed to privatize Social Security contributions (or a portion of them). Recall from our Social Security discussion earlier that if you and your spouse have earnings of only \$50,000 per year, the combined employer and employee contribution to Social Security is about \$6,200 every year. Wouldn't it be nice if younger workers could divert that Social Security tax and invest it as was just illustrated in the Example.

For an interesting Web-based tool that helps you determine what form of IRA would be better for you and your family, go to Web site, click on Retirement Planning and then IRA Tool.

Additionally, general information on IRAs is available by going to my Web site and clicking on Retirement Planning and then Types of Retirement Plans.

Section 403(b) Annuity.

If you are an employee of an educational institution or a Section 501(c)(3) charitable or religious organization, you may be eligible to contribute to a Section 403(b) Annuity. Under the 403(b) Annuity rules you can elect to contribute up to \$15,000 in 2006 (\$15,500 for 2007), with the federal and state income taxation deferred until retirement. The Section 403(b) Annuity acts exactly like a Traditional IRA, except that the contribution limit is much higher than \$4,000. More information on Section 403(b) Annuities is available by going to my Web site and clicking on Retirement Planning and then Types of Retirement Plans.

Self-Employed Plans.

If you are self-employed, rather than working as an employee, you have the ability to set up your own pension, profit-sharing, and/or Section 401(k) plan. Bear in mind that you will have to cover your employees who work for you more than 1,000 hours per year.

Tax Credit for Retirement Plan Contributions

A new tax credit for contributions to Section 401(k) plans, Section 403(b) annuities and both traditional and Roth IRA's adds an extra incentive to save for retirement. As discussed earlier, a dollar of credit saves a full dollar of tax. To be eligible to claim the credit, you must be age 18 or over, not a full time student, and not claimed as a dependent on another's return. The credit varies from 10 to 50 percent on contributions of up to \$2,000. Therefore, the maximum credit is \$1,000 ($\$2,000 \times 50\%$) per taxpayer. Thus, you and your spouse together may be eligible for a credit of \$2,000. The credit is nonrefundable (see **page 39** for the discussion on nonrefundable credits). The credit is in addition to any deduction taken for the contribution. This is one of the few times so-called double dipping is available. Only joint returns with AGI of \$50,000 or less, head of household returns of \$37,000 or less, and single returns of \$25,000 or less are eligible for the credit (\$53,000/\$39,000/\$26,000 in 2007).

Which Retirement Plan to Participate In

If you are a participant in your company's pension or profit-sharing plan, you are automatically enrolled in the plan after working more than a thousand hours a year and working for the one or two-year period of time required to make you eligible to participate. You will not have to elect to reduce your salary or otherwise make any employee contribution to the plan. Your employer will automatically make contributions to the plan on your behalf.

If your company sponsors a Section 401(k) Plan for which you are eligible to participate, the company will typically make a matching contribution based on your employee contribution. You will execute a salary reduction agreement indicating the extent of your employee contribution. Recall the Examples I gave you a few pages ago under the description of Section 401(k) plans and why you must maximize your contributions to this plan if you are eligible to participate.

Section 403(b) Annuity.

This retirement plan will be your next best choice. If you are eligible to participate in a Section 403(b) Annuity, restudy the Roth IRA analysis I just gave you a few pages ago - the Roth may trump your 403(b) Annuity as a preferred vehicle – at least up to the annual Roth funding limit of \$4,000 per year.

IRAs.

Last but not least we have the Individual Retirement Account. To the extent that you are not constrained by the AGI limitations noted under the earlier discussion of IRAs (on **page 73**), you can contribute up to \$4,000 to a Roth or up to \$4,000 a traditional IRA (but not more than \$4,000 to both – your total contributions to a Roth and Traditional IRA in any one year can't exceed \$4,000). As mentioned on **page 74**, your spouse can generally make an additional \$4,000 contribution to an IRA. To the extent you are contributing to a traditional IRA (as opposed to a Roth IRA), and are also eligible for and making contributions to the Section 403(b) annuity, you must reduce the maximum contribution to the Section 403(b) annuity by the amount you contributed to the traditional IRA.

Mechanism for Efficiently Making Contributions

If you are a participant in a pension or profit-sharing plan, you will make no employee contribution and you can't control the timing of the employer contribution being made on your behalf. If you are a participant in a Section 401(k) plan or Section 403(b) Annuity, you yourself must initiate contributions to the plan. Those contributions will be made through salary reduction via payroll withholding. Your employer will immediately forward your payroll withholding to your plan investment and dollar-cost averaging (discussed below on page 82) is assured.

How about other investments, such as IRAs? Some employers are very helpful to the employee in implementing a "forced savings plan." That is, an employer-sponsored plan is not involved, but the employer will allow its payroll department to make payroll withholdings in order to fund a Roth or traditional IRA contribution or to purchase a U.S. Savings Bond out of each paycheck. This is very helpful in disciplining yourself to make these payments and assuring efficient dollar-cost averaging. The idea is if we never see the money we won't have an opportunity to spend it. Always pay yourself first.

How about the many other situations where we don't have such an employer-assisted forced savings mechanism to rely on? Now we go back to the budgeting concept analyzed at the beginning of the book (page 4). As you put together your recurring monthly expenses, you factor in a monthly contribution to your IRA.

The Proper Investments for Your Retirement Money

Let's say you already are accumulating or have now decided to accumulate wealth in one or more of the retirement plans or IRAs we have just discussed. Typically, you will be able to direct that wealth into a variety of investment options. Which one is best?

Risk/Return.

Recall my beginning comments in this section of the book relative to compounding interest and the effect of investment yield over time. As I noted there, an investment yielding

6% over 36 years would double three times, whereas an investment yielding 12% would double six times.

Obviously, all things being equal, we would pick an investment with a higher yield, as it will accumulate significantly more wealth over time. But here is the rub: generally speaking, the higher the investment yield, the more risky that investment is. The classic comparison is between stocks and bonds.

Stocks.

Although small businesses take many different legal forms (proprietorships, partnerships, S corporations and limited liability companies), virtually all companies that are traded on a public market are regular corporations. Ownership in any corporation is evidenced by stock, typically voting common stock. Such a stock interest gives the stockholder a proportionate interest in the underlying equity and wealth of the corporation as well as a proportionate voting right. Thus, as the underlying value of the corporation goes up or down, so does the market value of a share of stock in that corporation.

Bonds.

Bonds are debt instruments. When you buy a bond, you are lending money to the company or governmental entity that is issuing the bond. The bond will typically pay a fixed rate of interest over a stated term, with the face amount of the bond usually repaid at maturity. For example, when I buy a \$1,000 bond paying 7% interest that matures in 10 years, I lend the bond issuer the \$1,000 and I am paid \$70 of interest each year until maturity of the bond 10 years down the road, at which point I am repaid my \$1,000. All things being equal, less creditworthy companies may have to pay a higher rate of interest than more creditworthy companies in order to sell their bonds.

Bonds have a relatively low and stable yield whereas stocks historically generate a much higher yield. Bonds (at least government bonds) are considered one of the safest forms of investment whereas an investor in the stock market may not see a high return at all and, in fact, could lose his or her investment in those stocks.

I am generally very bullish (optimistic, aggressive) about the American stock market. Why? Because I am very bullish on the American economy. Despite occasional dips and blips on the radar screen caused by political or world events, America is far and away driving the rapidly expanding world economy. We are experiencing a new economic revolution (far more powerful than the 19th century Industrial Revolution that we learned about as kids) and American companies are leading the way. Barring the long-term success of terrorism or another worldwide catastrophe, this phenomenon will not stop or slow down for long.

It is hard to fully accept this proposition in hard stock market times – like the early 2000s. But step back and focus on an historic example that will surely repeat itself in the near future. Think about what happened a few years ago with the Asian stock markets. Those markets, for a variety of reasons largely unique to them, took a significant hit. Our American stock markets also dipped in response. But then what happened? While the rest of the world's markets stagnated, ours increased, quickly making up for the temporary dip.

Why did this happen? For the reasons I mentioned above and also for a very significant additional reason - America is the safest place in the world to invest. In historic times, investing in gold was a safe haven in bad times. A more modern analogy is investing in American companies in bad times. There is a tremendous amount of wealth in the world besides in the United States. When things get bad elsewhere, that wealth floods into our markets, increasing the number of buyers. Under a simple supply and demand analysis, the more buyers chasing the same amount of goods or services will invariably drive the price up and this is exactly what happened to the American stock markets in response to the Asian market downturn.

Apart from pointing out another way that we are blessed as Americans, what is my point here? Don't be afraid to invest in the American stock markets if you have a significant period of time before you retire. Any stock market ebbs and flows. However, the important fact is whether it is trending upward over time. If it is (as our American stock market significantly has), the more time we have to work with the better assurance we will have that our returns over time will be meaningful.

What is my opinion on all of this? If you have 20 or more years before you retire, you should be entirely or substantially invested in the stock market.

Dollar-Cost Averaging.

If you are a younger person and do take my advice about investing in the American stock market, here is a simple way to make it work in a big way: "dollar-cost average" the investment in your retirement plan. Dollar-cost averaging is simply plopping in the same number of dollars on a regular basis (preferably monthly). If you follow this strategy and invest mostly or entirely in stock funds, you must decide beforehand that when the stock market does go down, you will continue to fund your stock account via this dollar-cost averaging method. This may strike you as throwing good money after bad but it absolutely is not. Here is why. We will note momentarily that stock funds over time have done very well. Nonetheless, there have been distinct dips in the historic record on stocks. If you are just buying into a stock fund when it is doing well, you are paying the top dollar price for your investment in that stock fund. The key is to also make some bargain purchases when the stock fund has declined. In this way, you are buying at the highs and lows and getting an excellent average rate of return over the long-term.

Take a look at the following EXHIBIT that dramatically demonstrates the wisdom of continuing to invest in bad stock markets as well as good ones.

Market Recovery Periods Since October 1987

S&P 500 Index

	Monthly Drop	Following 2 Months	Following 6 Months	Following 12 Months
October 1987	-21.52%	- 1.4%	5.5%	14.7%
November 1987	- 8.19%	12.0%	15.8%	23.2%
January 1990	- 6.71%	4.0%	10.1%	8.4%
August 1990	- 9.03%	- 5.3%	15.9%	26.9%
September 1990	- 4.92%	6.05%	24.8%	31.3%
June 1991	- 4.57%	7.14%	14.2%	13.4%
November 1991	- 4.13%	9.49%	12.3%	18.4%
March 1994	- 4.36%	2.94%	5.3%	15.6%
July 1996	- 4.42%	7.86%	24.2%	52.1%
March 1997	- 4.11%	12.42%	26.3%	48.0%
August 1997	- 5.60%	1.95%	17.6%	8.1%
August 1998	-14.44%	15.06%	30.28%	39.81%

Transition of Investment Strategy.

As discussed above, it is common and accepted wisdom that the longer your investment horizon (the longer the period of time until your retirement), the more aggressive you should be in seeking higher yielding investments. Conversely, as we approach retirement years and the need to start tapping our retirement plans, we need to re-evaluate our investment strategy and begin to transition into lower yielding yet safer investments. The following is an Example of one widely accepted strategy with regard to this transition in investment strategy.

EXAMPLE: John decided in his 20's to systematically fund for his retirement through his company's Section 401(k) plan. He and his wife, Kelley, also own IRAs. For decades, they maintained their participation in these arrangements and invested solely in stock mutual funds (John had studied the history of the stock market and determined that the stock market over time would yield an average of 10 or 11%). John and Kelley, although contributing only a few hundred dollars each month, have accumulated close to \$1,000,000 by the time they reach 50 years of age. Having hit 50, John and Kelley are now looking down the road to

their anticipated retirement at age 65. After researching the subject, John and Kelley devise the following strategy: as of retirement at age 65, they want to be invested in stocks in an inverse percentage to their age (that is, by the time they are 65 years of age, they want to be 65% invested in safer, fixed investments such as bonds and annuities and 35% invested in stocks). Each year thereafter they would continue to make this apportionment according to their then age. So, for example, when they reach 70 years of age, their retirement funds will be invested 70% in safer investments and 30% in stocks.

One concern that the couple has is how they attain that initial 65%/35% split when they reach 65 years of age. They do not want to wait until age 65 to make the transition all at once in the event that the stock market might be substantially down at that particular point in time. The couple determines that a more systematic transition over time would better fit the bill. They will start the transition at age 55 and make the necessary reallocations 1/10th per year between the age of 55 and 65. Thus, at age 54 they would still be invested 100% in stocks. In the year they attain age 55, however, they will reappportion 6.5% out of their retirement wealth out of the stock investments and into the bond investments (1/10th of 65%). In the year they attain age 56, they will reallocate their investments such that a total of 13% of their retirement wealth is in safer investments and 87% remain in stocks, and so on until at age 65, 65% of their retirement wealth has been transitioned into safer investments and 35% remain in stocks.

NOTE: We are living longer now than ever before. The transition strategy I have illustrated may be too conservative if we end up living ten years more than our parents did. In light of this, you may want to be 10% more invested in stock at any particular retirement age and/or invest in safer stock mutual funds (see page 90) in lieu of entirely investing in bonds with the "safer" component of your retirement wealth.

A useful tool to assist you in analyzing this issue of transition in investments as you approach retirement age is provided on my Web site (click on Retirement Planning and then Retirement Income Calculator).

Mutual Funds vs. Individual Stocks and Bonds.

Virtually all profit-sharing, Section 401(k) plans and IRAs allow the participant/owner to direct the investment of retirement funds. Almost always a menu of "mutual funds" will be available to invest in. More rarely, the participant/owner will have the option of investing in individual securities such as a specific stock or bond. In order to competently analyze which way to go, you must fundamentally understand the difference between investing in individual securities (stocks and bonds) and investing in a portfolio of securities through a mutual fund.

A mutual fund is a convenient method for you to diversify your investment. Diversification is critical in order for you to protect your long-term investment. Think about this. Your greatest risk is not that you will lose money in the market. As I have mentioned to you, historically the market has been a fantastic place to invest over time. Thus, the risk that the entire market would crash (as it did in 1929) and stay down should not be a great concern to you (this kind of risk is called "Market Risk"). What is a much more realistic concern are other types of investment risk: Industry Risk and Company Risk.

Industry Risk is where the market as a whole is solid but an industry segment takes it on the chin. The inherent risk here is greater than that under the Market Risk analysis, but significantly less than what we encounter with Company Risk. For example, when rumors were afloat a few years ago that cost controls on Medicare reimbursements could be a significant part of adding a pharmaceutical prescription drug benefit to Medicare, publicly traded pharmaceutical benefit providers to nursing homes lost a significant percentage of their market value across the board. Concern about heavy-handed government involvement often causes harm to industry segments.

Company Risk is specific to a given company. If you put all of your eggs in one basket and invest heavily with a single company, you are rolling the dice and gambling to an

unnecessary extent. Yes, you might invest in a Microsoft-type company in its early years and look like a genius. More likely than not, however, you will find that investing in a single company can stagnate your investment or cause it to decline significantly over time.

All mutual funds eliminate Company Risk. By investing in a single mutual fund, you will be indirectly buying into the many different companies that the mutual fund has itself invested in. Most mutual funds also tackle Industry Risk by investing across industry lines. Some mutual funds, however, are designed to invest primarily or solely in a specific industry segment like healthcare or high tech. With the industry specific mutual funds, you are hoping the industry segment your fund is investing in will significantly out-perform the market as a whole. You run the risk that the industry segment will be sideswiped while the rest of the market marches on.

