CREATIVE Wealth Maximization Strategies

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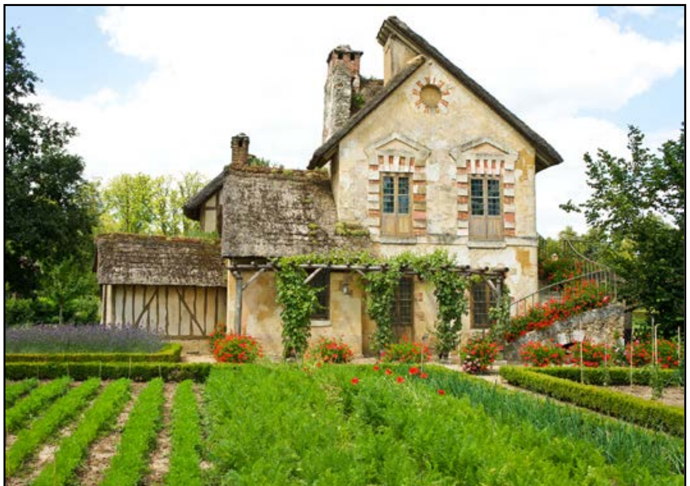

"If you do not look at things on a large scale first, it will be difficult for you to master any strategy."

Miyomato Musashi, 1643 AD

A BETTER WAY TO BUILD

Ever seen a "Goodyear" house? Most Goodyear houses are at least 100 years old, and are typically found in farm country. Although they may feature a variety of styles and building materials, the identifying characteristic of a Goodyear house is an obvious addition – a different roofline, a change in elevation, new material for the foundation or siding, and a mix of architectural styles are all telltale signs. This is because a Goodyear house is one where the farmer "had a good year," and decided to use his profits to expand or upgrade the residence. Farming being a notoriously unpredictable enterprise, additions were sporadic and the scope of the project was often limited by the size of the profit.

As you might imagine, this irregular approach to home improvement produces some funky configurations. Second-story bedrooms might be side-by-side, yet only accessible by different stairways. A bathroom ends up next to the kitchen (instead of close to the sleeping quarters) because the budget constraints keep all the plumbing in one area. A living room is finished with top-grade materials, while the porch attached to it is sparsely framed and covered. And a vintage Goodyear building often has one stairway that ends at a wall – it was just easier to leave it in place. Over time, the house gets bigger, but still looks incomplete.

Besides its quirks, a Goodyear house is quite likely to be inefficient; it may be hard to heat and cool, prone to structural problems, and expensive to maintain. No architect would ever use a Goodyear house as a template for a new home.

The Inefficiencies of Goodyear Financial Planning

Many Americans construct their personal financial programs similar to the Goodyear building method; when times are good, they add something – an investment account, a life insurance policy, a rental property, etc. There isn't always a rhyme or reason to these decisions, and over time these "Goodyear households" acquire many financial products, but the end results are often out-of-sync and financially inefficient.

For both a Goodyear house and Goodyear financial planning, the biggest problem is the lack of an over-arching set of objectives that guide decisions, and make it possible for new additions to integrate with existing assets. Given the often-sporadic nature of these new additions (both for a Goodyear house and a Goodyear financial plan), it is understandable that continuity is sometimes lost. Financial decisions are often made in a one-step-back-to-take-two-steps-forward environment, where a new addition often requires the destruction or discarding of previous work.

However, there is another issue at play as well: a tendency by institutions, advisors and consumers to compartmentalize each financial objective. This makes it difficult to construct holistic financial programs that deliver optimal results. Instead, an infinite variety of products and plans are presented as stand-

In This Issue…

alone items.

Staying with the house analogy, these financial planning processes are similar to designing a dream house room-by-room, with no regard for the overall structure. On one sheet, you lay out the perfect master bedroom, and use another to detail the ideal bathroom. There's a separate page for the living room, kitchen, den, patio, etc. In theory, the end result of combining these disparate spaces would be the perfect home – because every room is exactly as you want it. But how functional could a house be if it were built this way? It would be a hodge-podge. Adjoining walls might be different lengths, doorways wouldn't match up, extra materials would be required, and the exterior view could be less-than-pleasing. In order to work, the individual rooms have to be framed within a cohesive larger structure.

Who is your financial "architect?"

Consider all of the "rooms" in a typical financial life. Here's a partial list:

Borrowing	Saving
Insurance	Health Care
Real Estate	Transportation
Retirement	Leisure
Educational Funding	Estate Planning
Liability & Risk Management	Taxation

Those are quite a few rooms – and most of us probably have several more. When it comes time for a particular room to be added or updated, the tendency is to compartmentalize, to focus on that one room, and neglect how it might fit with other parts of our financial house.