The average investor should not invest in individual stocks and bonds and be subject to Company Risk (an exception would be bonds issued by the federal and state governments where there is no risk of default). The risk is unacceptable, particularly when we are dealing with your retirement. Fight the urge to invest in a single company despite all the wonderful things you might hear about that company in the news or on the Internet or from a stock broker. Please don't do anything but invest in a well-diversified mutual fund.

I will tell you a personal story to drive home this point. My father-in-law invested heavily in a single company that traded on the prestigious New York Stock Exchange. This company appeared to have everything good going for it. Its revenues were growing annually and steadily, as were its net profits. It was in the nursing home related industry in that it provided prescription drug management for nursing home and other institutionalized residents. What could be a better company to invest in? The population is aging, a large segment of the elderly population is residing in nursing home facilities and prescription drugs are growing as a method of healthcare for the elderly. My father-in-law invested approximately \$100,000 in this company, set up a trust account to provide for the education of his grandchildren, and gifted the stock to the trust.

Then came the Medicare scare that I mentioned a little while ago. Despite the fact that this company has maintained itself as a superbly run company, still generating impressive revenues and net profit, the stock lost more than 75% of its value. The educational account my father set up, \$100,000 in one stock, declined significantly to about \$25,000.

The point is, and don't let anybody on TV or in a brokerage firm or friends or family tell you otherwise, **NOBODY KNOWS**. All we can do is trust in the future of the American economy generally and diversify. As I just explained, mutual funds allow us the diversification we **MUST** have in our retirement portfolio.

Remember, get rich slowly over time. Don't go for the big score. Rather be content (and relatively stress-free) to invest in our fantastic economy through a well-diversified mutual fund.

NOTE 1: Being a political junkie, I must digress for a moment and talk about the connection between political policy and economic growth. Particularly in an election year, you will hear politicians strongly connecting politics with the economy. This is largely a scam if the politician is connecting certain affirmative steps taken by the government with economic growth. Not too long ago, Japan tried to meld government action and subsidies with Japanese companies and destroyed the Japanese economy in the process. Any reputable economist will tell you that the less government does the better we are with regard to economic growth.

A reasonable-not excessive-level of regulation and taxation is what is called for. Otherwise, too high regulatory and tax costs make our American companies non-competitive in the world market and/or simply add to the cost of doing business. As with any cost of doing business, the company will add tax and regulatory costs to the price of the goods or services being sold. In that manner, the higher taxes and regulatory costs that a politician is screaming for ends up being just another regressive consumption tax (falling disproportionately harder on those least able to pay it) in addition to making the company less competitive. In other words, businesses do not pay taxes; they charge taxes.

NOTE 2: Like most of my friends in college in the early 1970's, I would probably have been accurately described as a borderline Socialist. But as I aged and matured-and most importantly, became better educated-I realized that American capitalism is a far sight different from how it is betrayed by the Hollywood crowd and the highbrowed intelligentsia that still largely populate our educational institutions. Rarely is there a greedy "Capitalist Pig" or conspiracy underlying an economic concept or trend such as the price for oil. Almost always there are market forces at work that are beyond the control of specific business people. Indeed, this is the fundamental beauty of capitalism. Barring a major monopoly or undue governmental pressures, free markets are largely beyond the control of humans and will naturally seek a logical equilibrium.

Picking the Right Mutual Fund.

Let's rehash the bidding at this point. We now have learned that investing in individual stocks and bonds is a bad idea for the average investor. Rather, investing through stock or bond mutual funds allows us to significantly diversify our investment and provide insulation against Company or Industry Risk. We have also learned that the longer until retirement, the more risk we generally should assume. To state this last point a little differently, the longer you have until retirement, the more inclined you should be to invest in stocks as opposed to bonds or money market funds. Having established these general parameters, we still have some work to do. Why? Not all stock and bond mutual funds are alike.

Stock Mutual Funds.

The investment companies that provide mutual funds might label them somewhat differently, but most provide different categories of funds with a different investment orientation. There can be a great number of variations in this investment orientation, but generally speaking we can establish five categories that just about every mutual fund company will offer (again, the names given these different funds might vary from mutual fund company to mutual fund company).

We will talk about risk tolerance relative to these categories momentarily, but first let's describe them. Let's take a look at one of my favorites, TIAA-CREF. TIAA-CREF is one of the world's largest investment companies. Up until a few years ago, only employees of educational institutions, tax-exempt organizations and governments could invest through TIAA-CREF in that TIAA-CREF could only receive Section 403(b) Annuity contributions (page 77). In more recent years, the general public has been permitted to invest with TIAA-CREF. I am advising you to strongly consider this company as a good repository for some or all of your IRA monies (your investment options in an employer-maintained retirement plan like a pension, profit-sharing or Section 401(k) Plan will rarely offer TIAA-CREF as an investment option). The TIAA-CREF Web page may be accessed from my Web site-click on Retirement Planning then Mutual Fund Companies.

Now let's see how they divide up their stock mutual funds and what the risk/return strategy is within those different funds:

An International Fund. An International Fund invests in worldwide companies (many or most of which are non-U.S. companies) that are stable international firms. As I mentioned to you earlier in the Retirement Planning analysis, America is the safest place in the world to invest. Nonetheless, international firms headquartered outside the United States frequently trend upward in value at times when United States companies aren't doing as well. Therefore, if we are trying to completely diversify our stock strategy, we may want to mix some international stocks into our portfolio.

A Growth Fund. In a Growth Fund the fund manager is attempting to beat the stock market's return as a whole by focusing on companies that appear to be undervalued or poised for extraordinary growth as has occurred recently in the high tech and biotech industries.

An Indexed Fund. An Indexed Fund seeks to track the rate of return of a common stock market index like the S&P 500, the Dow Industrial, or a broader based index such as the Russell 3000 (which indexes the stocks of the 3,000 largest U.S. companies traded on public stock markets). The fund manager attempts to duplicate the rate of return on the index by investing proportionately in the same stocks that make up the underlying index. Since there isn't much

guess work here (the fund manager is simply proportionately buying the same stocks that make up the index), the expense ratio (discussed in more detail under Doing Your Own Mutual Fund Research on **page 94**) is typically lower than on other stock funds.

A Growth and Income Fund. A Growth and Income Fund invests primarily in larger, well-established companies with a good dividend paying track record. Ideally, the fund manager hopes to have the value of the underlying stock grow at a reasonable rate. Additionally, the fund manager hopes to supplement that appreciation in value by above-average dividends paid by those same companies.

A Managed Allocation Fund. A Managed Allocation Fund will invest primarily in stocks but will also invest a significant amount of the fund's wealth (perhaps 25% to 40%) in bonds as well. The idea here is to provide some hedging on risk/return as will be discussed in the next paragraph.

Risk/Return on Stock Mutual Funds.

As we noted earlier, stocks generally have a higher historic rate of return than do bonds, but are riskier investments. Similarly, within stock mutual funds, there is a risk/return analysis to do as well. Focusing on the general categories of stock mutual funds I just described to you, the International Stock Funds and the Growth Funds have a higher rate of return in good times but tend to take it on the chin in poorer times. Therefore, the higher rate of return is tempered by the thought that it could turn around quickly in bad times. The Indexed Funds have a lesser rate of return than do the Growth and International Funds but are deemed less risky. The Growth and Income Fund is less yielding still but also less risky. And lastly, the Managed Allocation Fund (since it is hedging on the risk feature by investing significantly in bonds) has the lowest rate of return of the stock funds but is the least volatile. Thus, going from riskiest to least risky in our general description of stock mutual funds we move from the International Stock Fund to a Growth Stock Fund to a Indexed Fund to a Growth and Income Fund to a Managed Allocation Fund.

What should you do? There is no absolute answer here, but keeping to the book's KISS philosophy wherever possible, I will at least tell you what I do. My personal belief is that, if you are under 50 years of age and plan on retiring at age 65, you should be invested primarily in stock funds. This view should become much more the rule the younger you are. I am 52 years old. In my own personal retirement plan, I have been invested entirely in stock funds. Still I diversify within those stock mutual funds. I have not followed the advice of some in the industry and plopped my entire nest egg in Growth Funds. Rather, focusing on the stock mutual fund options I just gave you, I divide my retirement wealth between the first four stock funds in a way that favors American companies: The International Fund (10%), the Growth Fund (30%), the Indexed Fund (30%), and the Growth and Income Fund (30%). Thus, I am diversifying within the stock funds and giving up a possibly higher rate of return in return for tamping down the risk factor somewhat.

NOTE: Some investment advisors go overboard in an attempt to diversify within stock mutual funds. For example, I have seen situations where the investor is placed only in stock mutual funds, but is invested in 15 or 20 different stock mutual funds. The attempt here is to more significantly diversify (and maybe to enhance the commission paid to the investment advisor). I don't necessarily like this. If you do your homework (see Picking the Right Mutual Fund below), you will probably find that you can plop your nest egg into a reasonable number of funds that sufficiently diversify across the market (which is what I do, as I just described).

Use your common sense. Don't go wild investing in too many different funds. Conversely, if you limit your investments to just a few funds, make sure that each fund has a good historic track record and is itself internally well-diversified (like a Russell Indexed Fund).

Bond Mutual Funds.

Most mutual fund companies will provide a number of bond funds. For example, TIAA-CREF has multiple bond funds in its mutual fund options. These bond funds invest primarily in

various high-grade bonds (issued by both governments and private companies) of varying maturities. As we discussed earlier, bonds are generally considered safer (though lower yielding) investments relative to stocks. Still, there is some volatility to bonds and the inherent value of them change continually.

Bonds vary in economic value depending on a number of variables. When you invest in bonds the underlying value of the bond itself will continually change. Here is why. Remember that the interest payments on bonds are typically fixed. When I pay \$1,000 for my \$1,000 face amount, 10-year bond, paying a fixed rate of interest of 5%, the market is saying an 5% interest yield is a fair rate. Let's say a year later the market rate of interest goes up to 7%. Why would somebody pay me \$1,000 for my bond paying 5% when they could go out and buy a newly issued bond for \$1,000 that paid 7%? Therefore, the inherent value of my bond would decline from \$1,000 to reflect this difference. Conversely, if the market rate of interest went from 7% to 5%, my bond paying a fixed rate of 7% would go up in value as it is now paying more than a market rate of interest. In this manner, both individual bonds and bond mutual funds will go up and down in value continuously as market rates of interest change.

There is also a risk/return variable between short- and long-term bonds. A short-term bond is generally lower yielding since it is relatively safer than long-term bonds (safe both from the interest variation I just illustrated in the prior paragraph as well as the aspect that there is less risk that the issuer will go bankrupt before the maturity of the bond). A long-term bond should pay a slightly higher interest yield to offset the two risk factors noted in the prior sentence. With a government bond, the risk that the issuer will go bankrupt is virtually non-existent. So it pays to check the rates to confirm the short-term vs. long-term dichotomy I just mentioned. This is particularly true if you plan on holding the bond to maturity. This last approach (holding a bond until maturity if you invest in individual bonds) is strongly recommended by a number of respected financial advisors.

In the case of mutual funds, the investment company may orient its bond mutual funds so that one invests primarily in short-term bonds while another invests primarily in long-term bonds. An illustration of this can be viewed on-line by looking at the TIAA-CREF mutual fund page (go to my Web site, click Retirement Planning then Mutual Fund Companies and then

TIAA-CREF). You will see some good examples of varying types of bond funds. This company's Short-Term Bond Fund conforms to what I just told you relative to Short-Term Bond Funds. Similarly, the Bond-Plus Fund is a longer-term bond fund significantly invested in high grade bonds. Additionally, TIAA-CREF offers a High Yield Bond Fund. This Fund obtains higher than normal rates of return by investing in the bonds of lower-rated companies (called "junk bonds"). As I mentioned to you earlier, if the credit rating of a company is not optimum, the company will have to pay a higher interest rate on its bonds in order to sell them.

Asset Allocation and Establishing Your Risk Tolerance.

What have we learned so far? Generally speaking, stock mutual funds have a higher historic yield than do bond funds, yet stock funds are riskier than bond funds. Bond funds provide a stabilizing force in an investment portfolio. If the economy takes a distinct turn for the worse, the inherent value of bond funds generally will rise at the same time that stock funds are falling.

Having made my pitch to be more aggressive if you are a younger investor, let me remind you of the theme of this book, keeping things simple (the KISS strategy) and relatively stress-free. If you are the type of person who is going to lie in bed awake at night every time the market takes a temporary dip, then my personal strategy is not for you. After all, I am trying to advise you on how to make your life more secure and comfortable, and if you don't have the personality that allows you to comfortably ride the long-term wave, you need to face that reality. But how do you objectively come to a determination of what is a realistic risk tolerance for you? Ultimately, the function of the risk tolerance analysis is to provide you with an optimum break down of what you should invest in vis-à-vis different types of stock and bond funds.

If you work for a company and you are doing your retirement investing through your employer's profit-sharing, Section 401(k) or Section 403(b) plan, generally you will have a set menu of stock and bond funds that you can invest in. Either your company's human resources or employee benefit's person and/or the investment company providing the underlying investments can provide specific advice to you with regard to doing a risk tolerance analysis relative to that menu of investments.

How about doing it on your own? I have provided to you on my Web page (click Retirement Planning then Analyzing Your Risk Tolerance), the TIAA-CREF material to help you determine your risk tolerance. The Schwab site will also assist you in evaluating your risk tolerance.

NOTE: Incidentally, if you are wondering, TIAA-CREF does not pay commissions or otherwise compensate individuals like me who refer business to them. My interest in the company, and my recommendation of it to you, is that it simply is one of the finest mutual fund companies in the country and its expense ratios are exceptionally low. Study the company yourself via the Web links I have given you as well as under the next heading, Doing Your Own Mutual Fund Research.

Doing Your Own Mutual Fund Research.

At this point, you have an understanding of how stock and bond funds work over both the short and long-term. You have also thought about my statements on an appropriate long-term investment strategy and you have further done a risk tolerance analysis. At this juncture, let's say you have determined to invest 25% of your retirement funds in an S&P Indexed Fund, 25% in an International Fund, 25% in a Growth Fund, and 25% in a Bond Fund.

As you finish your asset allocation and risk tolerance analysis, you will have various mutual funds recommended for purchase. Whether you are investing through a company sponsored plan or on your own in an IRA, your analysis is not quite finished. You may want to do additional research on a specific fund that has been recommended to you. You may, for example, have the ability to invest in a variety of different funds in the same category. They all sound good and now the question is whether the Fidelity Growth Fund is better than the Smith Barney Growth Fund is better than the TIAA-CREF Growth Fund, etc. Each of these funds will have a largely unreadable prospectus that has been fashioned more for legal cover than providing a good summary of relevant data for the typical investor. Is there anything that provides a short and precise summary of relevant data? Yes, the big mutual fund rating service, Morningstar, does exactly that.

This service can be accessed through my Web site (click on Retirement Planning and then Morningstar Ratings). Morningstar will rate a fund from one star (worse rating) to five stars (best rating). Additionally, Morningstar will show the year-to-date, one-year, three-year, five-year and ten-year returns for the fund if the fund has been around that long. Although relevant, you should not become overly influenced by the more recent returns but should focus on the longer three or five-year return record for the fund and compare that return to industry norms which Morningstar also provides.

Also, the Morningstar service provides a feature that I find very helpful relative to risk/return ratio. Morningstar will note whether the particular Fund is below, at or above average return and will also note whether it is below, at or above average for risk. A good strategy might be to look for four star funds (a five star fund might be over-bought because of its highest ranking) where the return is above average but the risk is below or at average.

Additionally, and of great significance, Morningstar will also note the expenses charged by the fund managers. A fund's maintenance expense can vary widely from fund to fund. If the fund has a good historic and current rate of return, you should be willing to pay a higher expense ratio. However, bear in mind that an additional 1% expense comes off the top and could have a significant long-term effect. For example, a fund with a 1% expense charge that is grossing 12% for the year, will net you 11%, whereas a fund grossing 12% with a 2% expense ratio will net you 10%. If that rate of return held for two decades of investing, the 1% difference would cause you to have \$41,000 less in the higher expense fund than in the lower expense fund if you invested \$5,000 per year.

Morningstar will also note any "load" associated with purchasing the fund. The load is a one-time fee usually used to enable the mutual fund company to pay commissions to any salesman/broker. Loads in the 4-6% range might be charged up-front on the initial purchase (usually associated with "A" funds) or if the purchaser sells the fund within four years of purchase (usually associated with "B" funds). All things being equal, you should strive to purchase "no load" funds such as those offered through Schwab (go to my Web site, click on Mutual Fund Companies and then Schwab).

Lastly, Morningstar has an excellent library of articles on mutual funds and other investment topics. You can access this information from my Web site by clicking on Retirement Planning then Morningstar Ratings.

Obtaining the Services of a Professional Financial Advisor

As mentioned above, if you are a participant in a company-sponsored retirement plan of a larger employer, your company may have an Employee Benefits or Human Resources Department that will help you with many of your investment questions. If you invest in your own IRA, the mutual fund company that you invest through will provide free investment counseling services to assist you with your questions. Despite the information available through these sources, the information provided you in this book, and other information that you may acquire through the Web sites I have provided to you, you may desire additional and more sophisticated investment advice. This more sophisticated investment advice is warranted during your working years if the dollar amount of your plan assets has become significant relative to your annual salary. Another point in time when it may make sense to pay a financial planner for investment advisory services is when you are nearing retirement and you need help with the distribution options open to you under your retirement plan or IRA.

If you go this route, you will want to obtain the services of a financial planner who has obtained a certification of competency. One respected certification for financial planners is the Certified Financial Planner (CFP) designation (granted by the Certified Financial Planners Board of Standards). A second designation that assures that the financial planner possess a significant degree of competency is the Chartered Financial Consultant (ChFC) designation (granted by the American College in Bryn Mawr, Pa.). As is the case with the CFP designation, the ChFC is granted only after the financial planner has passed a rigorous battery of course work and tests dealing with sophisticated financial planning issues.

How do you locate a competent CFP or ChFC? If you look in your local Yellow Pages under financial planning, you will most probably see a number of potential candidates. Determining the individual CFP's and ChFC's competency level and ethical standards might be more difficult.

I have already mentioned to you on **page 47** how to locate a competent CPA through your state's Society of CPAs. The state Societies all have CPA referral services that provide some assurance that the recommended CPA is a competent one. A significant trend in the professional business community is that a number of CPAs are additionally obtaining the CFP designation. These CPAs might additionally or alternatively obtain the Personal Financial Specialist (PFS) designation from the American Institute of Certified Public Accountants. The CPA/CFP or CPA/PFS is a great choice for you in that your state Society of CPAs can help you with the referral and the individual who you retain can assist you with your taxes as well as educational savings and retirement planning.

Another approach would be to go with a CFP or ChFC who you heard through friends or family is an excellent financial planner. Always check out a referred CFP or ChFC both with the Better Business Bureau and Attorney General's Office in the state where you live. Go to my Web site, click on Miscellaneous and then State Governments to find your state's home page and information on your state's Attorney General's Office. Lastly, check with the Certified Financial Planner Board of Standards (for CFPs) to determine if any complaints or disciplinary actions have been initiated against a CFP who you are considering retaining (go to my Web site, click on Retirement Planning, then Finding a Professional Financial Adviser and then CFP Board). At the same location on my Web site you can also do a search for Certified Financial Planners and obtain a large amount of excellent consumer investment information from the Financial Planning Association of Los Angeles (click on FPALA).

Concluding Thoughts

In any case, don't jump to any conclusion with regard to your mutual fund purchases. Obtain all information that is available to you, if you are married study it carefully with your spouse, and think about what you have learned for a few days before making your ultimate decision. Try not to converse with friends and family about their investment strategy. You will always get individualized, anecdotal stories that may or may not reflect reality. Stick with the information the professional sources I have referenced are providing you. Then structure your investment portfolio within the parameters of your risk tolerance analysis. And remember, never invest in individual stocks and bonds, only in mutual funds.

EDUCATIONAL SAVINGS AND FINANCIAL AID

A large number of tax-favored tools are available to Americans to assist in funding their and their family's higher education expenses. The trick frequently is not finding a tax-favored vehicle to assist in college funding, but rather determining which of the various tools are most helpful and applicable to a particular person since using one may preclude you from using another. What I have provided to you in this section of the Book is a road map to enable you to understand the basic rules on all of these education-funding devices. After studying this Section of the book, you will be able to understand which tool or tools are most applicable to you.

I will present them in a particular order: the earlier described areas will be more attractive the lower your Adjusted Gross Income (pages 9-10), whereas the later described funding areas will generally be more attractive the higher your AGI. This all can get pretty confusing. I will add a summarizing matrix at the end of this Educational Savings section to help you do a final sorting.

Educational Credits

The first two items discussed, the Hope Credit and the Lifetime Learning Credit, are both types of Education Credits. Both of them provide a significant tax credit to the taxpayer. Recall the value of a tax credit from our earlier discussion under the Tax Planning Section at page 38. A credit reduces tax liability dollar for dollar. Thus, a dollar of tax credit is far more valuable than a dollar of tax deduction that merely reduces the tax base, Taxable Income, by one dollar. Therefore, you want to make sure that you avail yourself of these Educational Credits before moving on to the other tax-favored educational funding tools. Here is how the Educational Credits work.

Rules That Apply To Both The Hope Credit and the Lifetime Learning Credit.

Both credits are "non-refundable" credits. This means if these Educational Credits are more than your gross tax liability for the year (before crediting your federal income tax withheld by your employer) the excess is not refunded to you or is otherwise useable. (Look at page 39)

under the Tax Planning Section and review the analysis of refundable versus non-refundable tax credits).

Expenses that qualify for the Educational Credits are based on tuition and fees that you have paid for yourself, your spouse or a dependent. If you are paying this qualified tuition expense for a dependent child (a child whom you claim as a dependent on your tax return), only you can claim an Education Credit for that tax year. If you do not claim the child as a dependent, only the child, to the extent he or she pays qualified tuition expense with his or her funds, can claim the Education Credit for that tax year.

NOTE: The Instructions to Form 8863 (discussed below) provide a helpful rule. Amounts paid by a dependent child for his or her educational expense are considered having been paid by the parents when the parents are figuring out how much eligible tuition expense they have paid. The student is not eligible to take the credit directly as he or she is claimed as a dependent on the parents' return.

Tuition expense is qualified for the credit if it goes toward tuition and fees required for attending an "eligible educational institution." An eligible educational institution includes a college or university that is eligible to participate in a student aid program administered by the Department of Education. Thus, the definition covers just about all legitimate public and private post-secondary institutions of learning in the country. Qualified tuition expense does not include room and board expense.

Tuition and fees paid to such an eligible educational institution from your or your child's savings constitute tuition expense qualified for the credit. Additionally, tuition and fees that have been paid for via a student loan constitute payment of qualified tuition expense and can be factored into the computation of your Educational Credit. Not qualifying as qualified tuition expense for purposes of computing your Educational Credit are higher education expenses paid with certain tax-free monies. Thus, to the extent you paid tuition expense with tax-free money from scholarships or grants (discussed below), Employer Educational Assistance Programs (discussed below), Veterans' educational assistance monies, Education U.S. Savings Bonds (discussed below), Qualified Tuition Program (discussed below), or Coverdell ESAs (discussed

below), those expenditures do not count as payment of qualified tuition expense. The college will provide a tax form, Form 1098-T, which highlights qualified tuition expense that the family has paid as well as non-qualified tuition expense paid from a tax-free source.

NOTE: An Educational Credit generally may be taken in a year in which you use certain tax-free monies to fund some of your educational expense. For example, say you paid for \$2,000 of tuition expense from a tax-free Education U.S. Savings Bond or a Qualified Tuition Program, but the child's tuition expense for the year totaled \$5,000. You paid the other \$3,000 from other savings. You would have paid \$3,000 of "qualified tuition expense" and would be eligible for an Educational Credit in an amount detailed below.

The wonderful tax benefits provided by the Educational Credits are unavailable for upper-income taxpayers. If you are a married taxpayer filing jointly, the tax benefits of the Educational Credits begin to be phased out once your and your spouse's Adjusted Gross Income (see pages 9-10) hits \$90,000 (in 2006), and is completely phased out by the time AGI reaches \$110,000. The range is \$45,000-\$55,000 for single taxpayers in 2006 (\$94,000-\$114,000/\$47,000-\$57,000 in 2007).

You can compute the amount of your Educational Credits by filling out IRS Form 8863. Also look at Publication 970 – Tax Benefits for Higher Education, for additional information on the Educational Credits as well as the other tax favored educational funding tools discussed under this Section of the book. The Form is available under the Tax Planning section of my Web site (<http://www.personal.kent.edu/~maltieri/web/guide/home.htm>). Publication 970 is located at my Web site under the Educational Savings tab as well as under the Tax Planning tab.

More Information on the Specific Educational Credits: the Hope Credit.

To be eligible for the Hope Credit, the student must be enrolled at least one-half of the normal full-time course load for at least one academic term (either a semester or a quarter) for the tax year. As of 2006, the maximum Hope Credit is \$1,650 each year for the first two years of the student's post-secondary education. The maximum \$1,650 per year would be made up of

100% of the first \$1,100 of eligible tuition expenses paid plus 50% of the next \$1,100 of tuition expenses.

Lifetime Learning Credit.

This is the second of the Educational Credits. With regard to a given student, the Lifetime Learning Credit is taken in a year in which the Hope Credit is not claimed. Thus, you would normally use the Lifetime Learning Credit for tuition expenses after the first two years of post-secondary education. There is no limit on the number of years for which this Credit can be claimed for each eligible student. Unlike the Hope Credit, the Lifetime Learning Credit is not based on the student being enrolled at least one-half time. The amount of the Lifetime Learning Credit is 20% of the first \$10,000 of eligible tuition expense paid for the student in a given year. Therefore, the maximum Lifetime Learning Credit allowed in a given year is \$2,000 (20% x \$10,000).

EXAMPLE: Dick and Jane are married and file a joint tax return. Their Adjusted Gross Income is \$75,000 and they have two children, Bob and Laura. Both of the children attend school full-time and are claimed as dependents on their parents' tax return. Bob is in his senior year of college and Laura is in her freshman year of college. Laura's qualifying tuition expenses totaled \$6,000 for the year and Bob's were \$8,000 for the year. Dick and Jane may claim a \$1,650 Hope Credit (100% x the first \$1,100 and 50% of the second \$1,100 of tuition expense) relating to Laura's expenses. They may additionally claim a \$1,600 Lifetime Learning Credit (20% of \$8,000) with regard to Bob's expenses. Bob's expenses are not eligible for the Hope Credit because he is past his first two years of post-secondary education.

Go to my Web site, click on Educational Savings and then Educational Credits for more on-line information on these fantastic Educational Credits – the Hope Credit and Lifetime Learning Credit.

Educational Savings Bonds

Do you own a Series EE U.S. Savings Bond that was purchased after 1989 and you were at least 24 years old when you purchased it? If so, the interest increment of the Bond that would normally be taxable at the Bond's maturity may be excluded from your Gross Income (it is never taxed) if the Bond proceeds (both principal and interest) are used to pay tuition expenses. Tuition expense means essentially the same here as it did under the Educational Credit analysis: tuition and fees paid to an accredited educational institution for the taxpayer, the taxpayer's spouse, and/or dependents. As we saw with the Educational Credits, to prevent you from doubling up on tax benefits, you can't count as qualified tuition those expenses funded through the tax-free sources noted on [page 99](#). If the total amount of the Bond proceeds exceeds the qualified tuition expense not all of the interest increment will be excluded.

EXAMPLE: Mark cashes in a qualified savings bond to fund his son, Bryan's, tuition expenses. The redemption proceeds were \$6,000 (a tax-free return of principal (original cost) of \$4,000 and interest of \$2,000). Bryan's qualifying tuition expenses were \$5,000. Since the total redemption proceeds exceed the qualified tuition expenses, only \$1,667 of the interest increment is excludable from Mark's Gross Income (\$5,000 divided by \$6,000 times \$2,000).

If all of the Bond proceeds are expended for tuition and fees, the entire interest increment that would normally be taxable is excluded from income. The exclusion is computed on Form 8815 (available on my Web site under the Tax Planning section).

Your ability to take advantage of this income exclusion is phased out as your Adjusted Gross Income ([see pages 9-10](#)) goes up. For married taxpayers filing jointly in 2006, the exclusion begins being phased out once AGI hits about \$94,700 and is entirely phased out by the time AGI reaches about \$124,700 (the phase-out range for single taxpayers is approximately \$63,100 to \$78,100 of AGI). These phase out ranges are indexed for inflation, so they go up a little every year. Again, remember that to the extent the Savings Bond interest is excludable from your income, you cannot use that tax-excluded income to pay tuition expense that you are also counting toward an Educational Credit ([see page 98](#)).

For more information on Educational Savings Bonds, go to my Web site, click on Educational Savings and then Educational Savings Bonds.

Interest Paid on Student Loans

Recall from our discussion of **Exhibit 1 on page 9** that the best type of deduction is an Above-the-Line deduction as the deduction is allowable whether or not the taxpayer is an itemizer (only the Itemized Deductions are taken in lieu of the standard deduction amount). One of the few instances where a personal expense can be deducted as an Above-the-Line deduction is in the case of interest expense on student loans. Interest expense on virtually any type of student loan qualifies. The loan could have been used to fund tuition, books, fees, room and board or transportation expense. The loan must be used by a student enrolled at least half-time at an eligible (accredited) educational institution.

The maximum amount deductible each year is \$2,500 of interest expense on such loans. This deduction is available until the student loan is repaid.

Recall that in the earlier discussion of Educational Credits and Educational Savings Bonds there was a prohibition against “double-dipping.” For example, you cannot take tax-free funds (such as exempt interest on an Educational Savings Bond) to pay tuition with it and also have those payments count toward computing your Educational Credit. Here, however, there is a bit of “double-dipping” permitted.

EXAMPLE: Mark, (father) arranges to have Bryan (son) take out a student loan to fund his college tuition expense. Bryan is solely or jointly obligated with Mark to repay the loan. Bryan is Mark’s dependent in the year in which the tuition expense is paid. Since Mark can count Bryan’s loan proceeds as an amount Mark is considered paying for tuition (see the Note on **page 99**), the loan proceeds pump up the qualified tuition expense Mark is deemed to have paid for Educational Credit purposes in the year in which the tuition is paid. Four years later when Bryan graduates from college and is no longer Mark’s dependent, he begins paying back the loan. Presuming he is within the AGI limits discussed

below, Bryan will deduct the interest expense on the loan as an Above-the-Line deduction.