Take the topic of retirement. Most of the discussions about how to provide for retirement quickly narrow to plan selection, then narrow again to whether your employer provides a tax-favored plan (such as a 401(k)), or you will establish a personal account (IRA) with similar features. In this compartmentalized context, it's easy to make apples-to-apples distinctions about contribution limits, investment options, withdrawal privileges and loan restrictions. But should this be the extent of the evaluation?

Since every decision to allocate funds toward one objective means other options must be forgone, it would also be wise to ask, "How will participation in a qualified retirement plan affect the other financial areas of my life?" For example, what will happen to your taxes, your estate plans, your ability to borrow, or your enjoyment of life? You may have evaluated retirement plans, but have you evaluated them in light of the larger objectives for your finances? If not, your compartmentalized decision about a retirement plan may result in a funky, ill-fitting addition to your financial structure.

Developing a Comprehensive Plan

A comprehensive financial plan is more than a longer, more detailed list of mathematical projections. Although numbers matter, a comprehensive financial plan is also about developing a philosophy toward wealth and how to attain it. It accounts for your values and priorities. It provides context for evaluating and using financial instruments. It is also flexible and anticipates change; adding new pieces shouldn't require the destruction or loss of existing structures.

This discussion, originally built around an analogy about a Goodyear house, is abstract, theoretical. So here's a real-world financial evaluation to illustrate the necessity of a comprehensive approach, one that considers <u>priorities</u> as well as investment performance.

Suppose you are considering two possible options to improve your financial condition. Both options project significant long-term benefits, but in different configurations. Assuming the projections are accurate, which future outcome would you choose?

a. $1,500,000 in accumulation held in a tax qualified retirement account

or…

b. $1,000,000 in cash values in a life insurance policy with a $2,000,000 benefit.

This evaluation is not apples-to-apples; it's not even apples-to-oranges. The programs have different tax treatment, investment risk, and contribution limits. Yet depending on one's financial perspective, you could make the argument that each option can provide both insurance ***and*** retirement benefits. And even though the choices have numerical values, some of the very prominent benefits in each program are subjective. Any decision for one option will certainly have ripple effects in other areas, such as estate planning and taxation. Further, financial limitations may make it impossible to implement both options; you may have to choose one or the other. **If you don't have a comprehensive plan for guidance, you can't make a good decision.**

Who is Your Financial Architect?

Home improvement can be a do-it-yourself project. But Goodyear houses across America are evidence that D-I-Y results are often less than stellar. It's no different with financial decisions: to maximize the results from your wealth-building transactions, most Americans need some expert assistance. Specifically, you need someone who can help you see the big picture. Many people in the financial services field are technically proficient in their area of expertise, whether it's insurance, investments, taxes, legal documents, etc. But from among these professionals, you must find someone who also can provide a big-picture perspective, to give you ideas on how to integrate these diverse financial issues and help to construct programs that promote your financial well-being.

Sometimes analogies are a stretch; the comparisons don't work. But the Goodyear house analogy is pretty spot-on. A well-designed building usually has an architect. It almost certainly has a written set of plans. In larger building projects, these plans will include future phases of

(continued on page 4)

“YOU CAN IF YOU WANT TO, AND YOU WILL WHEN YOU DO”

- Wheelchair athlete in an ESPN promo

Almost every survey and statistic says Americans don’t save enough. Economic experts and financial behaviorists can provide any number of explanations for this shortcoming, from higher prices to an unwillingness to delay gratification. But really, saving is a matter of habit, not a result of circumstances. And habits, both good and bad, have cumulative effects. The difference between a lifetime of saving and a lifetime of not saving? It might look a little like this:

I CAN’T	VS.	I CAN
I can’t save right now. I’m just getting started with life. I don’t make a lot yet, and I’m entitled to a little fun while I’m young. There is plenty of time. When I start earning a little more, I’ll save.	AGE 25-35	I’m saving a little bit right now. I’m just getting started in life. I don’t make a lot yet, but even though I feel like I’m entitled to a little fun when I’m young, I know saving today gives me more time to build a secure future.
I can’t save now. We have two kids and just bought a house. Being a parent and a homeowner has been way more expensive than I thought. But when these “new” expenses subside and I get my next raise, I’ll start saving.	AGE 35-45	I’ve been able to increase my saving to almost 10% of my income. Having kids and a house does cost a lot of money. But because we were able to make a sizable down payment, the monthly bills have been manageable.
I can’t save now. My two kids will be starting college in the next couple of years. Do you know how much that costs? We’re probably going to have to borrow to cover tuition. And I have a few medical issues that insurance isn’t covering. This is the most expensive period in my life. I can’t save a penny.	AGE 45-60	I’m really socking it away right now – about 25% of my take-home pay. The two kids want to attend college, and I think we will be able to pay for it without borrowing – that’s a relief for me, and it will give them a great financial head start.
I can’t save now. I know I should. But things aren’t breaking my way. I’m worried about getting down-sized out of a job, and it’s not easy for a person my age to start a new career. I’ll just have to hope I can hang on where I am.	AGE 60-70	I’m glad I’ve maintained the saving habit, even after we got comfortable. Because of my savings, I was able to take a pay cut to pursue a consulting position in a field I love; the money’s okay and the flexibility is great.
I can’t save now. I had to stop working because of health issues, and we’re living with my son and his wife – that’s a strain on his finances, too. The Social Security check doesn’t go very far. I wish I had started saving 20 years ago, but it’s too late now; you can’t save when there is no income.	AGE 70+	Even though I’ve stopped working, I still save. Some of our required minimum distributions are going to an account for our grandchildren’s education (although they may not need it, because both our kids have the saving habit). And one way or another, our savings will leave a nice legacy to our heirs. I’m so glad I started saving 50 years ago.