As noted in this Example, the person who is contractually obligated to repay the loan (as a sole or co-obligor) is the one who gets the deduction and furthermore that person cannot be a dependent on another taxpayer's return in the year in which the loan is repaid.

Once again we have Adjusted Gross Income limits that phase out and eventually eliminate the tax benefit for interest expense on student loans. For married taxpayers filing jointly, the phase-out starts at \$105,000 of AGI and is gone entirely at \$135,000. For single taxpayers, the range is \$50,000 to \$65,000.

For more on-line information, go to my Web site, click on Educational Savings and then Interest Paid on Student Loans.

Coverdell ESA

Another of the relatively new, innovative tax favored ways of funding higher education expense is the Coverdell Education Savings Account. The use of Coverdell ESAs was recently expanded to allow for the funding of elementary and secondary school expenses (as well as higher education expense) at both public and private schools. The ESA has a fundamental feature common to the Roth IRA we discussed under Retirement Planning (page 75). Like the Roth, the ESA does not provide a tax deduction in the year in which it is funded. However, there is never any taxation of the earnings or principal if they are withdrawn and used to pay qualified expenses which include not only tuition but also books, fees, supplies, room and board expense (if the student is enrolled at least half-time) and computers for school use.

The qualified Educational Savings Bond (discussed earlier) also yields tax-free interest income. The ESA, however, can be invested in higher yielding stock mutual funds. Unlike Qualified Tuition Programs (discussed below), where this investment transition is done for you, you will typically need to do it yourself in an ESA. If you invest in an ESA re-read the Transition of Investment Strategy section under Retirement Planning earlier in the book. In a nutshell, comparing that discussion to investing in an ESA, you should invest in higher yielding,

but riskier, stock funds until you are five or six years from needing the money, at which point you will start transitioning into lower yielding but safer investments. See for example, the investment options open to you in a Schwab Coverdell ESA by going to my Web site, clicking on Educational Savings and then Coverdell Education Savings Accounts.

Taxpayers may deposit up to \$2,000 per year into an ESA for a child who is under the age of 18. The child can get no more than \$2,000 per year from any and all sources — you and Grandma can't each give the child \$2,000 per year.

An attractive and flexible aspect of the ESA is that if the child does not need the money because he or she gets a scholarship or decides not to go to college, the wealth inside the ESA may be rolled over for the benefit of other family members.

Again we have an Adjusted Gross Income (see pages 9-10) phase out of the ESA benefit. The phase out starts out at a much higher level than we have seen in our prior educational funding tools: it begins at \$190,000 of AGI for married taxpayers filing jointly and is completely phased out once AGI reaches \$220,000 (\$95,000/\$110,000 for a single taxpayer).

More information on the ESA is available from my Web site by clicking Educational Savings off the main menu and then Coverdell Education Savings Account.

A Deduction for Higher Education Expenses

There is also a special deduction for taxpayers with qualified higher education expenses. Expenses that qualify for the deduction are based upon the same expenses that qualify for the Educational Credits, i.e. tuition and related expenses (not room and board) that have been paid for yourself, your spouse, or a dependent. The deduction is not available for single taxpayers who could be claimed as a dependent on another return. For 2006 and 2007, a maximum annual deduction of \$4,000 is available if your and your spouse's annual income is less than \$130,000 (\$65,000 for single taxpayers).

If a Coverdell ESA or Education Saving Bonds (discussed above) are tapped to pay tuition expenses, the higher education expense deduction is not available. Additionally, you may

not claim the deduction in the same year that you claim the HOPE or Lifetime Learning credit for the same student. Nor is the deduction available if you took a tax-free distribution from a Qualified Tuition Program (discussed below).

So far, we have seen that all our tax-favored educational funding tools are subject to Adjusted Gross Income limitations. Are any of the tools not subject to AGI limits? Yes, two, and both are equally usable and a good choice for upper, middle and lower income taxpayers alike: Employer Educational Assistance Programs and Qualified Tuition Programs.

Employer Educational Assistance Programs

Many employers provide an Educational Assistance Program as a fringe benefit to their employees, typically full-time or near full-time employees. Under these wonderful programs, the employer either reimburses the student/employee or pays the educational institution directly for tuition and fees. The economic benefit provided to the employee through the Program is an untaxed benefit of up to \$5,250 per year.

Both undergraduate and graduate instruction (full or part-time) qualify for tax-free treatment. “Double-dipping” is prohibited: you cannot use the value of your Employer Educational Assistance Program payment as qualified tuition payments in the computation of Education Credits (see page 98).

NOTE: If this benefit is available to you (even if you have to increase your work hours to get it), take full advantage of it. This is better than a tax credit or deduction that you otherwise are paying out of your wealth: it’s a tax-free gift from your employer.

As noted earlier, there is no AGI phase out of benefits under Employer Education Assistance Programs. More information on this benefit, excerpted from the relevant IRS Publication, Publication 970, is available from my Web site by clicking on Educational Savings.

Qualified Tuition Programs

A Qualified Tuition Program (QTP) allows a significant federal income tax benefit to families by allowing a tax exemption (like a Coverdell Education Savings Account or Educational Savings Bond) for earnings that accrue under the QTP. However, you may employ a QTP even if you don't qualify for a Coverdell ESA or an Educational Savings Bond because of the AGI limitations. QTPs are administered by various state agencies and vary significantly from state-to-state. Recent changes allow private educational institutions to establish their own QTPs. What you are doing under a QTP is prepaying college tuition, fees, books, and (if at least a half-time student) room and board expense.

A potential disadvantage to investing in the QTP is loss of control. You must rely on the investment programs available through the investment company. Contributors may not directly control the investments. This is contrary to Coverdell ESAs where investment decisions may be made by the contributor.

As noted earlier, there is no Adjusted Gross Income (pages 9-10) phase out of the tax benefits provided under QTPs. Therefore, as mentioned, it is the best educational savings tool for upper income taxpayers, but it is also a useful one for less well to-do taxpayers as well. When a QTP is finally tapped to pay college expenses, the income that has built up in the Program goes untaxed. This is a recent change to QTPs that will significantly increase their use as the higher education funding tool of first choice by taxpayers of all income levels.

EXAMPLE: Mike and Lisa are in the highest marginal tax bracket (Exhibit 2, page 11). Their daughter, Megan, is in the lowest 10% marginal tax bracket. Mike and Lisa make a non-tax deductible contribution of \$20,000 to a QTP to fund the future college education of Megan. By Megan's first year of college, the fund has grown from \$20,000 to \$40,000. The \$20,000 of earnings build up without being taxed and when tapped to pay for college expenses are not taxed to anyone.

There are two different types of QTPs. The first is a Pre-Paid Tuition Plan where future increases in tuition expense relative to the year in which contributions are made are covered. Thus, if you fund for your child's college expense ten years from now under such a Pre-Paid Tuition Plan and tuition expense increases an average of 4% per year over those ten years, you have earned 4% per year on your investment. If tuition expense increases 7% on average per year over the next ten years, you would be earning 7% per year on your investment. Typically, Pre-Paid Tuition Plans are limited to state colleges and universities under the umbrella of the particular state agency administering the Plan. Some state agencies have ceased to provide Pre-Paid Tuition Plans, having been burned by the stock market downturn in the early 2000's.

The second type of QTP is a College Savings Plan. These are like mutual funds in that nothing is pre-ordained. Whatever the College Savings Plan mutual fund grows to in value is what is available to pay tuition expense with. Thus there are risks and rewards. Under the College Savings Plan you can invest and get more of a stock market rate of return; however, if the mutual fund tanks you may earn little or nothing or even impair your original investment. The investment company through which you purchase your College Savings Plan will provide a systemic investment plan where typically more of the College Savings Plan assets are invested in stocks in the earlier years and are transitioned into safer bond-type instruments as the child approaches college age.

Thus, the type of QTP you pick (the Pre-Paid Tuition Plan or the College Savings Plan) can really be thought of as another study in risk tolerance (risk tolerance was analyzed in the Retirement Planning section at [page 93](#)). If you are risk adverse and like the idea of assuring future appreciation in tuition costs, the Pre-Paid Tuition Plan probably is the way to go. If you want maximum flexibility as to which educational institution is ultimately attended (public or private and in or out-of-state) and desire a higher (but riskier) market rate of return, the College Savings Plan would be the way to go.

An additional critical fact and another great advantage to funding a child's educational expenses through a QTP is its affect on the FAFSA application ([discussed later at page 113](#)). The ownership of the QTP is deemed to reside in the parent or grandparent setting it up. It is not deemed to be the property of the student who will benefit from it.

For a variety of source material on the fantastic QTPs, go to my Web site (at <http://www.personal.kent.edu/~maltieri/web/guide/home.htm>), click on Educational Savings and then Qualified Tuition Programs.

Educational Expense Matrix

The following matrix is a good summarizing tool. You can eyeball the different options a little more readily than my text allowed. The matrix has been adapted from IRS Publication 970, Tax Benefits for Education (go to [my Web site, click](#) on Educational Savings and then IRS Publication 970 to see or download the full Publication).

	Hope credit (Education credit)	Lifetime learning credit (Education credit)	Coverdell ESA	Traditional and Roth IRAs ¹	Interest Paid on Student Loans	Qualified Tuition Programs	Qualified U.S. Savings Bonds	Employer's Educational Assistance Program ¹	Higher Education Expense Deduction
What is your benefit? ²	Tax credit (non-refundable)		Withdrawals are tax free	No 10% additional tax on early withdrawal	Deduction to arrive at adjusted gross income (above-the-line)	Prepay future college expenses; withdrawals are tax free	Interest is excludable from income	Employer benefits are excludable from income	Deduction to arrive at adjusted gross income (above-the-line)
What is the annual limit?	Up to \$1,650 per student	Up to \$2,000 per family	\$2000 contribution per child under 18	Amount of qualifying expenses	\$2,500	None	Amount of qualifying expenses	\$5,250	\$4,000
What expenses qualify besides tuition and required enrollment fees? ²	None		Books, supplies, & equipment; Room and board if at least half-time attendance at elementary, secondary or higher educational institution (public or private)	Books, supplies, & equipment; Room & board if at least half-time attendance	Books, supplies, & equipment; Room & board; Transportation; Other necessary expenses	Books, supplies, & equipment; Room & board if at least half-time attendance	Payments to Qualified Tuition Programs and ESAs	Books, supplies & equipment	N/A
What education qualifies:	1st 2 years of undergraduate	All undergraduate and graduate levels							

	Hope credit (Education credit)	Lifetime learning credit (Education credit)	Coverdell ESA	Traditional and Roth IRAs ¹	Interest Paid on Student Loans	Qualified Tuition Programs	Qualified U.S. Savings Bonds	Employer's Educational Assistance Program ¹	Higher Education Expense Deduction
What other conditions apply?	Can be claimed only for 2 years; Must be enrolled at least half-time in a degree program; no felony drug conviction	Applies to expenses paid and for school attendance after June 30, 1998	Contributions not deductible; Must withdraw assets at age 30	Must receive entire balance or begin receiving withdrawals by April 1 of year following year in which age 70-1/2 is reached	Must be enrolled at least half-time in a degree program	Tax-deferred earnings go untaxed when withdrawn to pay qualified college expenses	Applies only to qualified series EE bonds issued after 1989 or series I bonds	Cannot also claim an education credit or higher education expense deduction	Not available if claiming hope or lifetime learning credit; if using educational IRA or educational savings bonds to pay tuition and some distributions from QTP's.
At what income range do benefits phase out?	\$45,000 - \$55,000 \$90,000 - \$110,000 for joint returns		\$95,000-\$110,000; \$190,000-\$220,000 for joint returns	N/A	\$50,000-\$65,000; \$105,000-\$135,000 for joint returns	N/A	\$53,100-\$78,100; \$94,700-\$124,700 for joint returns	N/A	\$65,000-\$80,000 \$130,000-\$160,000 for joint returns

¹ Any nontaxable withdrawal is limited to the amount that does not exceed qualifying educational expenses.

² You must generally reduce qualifying educational expenses by any tax-free income. You generally cannot use the same educational expense for figuring more than one benefit.

Tapping Qualified Retirement Plans To Pay Educational Expenses

Recall our earlier discussion of Traditional IRAs in the Retirement Planning section of the book. Remember that if you draw money out of such an IRA prior to reaching age 59-1/2, you not only have to pay regular income tax on it but generally have to pay a 10% excise tax to boot (see [page 74](#)). An exception to the 10% excise tax, however, is a withdrawal to pay tuition, fees, books, and (if at least half time) room and board. Regular income tax would still be owed but not the 10% excise penalty tax.

Although this is an option open to you, DO NOT DO THIS. It is one thing not to make a retirement plan contribution in a given year if other financial demands are extreme, but tapping

an existing retirement account (and paying regular income tax on it) should be a last-resort act. Why? You are eating your retirement seed corn.

Recall our discussion of the Roth IRA in the Retirement Planning on page 75. One of the favorable tax features of the Roth is the ability to withdraw a contribution (not earnings on those contributions) at any age without tax penalty. Thus, if you have a Roth IRA, tapping your contributions to it is a better idea than tapping into a Traditional IRA. Still, as I just discussed with regard to the Traditional IRA, I don't like this idea one bit. Again, you are eating your retirement seed corn.

The only option I think acceptable with regard to tapping Qualified Retirement Plans to satisfy educational expenses-and I very hesitatingly approve of this approach-is borrowing against your pension, profit-sharing or Section 401(k) employer-sponsor qualified retirement plan. I discuss the methodology for doing this in the Miscellaneous Section of the book at page 148.

Obtaining Financial Aid

Guidelines for and Forms of Financial Aid.

Let's say you are in the more typical situation of not having adequately saved for your and your family's college educational expenses. Now what? At this point, you will need to review the rules on obtaining various forms of financial aid and scholarships that might be available to you and your family members. Every family, regardless of income levels, should thoroughly explore potential college financial aid sources.

The best form of financial aid is so-called "gift aid," which does not have to be repaid. The most common forms of gift aid are grants and scholarships. Grants are frequently determined on the basis of the student's financial need while scholarships are typically awarded on the basis of merit and academic performance.

So-called "self-help" aid is assistance that must be earned or repaid. There are a variety of loans available to assist in financing college expenses. Some are "subsidized" loans (like

Stafford and Perkins loans) where the rate of interest is relatively low and that interest does not start to accrue or require repayment until graduation of the student. Unsubsidized loans might have a reasonable rate of interest but will start accruing interest immediately. Government and college subsidized work-study programs are another source of self-help aid that is readily available the more financially needy the student is.

Lastly, if the child is open to a four-year military career as an officer after graduating from college, ROTC scholarships and stipends are particularly generous. The ROTC benefit will cover at least two and up to four years of tuition, book and fee expense as well as providing a cash stipend of a few hundred dollars per month to the officer candidate. Another indirect benefit of the ROTC route is the fact that major corporations very heavily recruit management employees out of the armed services officer corps regardless of the individual's specific undergraduate degree.

Financial Aid Opportunities – Search by School.

How is this entire process initiated? As you explore the process through my related Web links (given below), you will see it is slightly more elaborate than I am briefly describing to you here. But the following is a good road map.

First, you, your spouse and the college-bound child will sit down with a good hard-copy college guide that you have picked up at the library or purchased. Some of my favorites are located at my Web site-click Educational Savings then click College Guide Books (you may obtain the noted books at virtually any public library if you do not desire to purchase them). There are also superb ways to do your college searching on-line. You can link to my favorite sites by going to my Web site, clicking on Educational Savings and then College Guides On-line.

After conducting your college review, you and your family will have tentatively picked out a half dozen or so college prospects for the child. Some may be public colleges and universities and others may be private colleges. At this point, do not presume out of hand that you will be unable to afford the additional \$10,000 or \$15,000 of annual tuition expense at the

private college. As we will see, typically the private colleges are well endowed and they have a lot of grant and scholarship money based on both financial need and merit.

So far you have tentatively picked out as many colleges and universities as you feel fit the needs and desires of your child. Now go to the Web site of each of these colleges to check up on available grants and scholarships that that specific college or university offers. After going to the appropriate college Web site, click on the Admissions tab. That category is where you generally will find information on grants and scholarships. The general College Guide books won't give you enough specific information although if you can get a paper catalog of the specific college or university (available at many libraries), you will be able to see details on grant and scholarship information.

Be prepared to be amazed at the number of opportunities available. The more that you are in financial need and/or your child is intellectually talented, the better off you are going to be to cash in on these opportunities. If you are both relatively poorer off financially and your child is gifted, you should be able to cover most or all of tuition, room and board. If your child is in this last category, the more expensive, private schools will actually be your better bet for a full ride.

NOTE: Throughout the book, I have pointed out to you some of the more egregious scams that are foisted on the public. Although what I am talking to you about now is not properly categorized as a scam, there is a potential for exploitation here. There are a number of financial aid services that are promoted to parents to provide the type of assistance that I am talking about. Most of these services charge a hefty fee to do what we have just learned you can readily do for yourself. Moreover, sometimes the service will do a less competent job of locating available money than you could do for yourself. Are all of these financial aid services scams? No. Indeed, the help of a professional in this all-important area can be very reassuring. But do tread cautiously here and by all means attempt to do the work yourself before you retain an outsider to help you. Also, you may want to look at a couple of superbly written books on financing college expenses written by clear experts in this field. If so, go to my Web site,

click on Educational Savings then Information on Financial Aid and look at the books written by Kristen Davis and the Barron's Guide.

There are numerous free-access Web sites providing general information on financial aid and the availability of grant and scholarship money. Go to my Web site (at <http://www.personal.kent.edu/~maltieri/web/guide/home.htm>), click on Educational Savings and then Information on Financial Aid. The best of these sites is the Department of Education's Finding Out About Financial Aid and Funding Your Education and the Web links off of them. Via the site, you will be able to obtain much of the information that people from financial aid services could sell you. The Department of Education's site is free, comprehensive, and an excellent Web starting point relative to what we have just talked about.

The FAFSA Application.

As you will see on the U.S. Department of Education's Student Financial Assistance site that was just referenced, part and parcel of the entire process of obtaining financial aid in any form (loans, grants or scholarships) requires the filing of the Free Application for Federal Student Aid (FAFSA). As you study the financial aid information provided by the colleges that you have selected, you will see the FAFSA heavily emphasized. The college will provide you with a Web link to the FAFSA homepage (or you can access it via my Web site click on Educational Savings and then FAFSA) that will allow you to file the FAFSA on-line. Alternatively, you can obtain a hard copy of the FAFSA from most public libraries or the financial aid office of the college that your child is interested in attending.

Any financial aid that is based on financial need – whether loans, grants or scholarships – will be predicated on your filing the FAFSA. Therefore, of all the various things we have talked about relative to financial aid, the timely filing of a complete FAFSA application is by far the most important single item.

It is wise to file the FAFSA as early in the applicable year as possible. If your child is entering college in the fall, you should have your FAFSA application filed by January or mid-February of that year. What information is included on the FAFSA? Your and your child's

financial resources will all be detailed on the FAFSA. Wealth owned in your child's name counts much more heavily toward the family's ability to pay than wealth in your and your spouse's name (in this regard, be wary of the time you gift property to your child as noted on the next page).

NOTE: The FAFSA will request your and your child's tax information from last year. If you are doing what I (and most colleges) advise and are filing the FAFSA in late January or early February of the year your child will attend college, you will be requested to provide information from last year's tax return—a return you probably have not yet completed since it is not due until April 15. What now?

The FAFSA allows you to estimate your tax information from last year if you haven't already filed your tax return. At this point, I would strongly recommend doing the following. Go back and restudy the information I gave you on computerized tax preparation software on [page 48](#). By the end of January you will have received your W-2 Form from your employer as well as miscellaneous other tax information from banks, etc. Purchase one of the tax preparation programs and use the tax information available to you by the end of January to create a draft tax return for last year. This process will force you to become familiar with the tax preparation software and will generate for you a tax return with numbers that are either exact or at least fairly close to being accurate. Again, the FAFSA specifically allows you to use those approximate tax return numbers to complete your FAFSA. Later, you will finalize and file your tax return and provide updated tax information to FAFSA if there were material changes from what you had earlier given them.

Gifts of Property to Children and Possible Effects on the FAFSA.

In the Tax Planning section of the book, we discussed generally the technique of gifting appreciated property to children (see [page 46](#)). I have just noted that a possible negative implication of increasing a child's wealth is that we diminish the possibility of the child obtaining financial aid to finance his or her college expenses.

More specifically, in completing the FAFSA, wealth that is in the child's name will count about three times more toward the family's ability to fund educational expenses than if such wealth was in the parents' name. Additionally, the parents' assets are buffered by an "asset protection allowance." The child does not get any asset protection allowance. Therefore, if you are using this tax planning technique of gifting appreciated property to the child to fund college expenses, you will want to time the gift so that it doesn't impair the FAFSA reporting.

EXAMPLE: Mark and Debbie are in the 28% marginal tax bracket (see [page 11](#)) on their ordinary income and a 15% rate of taxation on their long-term capital gains. Son Matt is 18 years old and is in the 10% bracket on ordinary income and is subject to a 5% rate of taxation on long-term capital gains (see [page 46](#)). Mark and Debbie own stock that they bought for \$1,000 that is now worth \$11,000. In completing the FAFSA, the value of that stock will count in the family's computation of ability to pay Matt's college expenses, but will be factored in at a lesser rate if the stock is in Mark and Debbie's name rather than Matt's name. When the family files Matt's FAFSA report, the stock is in Mark and Debbie's name.

On the basis of the FAFSA, Matt's financial aid office at his college grants \$5,000 of financial aid against the total \$15,000 cost for tuition, fees and room and board. At this point in time, it may be prudent for Mark and Debbie to transfer legal ownership of the stock to Matt and have Matt sell the stock in his name. This would affect tax savings of \$1,000 (the \$10,000 gain (\$11,000 sales price minus \$1,000 cost) taxed at Mark and Debbie's 15% long-term capital gain rate versus the \$10,000 gain taxed at Matt's 5% long-term capital gain rate). There should also be some state income tax savings here as well.

Matt would then take his \$10,500 of after-tax wealth (the \$11,000 sales price minus his \$500 tax cost) to help pay the remaining \$10,000 of tuition, fee and room and board expense.

NOTE: Recently passed legislation will significantly limit this technique beginning in 2008.

A Note on the SAT and ACT College Entrance Exams.

As we have discussed, there is a large amount of scholarship and grant money available to meritorious students. How do the college financial aid and scholarship people determine which students better merit scholarship money when the criteria is academic performance?

One of the disturbing trends in American education is the phenomenon of "grade inflation." What has happened in recent years at all educational levels (grade school, high school and higher education) is a marked increase in the grade point averages of students. Despite that general GPA increase, scores on standardized exams have stagnated or gone down. Thus, the inherent academic knowledge of American students has apparently not increased while GPAs generally have.

Although widely acknowledged in academic circles, the general public is not as familiar with this problem. The people who run college financial aid and admission offices are, however, well aware of it. Therefore, the student applicant's scores on the college admissions exams – the SAT and ACT – are often given more weight by admissions and financial aid officers than the student's GPA in the determination of that student's academic achievement.

Where am I going with all of this? Most colleges accept either the SAT or ACT score in the admissions and scholarship-awarding process. Check the admissions criteria for the school that you and your child have selected in order to confirm this. As I have just explained, a high score on the SAT or ACT will carry great weight in both the admissions and scholarship awarding process. With preparation, most students can greatly improve their SAT and/or ACT scores.

NOTE: As a parent, you can drive yourself to utter frustration trying to motivate your child to prepare for the college entrance exams. It is probably a distinct minority of high school students who have sufficient discipline and motivation to really attack the SAT/ACT preparation process (in my own family, maybe half of

my children have this ability). Remember the old adage, "You can bring a horse to water but you can't make him drink." This saying has particular meaning here. But if you do have a child who is motivated enough to prepare for the college entrance examinations, read on.

If you think your child is the type that will put in sufficient time and effort to prepare for the SAT and/or ACT exams, there are superb resources to enable that child to dramatically improve his or her scores. Excellent hard copy and computer programs are available to assist the student's SAT or ACT preparation (go to my Web site, click on Educational Savings then SAT/ACT Preparation Programs – these SAT/ACT sites also are excellent for general college searching and information on college careers and financial aid). My personal favorites are the Princeton Review and Kaplan courses. These courses have an excellent historic prospective on both the SAT and ACT exams, complete specific outlines of subject matter that will be tested and (most importantly) copies of old exams and model answers. Although the old exams are not repeated word-for-word, there is a great continuity in the style and substance of the questions. If your child spends sufficient time studying these old exams and the other related material, the child most probably will significantly improve his or her SAT or ACT scores.

NECESSARY LEGAL PROTECTIONS

Most of us would rather stay away from lawyers than embrace them. Retaining a lawyer can be a relatively expensive proposition. Nonetheless, there are certain legal devices and protections that all of us should take advantage of. We don't want to be penny wise and pound foolish in this regard. Here are the basic areas of legal protection that you should be informed about and further guidance on how to obtain necessary legal assistance.

Wills

All of us have seen the TV ads featuring a lawyer-looking actor promoting a "Do-it-Yourself" will kit (I will talk about these kits below). The ad always insinuates that if you die without a will, your property will be in jeopardy of being confiscated by the state. This is less than half-right. Only in the rarest of circumstances will the state obtain the wealth of a dead person. Every state in the country has a law called the intestate statute. If you die intestate (that is, you die without a will), the intestate statute of your state kicks in. What happens is that the dead person's property is left to his or her family under a "best guess" scenario. For example, if you die without a will and leave a surviving spouse but no children, your spouse will inherit all of your property. If you die leaving a surviving spouse and children, typically the surviving spouse will get one-third of your property and the children will divide up the balance of your wealth. If you die without a will and have no spouse, children, or grandchildren, the state law will then provide that your estate goes to your parents, siblings, etc.

So intestate succession laws assure that someone in your immediate family will succeed to your wealth if you die without a will. Where the TV ads are correct is that you lose the ability to direct where your wealth will specifically go. Another point that is of great importance to parents with minor children is that a will provides the vehicle to name the guardian of your minor children in the event that both parents are dead.

So it does make a great deal of sense for both you and your spouse to have a simple will to address these concerns. A simple will between spouses is commonly referred to as a "Mom and Pop" will. My wife and I each have one of these simple wills and I will use my own family's

situation as an example. My wife and I can cover our needs with these simple wills because in our current economic state, we are not subject to the federal estate tax (I will comment on federal estate taxation below) and otherwise (like most people) do not have a complicated estate to deal with.

Under Debbie's and my will, we attend to simple but very important hypotheticals. If I die and Debbie survives me, all of the wealth in my probate estate (I will define a probate estate below) is left outright to my wife. Also, my will provides for an executor. An executor is the person in charge of wrapping up my estate. My will states that if my wife has not predeceased me, she will be the executor of my estate.

Lastly, my will addresses what will happen in the event that my wife has predeceased me. First, it provides for the equal division of my estate between my children. Next, it specifically names a person who would act as executor of my estate in the event my wife is dead. Lastly, my will names a guardian for our minor kids (a person my wife and I have previously agreed upon and talked to about this role) who would have legal authority to raise the kids. My wife's will is the mirror image of mine, with me receiving her estate and being the executor of her estate in the event that she predeceases me.

How about buying your own cheap "Do-it-Yourself" will kit rather than having a lawyer prepare your will? If this is all you truly can afford, it is better than not having any will at all. However, I am strongly advising you to seek out an appropriate lawyer (I will tell you how in a moment) to prepare your will rather than doing it yourself. Why? Aren't lawyers just a bunch of exploitive crooks?

For the sake of full disclosure, if you have not already noted, among my various professional degrees and certifications I hold two law degrees and am a practicing lawyer. However, please believe the advice I am giving you on retaining the assistance of a lawyer. Although I do generally share the public anger against trial lawyers, the availability of competent, well-trained lawyers is a necessity in any orderly society, particularly ours. Although lawyers may appear to be exploitive and overpriced, generally they are honest, highly trained, intelligent professionals who are well worth the expense.

Even for something as relatively simple as a Mom and Pop will, a lawyer should be retained. In the process of preparing the will, the lawyer will frequently ascertain other legal problems that are highly relevant to the succession of your wealth. For example, a good lawyer will determine that the beneficiary designations on your retirement plans and insurance policies are current and name the proper beneficiary. I have seen and heard of many situations where a deceased parent or an ex-spouse is still the named beneficiary on retirement plans and insurance policies. Also, a lawyer should be consulted to implement the probate-avoiding strategies discussed below. All of this (and the peace of mind that will go with it) are well worth the legal expense it will cost you.

Once you have a properly drafted will, you will have attended to much of what lawyers, accountants and financial planners generally refer to as "estate planning." We are not quite done with the estate planning analysis, however, even if you are not wealthy.

Estate Planning

Estate planning is another area that is ripe for exploitation by various hustlers. You have all seen ominous advertisements in your local newspaper warning you that you must attend a certain financial advisory seminar or risk having the federal government confiscate 46% of your wealth at your death. It is true that the federal estate tax (which is a tax separate and distinct from the federal income tax) has rates of taxation as high as 46%. What the hustlers don't tell you is that only a very small fraction of the population is subject to federal estate taxation. Why? There is a large credit against the federal estate tax liability that insulates the first \$2,000,000 of wealth (rising to \$3,500,000 in the next few years) from estate taxation. Additionally, there is an unlimited ability to transfer wealth between spouses on an estate and gift tax-free basis. Lastly, there is a fairly bipartisan effort within Congress to limit the Federal estate (but not gift) tax.

NOTE: If Congress doesn't authorize its modification by December 31, 2010, the insulating credit noted above will revert to its 2002 level of \$1,000,000.

NOTE: If you are a small business owner or have accumulated a fair amount of wealth, do not ignore the federal estate tax. Unlike the income tax that is levied on an annual basis, the federal estate and gift tax is a tax on the cumulative wealth you have transferred during your lifetime and at death. Things that might increase your estate are common, big-ticket items like the fair market value of the home, life insurance policies, and retirement plan assets. For the small business owner and family farmer, the federal estate tax is something to be particularly wary of if death occurs before it is phased out.