A classic pearl of motivational wisdom says:

Your habits become your character. Your character becomes your destiny.

If you have the saving habit, you know your financial destiny has promise.
If you have children, be sure they acquire the same habit; the sooner they start, the better their future.

(*continued from page* 2) **A BETTER WAY TO BUILD**

construction. These are essentials to achieving a good outcome, and homes built without competent planning will probably not last, not look good, and waste materials. The same can be said for financial plans. Haphazard, compartmentalized financial decision making does not produce good results.

You may have a variety of financial assets, some of them very sophisticated and profitable. But here's a simple 3-question checklist to see if you are building a solid financial house:

1. **Do you have a financial architect?**
2. **Do you have a comprehensive financial plan?**
3. **Does it allow for future additions or changes?**

LOCKING IN YOUR MORTGAGE RATE: FOR 15 OR 30 YEARS?

After several years of historically low interest rates, May 2013 saw a slight uptick. At the same time, some data showed home prices starting to rebound as well. For both prospective home buyers and current homeowners, this may indicate a closing window of opportunity to secure a favorable mortgage. Besides locking in a low rate, borrowers will also be considering: Is a 15-year or 30-year mortgage better for my situation?

Assuming you can afford the monthly payments for either option, conventional financial wisdom favors the 15-year option, simply because it greatly reduces the amount of interest paid over the term of the loan. On a $250,000 loan at 4%, the numbers seem compelling:

	OPTION 1 15-yr mortgage	OPTION 2 30-yr mortgage
Mortgage amount:	$250,000	$250,000
Monthly payment:	$1,849.22	$1,193.54
No. of payments:	180	360
Total payments:	$332,859.60	$429,674.40
Interest payments:	**$82,859.60**	**$179,674.40**

Choosing a 15-year mortgage means a 54% higher monthly payment, but a 30-year mortgage results in 116% more interest paid. If you can afford the higher payment, the 15-year mortgage is the way to go, right? **But wait…there's more to consider.**

What if the borrower selects a 30-year mortgage, and deposits the difference in monthly payments into an accumulation account?

$1,849.22/mo.
- $1,193.54/mo.
= $655.68/mo. deposited to acct.

At a later date, the borrower uses the accumulated savings to pay off the mortgage early. Using the same $250,000 mortgage, and assuming the annual rate of return on accumulated funds is also 4.0%, guess what? The outstanding balance on the 30-year mortgage after 15 years is $161,000, and the accumulation account has grown to $161,000. If the borrower chooses, a simple transfer can pay off the loan.

Because the amount borrowed, interest rate, and total monthly payments are equivalent, the outcome is the same using either strategy; the house is free and clear in 15 years. However, choosing Option 2 provides some additional benefits, both mathematical and practical.

- With the 30-year mortgage, a borrower pays $126,193 in interest over 15 years. On a 15-year mortgage the total is $82,859. If the homeowner is able to itemize deductions, Option 2 means 52% more deductible interest.
- A household that can afford Option 1, but selects Option 2, has a lower risk of default and loss of the property. First, the lower payment is less of a burden on monthly finances. Second, the accumulated funds can be used to make the mortgage payment in the event of a complete loss of income.
- Some or all of the side accumulation can be easily accessed from Option 2 if another financial opportunity arises. With the 15-year plan, the "accumulation" is equity in the home. If the individual wants to tap this equity, a home equity loan is required. This transaction is subject to a lender's approval, and usually requires a monthly repayment.

So…all things being equal, the best approach may be to take the 30-year mortgage, save your "extra" principal payments in a separate account, and pay off the mortgage in a lump sum. This strategy will not only pay off the mortgage just as soon, but also give you greater access, flexibility, control, and tax breaks for your money.

Yeah, but….