EXAMPLE: Joe and Jane Smith incorporated a manufacturing business 30 years ago. The business has done very nicely and has expanded a number of times over the years. Joe and Jane, however, do not think of themselves as being particularly well-to-do. Between the two of them, they have never taken more than \$100,000 of salary out of the incorporated business, but rather have left the business earnings in the corporation to fund future growth and expansion of the business. Joe predeceases Jane, leaving all of his stock ownership outright to her at his death. Jane plans on leaving all of the stock at her demise to their son, Dick, who is active in the business.

Although the owners have derived limited current income from the business, that does not mean the value of it is insignificant. Say the value of the bricks and mortar, inventory, going concern value and goodwill of the company at Jane's death is \$15,000,000. Although at Joe's death there was no federal estate tax because of the unlimited ability to transfer wealth between spouses, at Jane's death the federal estate tax will come home to roost, based on a \$15,000,000 valuation of the business. The business may have to be sold, rather than transitioned to the next generation, in order to pay the resulting estate tax.

Controlling Probate Expenses and Stress.

As we just noted, the typical American will not be subject to the federal estate tax. However, as the old saying goes, two things are certain in life-death and taxes. A dead person is

legally known as a decedent. Although not typically subject to estate tax, a decedent's estate frequently will be subject to probate. Probate is the legal procedure for managing the distribution of a decedent's estate. The law is state (not federal) law and the court that has authority in probate matters is typically a county level court, designated the Probate Court.

There are a number of potential problems with the administration of a probate estate. First of all, the probate records are public records. Therefore, if the decedent's family desires to insulate the estate from public scrutiny, the probate estate needs to be limited. Also, expenses associated with the administration of the estate may rise as the value of the probate estate rises. Even if the probate estate is fairly small, there may be a Probate Court authorized minimum probate fee that is relatively significant. Lastly, surviving family members may be in need of assets which are tied up in the probate estate and are not released until approval of the Probate Court is obtained (frequently a lengthy process).

How do we reduce the probate estate? It is actually a very simple thing to do, particularly between spouses. Any property that passes by contract at death avoids probate. What are examples of wealth transfer in this category? What we are looking for are contractual provisions like the beneficiary designation on life insurance contracts and qualified retirement plans, or property that is owned by title or deed in "joint ownership with a right of survivorship." The "joint ownership with right of survivorship" form of ownership noted in a title or deed must use the correct survivorship language in order to work the way I will illustrate for you. Without the "right of survivorship" clause, jointly owned property is deemed to be owned by the owners as "tenants in common," which has very different legal implications and will not affect the avoidance of probate illustrated below.

Thus, in a properly planned situation, the expenses, stress and public disclosure of the probate process can be completely avoided. Also, most Probate Courts exempt smaller estates from any requirement to log in and be cleared by the local Probate Court. As I mentioned above, this planning scenario is particularly helpful in the case of spouses (the surviving spouse is typically the wife – on average, women are still killing us men off a few years earlier than when they die).

EXAMPLE: Mark's will provides that all assets that he owns outright at his death (assets that do not automatically pass to Debbie by operation of a deed or a contract) will be bequeathed to Debbie if Mark predeceases her. Mark and Debbie's principal assets are their home, Mark's Section 401(k) retirement plan, a \$500,000 term life insurance policy (discussed in the next Section of the book) insuring Mark's life, the couple's automobiles, and their checking and savings accounts. The home is titled to Mark and Debbie, as joint owners with right of survivorship (see NOTE below on a tenancy in the entireties). Debbie is named as the beneficiary under the Section 401(k) Plan in the event Mark predeceases her. Debbie is also named as the beneficiary under the life insurance policy. The automobiles are titled jointly with right of survivorship, and the checking and savings accounts are in the names of both of the spouses.

If Mark predeceases Debbie, she will by operation of law automatically become the legal owner of all the noted assets. All of these assets bypass Mark's probate estate. Other miscellaneous assets that Mark owned at his death (that are in his probate estate) are relatively insignificant in value. Due to the small size of Mark's probate estate, no formal proceeding need be initiated in the Probate Court. Per Mark's will, Debbie establishes legal ownership in the other miscellaneous assets that are included in Mark's probate estate. Other than filing a claim with the plan administrator of the Section 401(k) plan and a death claim with the insurance company, Debbie is relieved of the need to do anything further to solidify her legal interest in all of this wealth.

NOTE: I mentioned before the "tenancy in the entirety" form of ownership of the home between spouses. A limited number of states allow spouses to own their home as tenants in the entireties. It is a form of joint ownership with a right of survivorship-on the death of one spouse, the surviving spouse will own the entire property. The big difference is not on the death of one of the spouses but in the event of insolvency while both spouses are alive. In the event that one of the spouses becomes debt-ridden and insolvent, the home may not be sold to satisfy

that spouse's debt. If your state law allows spouses to own their home as tenants in the entirety, by all means assure that the home is titled in that manner rather than as joint tenants with a right of survivorship.

Living Trusts.

A living trust (not to be confused with a living will discussed later in this section) is a trust device used specifically to avoid probate expense. The idea with the living trust is to transfer legal ownership of all sorts of property to a revocable trust of which the grantor is the trustee. The trust becomes irrevocable on the death of the grantor and the disposition of the trust property is governed under the trust instrument. Therefore, since the trust property passes by the contract incorporated into the trust agreement, it bypasses the grantor's probate estate. This is a much more sophisticated way of avoiding probate. It is an inappropriate device for the typical American. For example, my wife and I have attended to our probate avoidance exactly as I just illustrated to you in the last Example. Therefore, there is not a need to do so by way of a living trust document, which merely adds another layer of complexity, confusion and expense to the mix.

NOTE: Although the living trust is a legitimate estate planning device for more well-to-do Americans (the legitimate uses of a living trust are noted at my Web site click on Legal Protections, then Living Trust), it is a commonly employed tool by marginal financial planners promoting services to lower-income Americans. Not infrequently, the living trust will be used by these advisors much like another generally legitimate estate planning tool, the charitable remainder trust (that I discussed along the same lines in the Tax Planning section on page 34). The simple methods of avoiding probate that I illustrated for you above are generally ignored in lieu of a more complex living trust arrangement. Additionally, these promoters frequently spin the living trust into something that it is not -- an income tax avoidance tool or, perhaps, an estate tax avoidance tool (without pointing out that most of the people being hustled are not subject to the federal estate tax). Always remember my advice with regard to these promotions -- if it sounds too good to be true, IT IS. If a promotion is going beyond the simple types of solutions I have outlined in this book and is being marketed to

lower or middle-income people, WATCH OUT. Ninety-nine times out of a hundred it's going to be a con job.

A Living Will and a Durable Power of Attorney.

A typical concern for the average American, yet one that is rarely planned for and addressed beforehand, is the possibility of an extreme and unexpected disability being suffered by you or your spouse. We read and hear about these horrible situations all the time, yet rarely do we think such an event could befall our families or ourselves.

Think about it for a moment. What would your family do if you had an accident that thrust you into a coma. In a worst case scenario you are "brain dead" yet still able to be kept alive through artificial means. This would be an ethical nightmare for your family and doctors (the doctors would also have certain legal concerns). Should the family "pull the plug" or continue to exhaust the family's resources and mental endurance by keeping you alive? Moreover, your family probably is not aware of what your desires would be in this situation, which just adds to the confusion and guilt of all concerned.

Throughout this book we have looked for sound but simple answers to our most pressing financial concerns. Frequently, we have found a relatively simple solution to something we previously thought was an uncontrollable concern or problem. Here we see another situation where the nightmare I just described can be completely and cheaply addressed before the problem arises.

Living Wills.

A living will is a legally recognized document under which a person states that he or she does not wish to receive unusual or extraordinary medical treatment in order to preserve his or her life. The living will typically rejects the use of life-extending medical procedures that would artificially delay the dying process. Rather, the living will will voice a preference on the part of the person to die naturally in such a circumstance. Such a determination, incidentally, is deemed morally acceptable by the major religions and it is distinguished from the unacceptable practice

of euthanasia (see, for example Section 2277 and 2278 of the Catechism of the Catholic Church-go to my Web site, click on Legal Protections, then Living Wills, then Ethical Considerations).

A Durable Power of Attorney.

A durable power of attorney (POA) is a legal document that gives someone the power to make decisions in your best interests and otherwise deal with your assets. The person who you are authorizing to act on your behalf is referenced in the document as the "attorney" even though that person does not need to be a lawyer. Obviously, the person designated as your attorney under the durable power of attorney document would be someone that the grantor of the power completely trusts. The grantor may revoke any POA at any time as long as the grantor is legally competent when the revocation occurs.

For example, I am designated the attorney on my father's durable power of attorney. The POA extends to Dad's real estate as well as his personal property. Therefore, to assure its enforceability, I recorded it in the same place that mortgages are recorded in the County Recorder's office where Dad lives. Thus, I am legally empowered to deal with any and all of Dad's real and personal property in the same manner that he could.

Why did Dad give me the POA described in the Example? A couple of reasons. If he was competent, but not physically present to effect a transaction involving his real and personal property (because, for example, he was out of the country), I could complete the transaction on his behalf. But the big reason is that if Dad ever became legally incompetent and/or physically or mentally incapacitated, I would have the legal authority to deal with his assets on his behalf. Without the POA, if Dad became incapacitated, his family would have to go through the time and expense to petition the local Probate Court to appoint a guardian on his behalf who would be so empowered.

Certain states allow for a more limited power of attorney that becomes effective only on the legal incompetency of the grantor. This type of power of attorney is called a "springing" power of attorney. Unlike the durable power of attorney that is effective from its creation, the springing power of attorney only becomes effective on the incapacity of the grantor.

Living wills and power of attorney documents are readily available as "fill in the blank" forms that may be purchased in bookstores or off of the Web. In the case of a living will, the form may be obtained from most hospitals. As was the case with your will, I strongly advise that you spend the few hundred dollars (ask for a quote in advance) that it will cost you to have a lawyer prepare your living will and power of attorney document. As we have discussed above, these documents are simply too important to mess up and they are among the cheaper legal documents that you can obtain from a lawyer.

Locating a Lawyer

OK, I have convinced you that you and your spouse are in need of these basic planning techniques and legal documents and that a lawyer should prepare them for you. How do you find a competent lawyer who has experience with these matters? If I was a person inexperienced with lawyers, I think I would proceed along the following lines. I would first start by looking up "Attorneys" in the Yellow Pages of my local phone book. There I would see all kinds of lawyers listed, and may focus on some in my immediate town who would be more convenient for me to see.

However, the phone book gives me only the name, address and phone number of the attorney (and maybe ads that may or may not be accurate). How would I verify that the attorney is competent? Many public libraries contain a set of books called the Martindale-Hubbell Law Directory. This set of books will be broken down on a state-by-state basis. Within the Martindale-Hubbell Directory for your state, the listings are further broken down city by city. In that listing you will see all of the attorneys practicing in that particular city.

Additionally, the Directory frequently provides much more detailed information on the attorney. For example, the attorney's area of practice is specifically described as well as awards and associations that that attorney has received or made. Any academic articles that the attorney has authored will also be noted. Lastly, and very significantly, many (not all) of the attorneys will have a Martindale-Hubbell rating. The AV and BV ratings are indicative of higher rated, generally more competent (but probably slightly more expensive) attorneys. A Web-based

version of the Martindale-Hubbell Directory is also available online (go to my Web site, click on Legal Protections, then Locating a Lawyer).

Just as state societies of CPA's provide CPA referral services (see my discussion of this on page 47), state and county bar associations frequently provide lawyer referral services. The more urban the county that you live in, the more likely it will be that the county bar association provides such a referral service. For example, I live in Cuyahoga County, Ohio (the Greater Cleveland area). The Cleveland Bar Association has an attorney referral service by legal specialty. State bar associations (always located in the capital of the state) frequently provide similar referral services.

LIFE INSURANCE PLANNING

Tax Advantages of Life Insurance

Before getting to the contractual aspects of life insurance contracts, let's first explore the highly tax-favored status of life insurance. As we saw in our earlier tax analysis, generally whenever there is an increase in our recognized wealth, there is a corresponding increase in our Gross Income (see Exhibit 1 on Page 9). One of the few exceptions to this rule is that death proceeds from life insurance contracts are income tax-free to the recipient (beneficiary) of those life insurance proceeds.

EXAMPLE: Mark maintained \$400,000 of life insurance on his life through the purchase of cheaper Term life insurance contracts (described below). His wife, Debbie, is the named beneficiary under those contracts. Mark predeceases Debbie and the life insurance company makes a lump-sum payment to her of \$400,000. After dancing on his grave, Debbie invests the \$400,000 in various forms of investments to provide income. The \$400,000 payment to Debbie is totally income tax-free to her. Income generated from the \$400,000 of principal, however, will be subject to normal income taxation.

There is also an income tax deferral benefit with regard to life insurance contracts within which there is a cash value element. Cash value life insurance policies are described in detail below.

Term Life Insurance

There are two broad categories of life insurance contracts: "Term" life insurance and life insurance with an investment component to it, generally referred to as "Cash Value" life insurance. Let's start with Term life insurance.

Term life insurance has no investment component to it. In other words, it is pure death protection without any cash value build-up within the policy. Therefore, Term life insurance is

significantly cheaper than Cash Value policies since all you are buying is the death protection rather than death protection and an investment.

Annual Renewable Term Life Insurance.

Since Term life insurance is solely death protection, in pricing the policy the life insurance company will charge a smaller premium in your younger years (when the actuarial risk of death is less) and will charge correspondingly higher premiums as the insured policy holder gets older. The best example of this is a type of Term life insurance known as "Annual Renewable" Term life insurance. Here the premium will change every year, increasing slightly each year as the insured ages. The policy is generally non-cancelable except for non-payment of premiums through a stated age – 65 or 70 (premiums generally become too expensive for most people's budgets about this age).

Level Term Life Insurance.

A variation on the Annual Renewable Term life insurance contract is a Term policy for which the premium is level for a 5, 10, 15 or 20-year period. If you are trying to budget your resources as tightly as possible, you could lock in your premium outlay over that chosen period of time. The level premium is generally guaranteed over the applicable term. Usually these type of policies have a conversion option and the policy may be converted to a more expensive Cash Value policy at any time within the applicable term (but is not automatically renewable into another Level Term policy at the expiration of the term).

We will talk about the great variations in cost of Term life insurance under the How To Shop for the Cheapest Term Life Insurance sub-section below. It could change the fundamental fact I am pointing out to you in this paragraph. When you buy a Level Term policy, all things being equal, you should hang on to the policy for the full 5, 10, 15 or 20-year duration. This is because the level premium policies are priced in a way that overcharges premium in the earlier years and undercharges it in the later years. Remember that with Term Insurance, the inherent premium cost of the policy increases over time as the insured ages. So if the premium is level for a 5, 10, 15 or 20-year period, the life insurance company must be accomplishing this

premium structure by overcharging at the beginning and undercharging at the end of the lock-in period.

However, because of competitive pressure, the price of Term life insurance (including Level Term) has declined significantly in recent years. With the general ease that consumers now have in shopping for life insurance policies (discussed below) and the decline in the cost of Term life insurance generally, you may not stay with the Level Term policy for its full term if you are insurable.

Group-Term Life Insurance.

Group-Term life insurance is another variation of Term life insurance. It is an extremely common form of fringe benefit that many employers provide to their employees. It is the employer who shops around not the employee. The employer purchases one large Group-Term contract from an insurance company under which each of the employer's full-time employees get individual life insurance coverage, usually based on a percentage of salary. The employer often pays for the entire premium cost for this type of insurance.

Although the employee is getting an employer paid life insurance benefit under this arrangement (thus providing another form of compensation to the employee), the employee usually receives the Group-Term life insurance benefit tax-free. Only when the employee received Group-Term life insurance coverage in excess of \$50,000 is there a small inclusion of additional wage income.

EXAMPLE: Mark and Joe are employees of Acme Corporation, which provides a Group-Term life insurance benefit to all of its full-time employees. The death benefit is one times annual salary. Mark's salary is \$50,000 and Joe's is \$75,000. Therefore, Acme provides Mark with Group-Term life insurance protection in a face amount of \$50,000 and provides Joe \$75,000 Group-Term coverage. The company's premium cost to purchase Mark's coverage is \$200 per year and is \$350 per year for Joe's. None of the \$200 of premium cost expended for Mark's benefit is included in Mark's income since the amount of Mark's Group-Term life

insurance protection for the year does not exceed \$50,000. Joe will have an income inclusion for the year that will be added to his wage income and reported on his Form W-2. The amount of the income inclusion will be based on the \$25,000 of insurance in excess of the \$50,000 tax-free threshold and will further be a function of Joe's age that year.

Mortgage and Credit Life Insurance.

Whenever you borrow money (for example, a mortgage loan from a Bank or a loan to purchase an automobile), the lender will almost always ask you if you desire to purchase credit life insurance. This form of insurance is decreasing Term life insurance (the face amount of the life insurance protection decreases every year). The purpose of the credit life insurance is to pay off your outstanding debt (which is decreasing over time as you pay it off). This sounds like a great idea, and, indeed, lenders sell a ton of Credit life insurance.

What do I think? Rarely, if ever, buy it. The reason is that it is the most expensive type of Term life insurance. If you do need additional death protection, buy more Level Premium Term or Annual Renewable Term life insurance. You'll get a much greater amount of coverage for the money. One instance where Credit life insurance is highly advisable is if you are otherwise uninsurable, as normal evidence of insurability may not be required.

Cash Value Life Insurance

Distinct from Term life insurance are Cash Value life insurance policies. A Cash Value policy has two elements: death protection and an investment. As noted above, Term insurance only pays a benefit on the death of the insured (since it is only pure death protection). A Cash Value policy, however, is available to pay wealth to the owner of the policy to the extent of the investment component whether or not the insured under the policy has died. Cash Value policies generally go by many different names, with Whole Life, Ordinary Life, and Universal Life being the more common labels. The distinctions between these Cash Value policies are often blurred and the different characteristics of them sometimes are combined, but I'll give you some general points of reference.

Whole Life and Ordinary Life Insurance Policies.

Under the more traditional version of this type of policy, there is a guaranteed, level premium for the entire life of the insured. The death benefit payable on the death of the insured often remains constant as well. The contract essentially has two component parts, decreasing term insurance and an increasing investment component: if the total death benefit remains constant at a \$100,000, as the investment component of the policy increases the death protection component of the policy necessarily decreases. In the traditional version of this type of policy, a cash value is guaranteed in that the policy will "endow" at a sum certain at a given age (65 for ordinary life and age 100 for whole life) as long as the premiums are paid in full until that endowment date.

Policy Dividends.

Many Whole Life and Ordinary Life insurance contracts make a payment referred to in the policy as a "dividend." Dividends paid on life insurance policies are very different than true dividends paid to the stockholders of a company. Whereas dividends paid to the stockholders of a company are taxable income to the recipient stockholders, "dividends" paid to the owner of a life insurance policy are considered by the IRS to be a rebate of premiums. Therefore, life insurance dividends and cash value withdrawals on a partial surrender of the policy are a tax-free return of some of the original premium costs of the policy. This tax-free treatment of life insurance dividends continues until the cumulative insurance dividends exceed the aggregate premium payment over the life of the policy. It is rare (at least for a number of years) that total policy dividends paid exceed total policy premiums and, therefore, the dividends paid to the policyholder usually are tax-free.

NOTE: Despite this general tax-free treatment of life insurance dividends, the insurance company might send you a Form 1099-DIV (generally associated with taxable dividends). Again, unless total cumulative policy dividends have exceeded total premiums paid over the life of the policy, you can ignore this Form 1099-DIV and treat the dividend as a tax-free return of your investment in the policy.

As an alternative to these tax-free policy dividends being paid to you in cash, another option typically offered under the policy is to utilize the policy dividends to buy "paid-up additions." Under this option, a small amount of fully paid-up insurance is purchased as each policy dividend is declared under the basic policy. These paid-up additions themselves may accumulate an additional cash value and/or pay an additional small dividend yield.

Another variation on this theme is the so-called "disappearing premium" policy. With certain of the better mutual life insurance companies, the policy might be structured in a way that after the initial years of policy maintenance the dividend yield off the policy will be sufficient to cover the entire annual premium cost. Under this type of policy design, premium costs in the earlier years of the policy are somewhat inflated such that the dividend yield off the policy by later years (9 to 20 years later depending on the company and policy design) is sufficient to cover the ongoing premium costs thereafter. Remember, however, that if the cumulative dividend return exceeds the aggregate premiums actually paid on the policy in its later years, the excess dividends will be included in the policy owner's income. This type of policy is a very good choice to the extent that maintenance of a larger amount of insurance until the death of the insured is desired.

I will talk about when this makes sense under the section on Shopping for Insurance. However, for most of us buying large amounts of insurance and keeping it in force until the death of the insured is not a good idea. Yet, even for those of us of modest means it will make sense to maintain some life insurance coverage until mortality to cover funeral and other death expenses. But it is often prohibitively expensive for typical Americans to maintain large amounts of coverage until they die. Rather, for the typical American, insurance should be maintained in significant amounts during those years when he or she is most in need of insurance-when there are children in the household and the income generated by one or both parents is necessary to get those kids through their college years.

Universal Life Insurance Policies.

Another broad category of Cash Value life insurance policies are called Universal life insurance policies. These policies, like Ordinary and Whole Life policies, have a cash value

element as well as a life insurance element. Unlike Ordinary or Whole Life policies, this category generally pays little or no policy dividend.

At the inception of the policy, the policy owner is expected to pay a level annual premium to fund the life insurance and cash value buildup under the policy. After the policy has been in force for a while and the cash value element has built up sufficiently (usually a year or two), the total death benefit under the policy typically starts getting bigger. Instead of continuing to pay the annual premium and allowing the death benefit to get bigger, the policy owner has the option of reducing the annual premium costs. The trade off would be that if the annual premium costs were reduced, the death benefit under the policy that had been increasing would either level off or reduce. Some years the policy owner might pay the full annual premium. Other years the owner might reduce or not pay any annual premium on the policy.

What is happening in the years when the annual premium is not being paid is that the cash value under the policy is being tapped to pay that premium. This scenario can't be maintained indefinitely: if cash values aren't accumulating sufficiently, the owner ultimately will be unable to maintain the policy in this manner.

Investment Options in Cash Value Policies.

Sometimes the owner of a Cash Value life insurance policy will have optional investments available for the cash value accumulating within the policy (the policy might be referred to as a "variable" life contract). One option might provide a lower but guaranteed rate of return (maybe in the 3% range). However, the upside rate of return on this type of investment option would generally be limited. This choice might, therefore, provide a rate of return similar to a long-term government bond and might appeal to someone who is generally risk adverse over the long-term per our earlier Retirement Planning discussion of risk tolerance (see [page 93](#)). Another choice to the owner of a Cash Value policy might be a portfolio of stock mutual funds. There is no guaranteed rate of return but the investment element has the ability to obtain more of a higher (but riskier) stock market rate of return. Here the owner needs to be less risk adverse. Again, we are looking at the same risk-return dichotomy that we studied earlier under our general Retirement Planning Base risk analysis.

Thus, if I direct the policy cash values to be invested in stock mutual funds, I can obtain a stock market rate of return. In the event that I die, the policy beneficiary would get the death proceeds under the policy as income tax-free life insurance proceeds even though that death benefit is comprised of the cash value element that was invested in stock mutual funds that would normally be a taxable investment. These facts are potent ones that are used to market Cash Value life insurance policies. One problem with investing in stock mutual funds available through life insurance contracts might be the administrative expense – the expense ratios and other costs might be relatively high.

As with Ordinary and Whole Life insurance, the purchase of Universal life insurance makes more sense as an insurance option for our long-term, relatively permanent, insurance needs.

When to Buy a Cash Value Policy

Let me first reiterate and highlight the positive aspects of Cash Value policies. As we have noted, Cash Value policies have two component parts: a life insurance element and the investment element. If the insured person under the policy dies, the policy pays a death benefit that is the total of these component parts. Remember I mentioned the tax advantages of life insurance policies: if the policy matures and pays off by reason of the death of the insured, the entire death benefit is income tax-free to the beneficiary receiving those proceeds. Thus, in the event of the death of insured, the cash value component of the policy is paid off tax-free whereas if the policy was simply cashed in by the owner without the insured dying, the cash value component in excess of premiums paid on the policy would be taxable. Another tax advantage of a Cash Value policy if the insured doesn't die is that the cash value investment element grows tax-deferred like in the qualified retirement plans we analyzed earlier under Retirement Planning. Not until the policy owner cashes it out is there taxable income to the extent the cash value exceeds the aggregate premium payments on the policy.

Therefore, Cash Value life insurance policies are frequently touted as a win-win investment that every American should have: if you die, the policy pays an income tax-free death benefit to your beneficiary; if you live and cash the policy out when you retire, you have another

form of tax-deferred retirement income in addition to your IRA's and other qualified retirement plans. Also, the insurance industry will frequently tout cash value policies as a form of forced savings.

Every one of these points is valid and true. Why then do I recommend that the typical American not purchase Cash Value insurance to satisfy the majority of his or her life insurance needs? Because there is frequently a better way to get the same results other than through the purchase of a Cash Value life insurance policy. I will explain in detail what those better ways are in a moment.

However, before leaving this discussion, let me highlight those occasions and times when the purchase of a Cash Value policy does make great sense. Even if you are most concerned about maintaining high amounts of Term life insurance during your working/child-rearing years, all Americans should plan on maintaining some Cash Value life insurance until they die. For example, regardless of how much wealth you have accumulated in your retirement plans and otherwise, it is sound wisdom to have a ready source of tax-free cash available to your family to fund funeral expenses and other death costs as well as to provide for living expenses until your other sources of wealth can be systematically tapped.

Because Term insurance becomes prohibitively expensive as the insured ages, it is unrealistic to attempt to carry Term life insurance until the death of the insured. But because of the ability to leverage the premium cost through the investment element, maintaining a life insurance policy until the death of the insured becomes much more feasible with a Cash Value policy.

What are some other situations when we can anticipate a need to maintain large amounts of life insurance until the insured dies? The following situations involve facts and circumstances that generally will not be encountered by the typical American. For example, if you are in the distinct minority of Americans who will be subject to a significant federal estate tax at your death, one of the ways of accommodating that ultimate estate tax liability is by getting a big slug of income tax-free life insurance proceeds on your death so that your estate has the cash liquidity to accommodate the death taxes. In that situation, since you don't know whether you are going

to die at the age of 60 or 100, the best way to assure that you have the necessary life insurance policy in force at your death is through a Cash Value policy.

Another situation that dictates the use of a Cash Value policy involves a profitable but closely-held (owned by only a few individuals) business. Frequently in these enterprises, the owners agree in advance that on their death, the company will buy back their ownership interest. The owners do this so that succeeding ownership can be restricted.

EXAMPLE: Owner A and owner B are happily working together. However, if owner A dies, owner B does not want to be partners with owner A's widow or some other family member. Owner A feels the same way with regard to owner B's successor. So owner A and B agree between themselves that the first to die will contractually mandate his estate to sell his ownership interest in the business back to the company, typically at a predetermined price. When one of the owners dies, the company now must come up with a large sum of cash to fund this extraordinary expense. Usually the best way to accommodate this expense is through company owned life insurance on each owner's life. When the first owner dies, the insurance company pays to the company (which is also the beneficiary under the policy) a large income tax-free death benefit to purchase the deceased owner's stock interest in the company.

If you do buy Cash Value insurance, plan on keeping it in force for at least 10 years. Cash Value policies are heavily "front-end loaded" in order to pay the selling agent's commission and will accumulate little cash value in the early years of the policy.

A More Typical Scenario – Buy Term and Invest

The vast majority of Americans, however, are not in the situations I just described. Frequently, Americans who own large Cash Value policies end up cashing it out when he or she gets toward retirement age. This typical approach ends up causing two very negative results. This typical American has 1) almost surely had way too little death protection during those years

when he or she needed it most, and 2) a less than optimum investment (the cash value investment element of the policy) to help fund his or her retirement.

So what is the alternative? A markedly better approach is to break up the two components parts of a Cash Value policy by buying the most economical Term life insurance policy for death protection and separately investing the cash value component of the policy in a tax-deferred investment. In other words, take the dollars you would have paid for the premium costs of a Cash Value policy and instead buy Term life insurance and invest the difference. This is a better approach for the typical American. This statement becomes irrefutable if you can buy Term insurance and invest the difference in a tax-favored retirement vehicle like an IRA (an alternative that is open to most of us). Let me give you an example of the unbelievable difference this approach can make.

EXAMPLE: Dave and Sharon are both 35 years old and have three children. Sharon works part-time but primarily is at home taking care of the children. Dave is the primary breadwinner. The couple's total combined Gross Income (see pages 9-10) is about \$65,000. After consulting with a life insurance agent, the couple decides to buy \$100,000 of life insurance protection. The agent convinces Dave and Sharon that a traditional Cash Value policy with a \$2,000 annual premium cost will best fit the bill.

The agent illustrates to Dave and Sharon that the policy will therefore cost a total of \$60,000 over the next 30 years until Dave's anticipated retirement at the age of 65. At that point in time the kids will be long gone and educated and the policy will have accumulated close to \$100,000 in cash value. Therefore, the agent logically points out there will be \$100,000 death benefit available for the next 30 years until retirement at which point the couple can cancel the policy and draw out a nice little nest egg to supplement their retirement income.

What the agent does not fully explain to Dave and Sharon is that the cash value accumulations will provide only about a 4% rate of return. Additionally, the agent does not explain to the couple what their alternatives would be under a

"buy Term life insurance and invest the difference in an IRA" approach, which was an investment available to the couple for all the years at issue.

How would the facts have changed if the buy Term and invest the difference approach had been followed? Let's assume that \$250,000 of term insurance, rather than a total \$100,000 death benefit, was maintained for all years prior to Dave's retirement. Remember that with Term insurance, the premium cost starts low and increases as the insured ages. Using some of the rates available from my Web site, 10-year Level Term rates for \$250,000 of coverage for a 35-year old male start out at \$140 per year. Using current rates, the annual premium would rise every 10 years to \$250 by the time the insured reached the 45-54-age bracket and \$600 per year for the 55-64 age brackets. Therefore, cumulative premium costs for a 35-year-old male for 30 years would be about \$10,000.

Also presume that Dave was taking the difference between the cumulative \$60,000 premium cost on the Cash Value policy and the \$10,000 cumulative 10-year Level Term premium cost just described and investing the difference in a Roth IRA. Recall from our discussion of Roth IRAs under the Retirement Planning section on [page 75](#) that a contribution to the Roth is not currently tax deductible but when wealth is withdrawn from the Roth on retirement nothing is taxable. Dave invests the IRA money in a relatively safe stock mutual fund, like the TIAA-CREF Growth and Income Fund described on [page 90](#), where a long-term annual 9% - 10% rate of return is very realistic. By age 65, the Roth IRA would have accumulated about \$325,000 of wealth – all of which would be available tax-free, whereas the cash value in excess of the total \$60,000 premium expense over the life of the policy would be taxable to Dave and Sharon under Scenario 1.

You see in the Example how short changed you would be under the traditional Cash Value life insurance approach. Under that approach, in your younger years when you really need more insurance (the kids are at home and aren't yet through their college years), you are

significantly under-insured in terms of what you need by way of death protection (we will try to more exactly quantify the amount of death protection you actually need below). Also, as is the case with the vast majority of us, you do not die before your retirement years and end up cashing in the policy at retirement as a supplemental retirement benefit.

Under the buy Term life insurance and invest the difference approach, we see a markedly better result, as illustrated in the Example. During the years when you need more life insurance (and the cost of Term life insurance is cheaper) you are able to buy an appropriate, and much larger, amount of death protection. As icing on the cake, the growth and wealth in your IRA will likely provide you with significantly more wealth accumulation by retirement age than the cash value element did under the traditional Cash Value life insurance policy.

NOTE: Although this is the better approach for the typical American, a saving grace with regard to the traditional Cash Value life insurance policy is that it is a "forced savings" program: you must pay the entire premium and on paying it you have both the life insurance protection and your cash value build up. On the other hand, the buy Term and invest the difference approach requires the discipline to devote the same total cash outlay in two directions. If you break down and pay the Term life insurance premiums but not the contribution to the IRA, the whole logic of the preferred approach breaks down. Like many things in this book, a basic budgeting and disciplining process is necessary to reap the reward. Remember that it's simply not that difficult to accomplish. You can do it-and in doing it will make your life immeasurably less complex and stressful.

How Much Insurance Do I Really Need?

We have already noted that the typical American needs more life insurance protection in his or her early years than in later years. Why is this? The need to replace the lost income of the deceased person is obviously greater when children in the family are younger and still need to be supported and educated and/or where the surviving spouse needs or desires to be at home with the children. Also, if you proceed with the Retirement Planning outlined in this book, you will

be accumulating significant amounts of wealth by your later years to either live on or pass on to your heirs. Let's look at an example.

EXAMPLE: Mark maintains about \$500,000 of Term life insurance coverage. He thinks that is a lot, maybe even an excessive amount of coverage. In reality, Mark is significantly underinsured. Let's look a little more closely at the underlying facts. As a professor, Mark generates a very nice income of about \$100,000 per year. However, that money goes fast with six children to raise and educate with the oldest two in college. Mark's wife, Debbie (the real worker in the family) is at home with the kids, organizing and providing for them.

A simple but relatively accurate rule of thumb in measuring Mark's life insurance needs would be to calculate a principal amount that at a fairly high rate of return would generate enough income (without touching principal) to make up for his lost income. Let's take a 7 or 8% rate of return, which would be a fairly good number for a relatively safe stock and bond mutual fund like the TIAA-CREF Managed Allocation Fund described back on [page 90](#). It would take a \$1,250,000 of life insurance proceeds invested at 7% to throw off \$100,000 of income to replace my lost wages. Mark would like to leave the \$1,250,000 of principal alone so that Debbie would have that amount when she reaches her retirement age as a substitute for the wealth Mark would have accumulated under his qualified retirement plans and IRAs if he hadn't died. If Mark were a very risk adverse individual who would not trust the mutual fund to provide a relatively steady 7 or 8% rate of return, and instead wanted a guaranteed rate of return as would be provided under a government bond returning 3.5 or 4%, Mark would need to double again the amount of my life insurance coverage.

As the children get older and through college, and the corresponding expenses of raising the kids and my wife's need to be at home with them decline, Mark can start tapering off the amount of life insurance protection. Again, remember that Term life insurance gets more expensive the older we get so this

decline in coverage would correspond nicely to the cost of the underlying insurance: as the insurance becomes more costly, Mark needs less of it.

So you see from this Example how very underinsured many of us are. The only way that most of us can afford an amount of life insurance approximating what we really need is to buy Term life insurance.

How to Shop for the Cheapest Term Life Insurance Rates

As I mentioned earlier, Term life insurance is a very low commission sale for the life insurance agent. Therefore, it is only the most charitable agent who will promote Term life insurance. So you are either going to have to ask your agent about it or shop for it yourself as I will describe to you now.

Many of us have the availability of so-called "affinity" benefits via an association or group that we belong to. For example, I am a member of the American Institute of Certified Public Accountants. The AICPA offers a menu of benefits to their members. It so happens that after shopping around, the very best Term life insurance rates I could find were the AICPA affinity rates.

This may be the case for you as well with affinity benefits that you might have access to through AAA or AARP or others. But don't jump at the first affinity promotion as being the best for you. Through my membership in a variety of other professional associations, I also have a number of other affinity Term life insurance rates available to me as well. None of them come close to the AICPA rate (or, in most cases, rates of insurance that anyone can buy through the sources I will describe to you now).

One of the many great things about America, and why our general cost of living is so much less here than in the rest of the world, is competition. Significantly increasing our access to competitive rates on Term life insurance is our old friend, the World Wide Web. There are a number of excellent Web sites available that will allow us to confidentially and easily shop for the best Term life insurance rates.

Before going to the Web site, recall how Term insurance is priced. Term insurance, being pure death protection without an investment element, becomes more expensive as the insured grows older and the actuarial risk of death increases. Thus, all things being equal, Term life insurance costs per \$1,000 of coverage should increase a bit every year as the insured under the policy ages. As we also noted earlier, if premiums are level and guaranteed over a 5, 10, 15 or 20-year period, as in level Term life insurance (page 130), what is theoretically occurring is an overcharge in the earlier years of that period (when the actuarial risk of death is lower) and an undercharge in the later years of the period (when the actuarial risk of death is higher). Therefore, Annual Renewable Term Insurance (page 130) should theoretically be the most economical form of insurance since it readjusts in one year increments.

In the real world, however, the theoretical norms are frequently distorted. For example, in today's insurance market, it is not as easy to find Annual Renewable Term life insurance (ART) as it used to be. Moreover, when you do find ART available, it is often priced higher than other Term policies. For example, if you go to the TIAA-CREF life insurance cost calculator (go to my Web site, click on Life Insurance Planning and then TIAA-CREF), you will see that \$500,000 of ART on a 48 year-old, non-smoking male (me) has a first-year premium cost of \$950 and increases each year thereafter. However, if you go to the Quotesmith Premium Calculator (at the same site), you will see that the 10-year Level Term rate for that amount of coverage can be obtained from an excellent company for \$550 -- \$600 per year guaranteed level for that 10-year period.

Why the dramatic difference in premium costs between the ART and Level Term policies? You have to be aware of the underlying policy provisions to understand this. The TIAA-CREF policy is guaranteed renewable through age 70 whereas the Level Term policies are guaranteed only for the 10-year period. If you're health deteriorated, you could continue to renew the TIAA-CREF policy through age 70. Whereas, with the Level Term policies, if your health deteriorated you would either have to find new insurance (which would be hard if your health is seriously in question) or you would have to convert the Level Term policy to a much more expensive Cash Value policy provided by the insurance company by the end of the 10-year term.

So it is a bit of a roll of the dice and a "pay me now or pay me later" dichotomy. What would I do? If your health is good and you have no family history of serious disease, I would not hesitate to obtain one of the lower priced 5 or 10-year Level Term policies. If your health remained good, you could continue to shop around for newer and cheaper policies. If your family health history is not so good (or you are more risk adverse and wanted to play it safe), I would give more consideration to a longer 15 or 20-year Level Term policy or a Cash Value policy.

NOTE: There are two big reasons for not shopping around for newer and cheaper insurance but rather staying with your old insurance company. If your health has worsened or (in a worse case) you have become uninsurable (because of extreme health problems), the last thing you want to do is cancel your existing life insurance policy. Also, under the insurance laws of most of the states, an insurer can contest paying a death benefit if death occurs within two years of the policy being taken out and the insurer demonstrates that the policy owner misrepresented substantial facts on the life insurance application. Additionally, most life insurance policies include a two-year suicide clause. If the insured under the policy commits suicide within two years of the policy being taken out, the insurer does not have to pay. Once the policy has been in force for two years, the owner need no longer worry about a contested claim by the insurer under the incontestability and suicide clauses of the policy.

Since the vast majority of us do not misrepresent substantial facts on our life insurance applications, do not plan to kill ourselves, and are in good health, there is no reason (other than the time it takes) not to regularly shop the life insurance market for the best and cheapest Term life insurance available. This way, the typical American can keep his or her eye on the ball and more realistically provide an adequate amount of death protection.

I have made available to you excellent sites to price and purchase Term life insurance at the best rates. Go to my Web site and click on Life Insurance Planning. If you are in the less common situation of needing a Cash Value policy because you plan on maintaining the policy for an extended period of time, it is best to deal directly with an experienced life insurance agent.

In my estimation, the finest life insurance company in the country for the provision of quality Cash Value life insurance products is Northwestern Mutual Life Insurance Company. You can find local agents in your Yellow Pages under Life Insurance or check them out on my Web site. TIAA-CREF is listed as well and that company also provides quality Cash Value products and good counseling over the phone.

MISCELLANEOUS — OTHER MAJOR ITEMS THAT DIRECTLY IMPACT
YOUR FINANCIAL WELL-BEING

Consumer Interest Expense

This book detailed two situations where you can obtain a significant tax deduction for the interest expense you pay on borrowed monies. The first was the home mortgage interest expense (explained at page 16). The other was the deduction that you or your child may obtain on interest expense paid on a student loan (see page 103).

Now let's talk about another form of interest expense that you are likely paying: interest expense on consumer debt. Consumer debt comes in many forms. For example, the interest expense on your family car loan, the financed refrigerator or television set you bought from Sears, and last but not least, the interest expense on your personal MasterCard, Visa or Discover Card. There are a number of problems with running up consumer debt apart from the fact that it probably eats into a large amount of your disposable income.

Let's start with the fact that interest expense on consumer debt is not tax deductible. Add the fact that you are probably paying a very high rate of interest (10 – 15%) and you come up with a horrible mix. If you are hip deep in this common problem, here are some things to consider.

If you do have cash reserves, use them to pay off the entire balance on your credit cards. It makes no sense to be earning 3 or 4% on a certificate of deposit when you are paying 10 – 15% on non-deductible consumer interest expense. What if you don't have readily available cash reserves but do have assets you could liquidate to pay down the consumer debt? If you have assets other than your home and outside of your retirement plan, strongly consider liquidating them (remember that if they are appreciated in value there will be a taxable gain – a capital gain – on their sale) and use the after-tax sales proceeds to pay off the consumer debt.

In certain cases, I might advise that you utilize your retirement plan assets if you are a participant in a company sponsored pension, profit-sharing or Section 401(k) plan. You would

do this only if you took the necessary steps (discussed below) to assure that you would not simply run your credit card debt back up again after pursuing this strategy. Here it is.

Most company sponsored retirement plans allow participants to borrow against their account balance in the plan. Most plans additionally allow participants to secure such loans from the plan by the participant putting a second mortgage on his or her home as collateral. Generally, because of the mortgage security, interest expense on this retirement plan debt would then be an Itemizable Deduction as mortgage interest expense (see page 20). To make it even better, what you are doing at this point is repaying what you owe to yourself. That is, the principal and deductible interest expense you are repaying the plan is all being credited to your account balance under that plan.

Where to Get Help on Credit Problems

Back in the Budgeting section of the book (page 4), we noted that a formula for disaster is to borrow money on your credit card to meet recurring and non-recurring expenses. If you engage in that type of credit card use repeatedly and in an undisciplined manner, you will quickly run up a balance that you will not be able to easily repay. As we have just noted under the Consumer Interest Expense analysis, the interest expense you pay to the Bank issuing the credit card is nondeductible consumer interest expense. Additionally, Visa, MasterCard, or Discover Card debt is almost always unsecured. Therefore, you are likely paying a very high rate of interest (maybe triple the prime rate of interest that banks charge their most credit worthy customers).

At this point, you are something of a slave to the bank – probably just making the monthly minimum payment and doing little to pay down the principal amount of the debt. If, as often happens, you continue to borrow on the card, you are merely compounding the problem. What are you to do when things seem impossible to control and a bad problem just continues to get worse?

As mentioned above, if you have any source of cash, utilize that cash to pay down your cards and then cut them up. Utilizing available cash to pay down credit card debt is particularly

advisable if your cash reserves are earning a return that is less than the nondeductible interest expense you are paying on the credit card debt.

What if you don't have the cash reserves? Many individuals simplistically think of filing for personal bankruptcy in this situation. This is not the way to go if you find yourself in this predicament. Going through a personal bankruptcy will significantly harm your financial universe. Although certain assets such as a limited housing allowance and your retirement plan assets may be exempt, virtually everything else will be liquidated to pay for the attorney's fees and to provide some repayment to your creditors. Additionally, your ability to borrow money and otherwise obtain credit will be impaired long-term. Also, the implications of this are far reaching – your name will be financial dirt far into the future.

A much more advisable route would be to attempt a negotiated settlement and workout with your creditors. There are many resources and public interest groups available to assist you in this process. The function of these advisors is to negotiate with your creditors, write down some of your debt obligation and to go through a budgeting process (not unlike what we did in the Budgeting section of this book) that will take into account your assets and cash flow and formulate a workable monthly debt repayment methodology. A big part of this counseling will be an examination of why financially and psychologically you created this significant debt in the first place. You can find these debt counselors listed in the Yellow Pages or you can study those available at my Web site by clicking on Miscellaneous and then Debt Counselors.

Emergency Rainy Day Fund

One of the first things we studied in this book was how to establish a budget. The Budgeting section of the book (page 4) introduced a process by which we determined our in-flow (our revenue stream) and reasonably estimated our recurring monthly expenses as well as our significant non-recurring expenses (our out-flow).

In addition to necessary living expenses that we all must budget for, there are discretionary items we discussed in the Budgeting section that must be worked into your budget. Leading this list would be contributions to a Section 401(k) plan (discussed in detail in the

Retirement Planning section of the book) that you are eligible to participate in or your contributions to an Individual Retirement Accounts (also discussed in the Retirement Planning section of the book) if you are not participating in a company-sponsored retirement plan.

Let's say you have done this and after calculating your revenue stream you find that your recurring and non-recurring expenses are less than revenue. Congratulations, you have a surplus. There are many wise things to do with your surplus wealth. This book has been devoted to chronicling savvy things to spend your money on, from maximizing your accumulations of retirement wealth, to adequately funding for your, your spouse's and your dependent's educational expenses.

In addition to these all-important investments, ideally you will find enough wealth to set up a "rainy day" fund. The purpose of the rainy day fund is to accommodate large expenses that could not be reasonably anticipated in the normal budgeting process. Some examples would be major, unanticipated car expenses and uninsured health care costs. Wouldn't it be nice if you could tap your rainy day fund for \$2,000 to pay for having your engine or transmissions rebuilt at a point in time when your vehicle is still relatively new but, of course, just past the warranty period.

When you go through your normal budgeting process, think about devoting \$30, \$40 or \$50 per month toward a rainy day fund. You can set up an interest bearing money market account (see the Budgeting section on page 4) and start methodically building up this fund.