Thirty-year mortgages typically have higher interest rates than 15-year offerings, as lenders see more risk with the longer time frame. And whether or not a separate accumulation account can deliver returns equal to the mortgage interest is also problematic. What happens if the comparison is skewed to reflect these realities?

On May 31, 2013, bankrate.com quoted 30-year fixed mortgages at 4.0 percent and 15-year mortgages at 3.3 percent. At 3.3 percent, the monthly payment is $1,762.75/mo., which means the monthly difference between a 30-yr fixed at 4% is $569.21/mo. (as opposed to $655.68/mo. in the previous all-4-percent example). Let's also assume the saving earns only 1%, reflecting the current low rates for conservative interest-bearing accounts.

The combination of the smaller amount available to be saved and a lower rate of return on the deposits means there will not be enough accumulation to pay off the 30-year mortgage in 15 years. After 180 payments, the 30-year mortgage has an outstanding balance of $161,357. The accumulation account has $110,584, a gap of $50,773.

So…"real-world" calculations support taking the 15-year mortgage? **Not necessarily.**

Even under these circumstances (smaller monthly saving amount, lower return), the $50,000 gap can be eliminated in 216 months – ***just three more years.*** Is this a bad trade-off for the tax, accessibility, flexibility and control benefits that come from establishing a side account? And…

Since it appears that interest rates are rising toward their historical averages, what is the likelihood that returns from the side account might also increase? If the annual rate of return on savings were to jump to 6%, the 30-year mortgage could be paid off in 14 years, 8 months!

Although the numbers are relevant, these projections (for and against either option) can't be considered persuasive. Ultimately, **the real issue is the value you place on having personal control over your financial actions.**

If the goal is to pay off a mortgage in 15 years, the straightforward solution is to select a 15-year mortgage and allow the lender to set the terms; this is the interest charge and this is the monthly payment. But if a lender is willing to offer other, less-restrictive terms (a 30-year mortgage with lower monthly payments and no penalty for early payoff), those who value financial control should take a long look at the possibilities that might arise from taking the longer term and developing an additional source of savings.

By the way…

Extra thought #1: From this discussion, it is possible to make another practical application:If you can afford a 15-year mortgage, choose a 30-year – and save the difference. If you can't afford a 15-year term, selecting even a 30-year mortgage is a bit of risk, because you may not have additional savings to ensure your ability to make future payments.

Extra thought #2: Making extra principal payments each month on a 30-year mortgage will also result in paying off the loan earlier, but is not the same as accumulating in a separate account. The extra principal adds to the home's equity, but the only way this additional "savings" can be accessed is by approval of the bank through a home equity loan.

Extra thought #3: Finding the appropriate financial instrument(s) for your savings is a key component in successful execution of this strategy. A financial professional should be able to provide several options, taking into consideration potential return, accessibility, and tax consequences.

FINANCIAL ACRONYM VIOLATION:

Man ROBS IRA, IRS Issues Steep Fine

Mainstream financial wisdom has long endorsed the pre-tax saving format of qualified retirement plans, extolling the value of tax-deferred compounding. While tax deferral is certainly a positive, there are some limitations, such as…

- Restrictions on the types of assets that can be held in a qualified plan.
- Regular distributions from a qualified retirement account prior to age 59½ may be subject to a 10% penalty tax.
- Large distributions in one year may result in a significantly higher marginal tax rate.

For an employee who participates in a company 401(k), works past 59½, and uses the account to provide a stream of income in retirement, these limitations are of minimal significance. But potential entrepreneurs, especially those who might make a career change before age 59½, may want to re-consider maximum funding of a qualified retirement plan.

For example, consider a 50-year-old mid-level corporate executive who decides to invest in a franchise restaurant. The $500,000 buy-in is steep, but the executive has been a diligent saver; he has over $1 million in the company 401(k). What happens if he uses his 401(k) for this opportunity?

A withdrawal of such a large sum would not only result in a hefty increase in taxable income for the year, but also run afoul of the pre-59½ penalties. If state income taxes are also applicable, the total tax rate could approach 50%, meaning almost the entire account would have to be liquidated to net the $500,000 franchise fee.

For most savers, losing half of their lifetime savings to pursue a new venture is a tough pill to swallow, so tough it may cause them to forgo the opportunity. Their accumulation vehicle restricts how and where those savings can be used.

But the complexity of tax law is also a land of opportunity for creative tax strategists. Enter the ROBS concept. Quoting Angela Bohman, writing for "Benefit Notes" on May 16, 2013:

> Various promoters have suggested to entrepreneurs that they use the assets in their 401(k) plans or IRAs to finance a new business. These programs are sometimes known by the acronym ROBS, or Rollovers as Business Start-ups. The basic structure involves the entrepreneur's rollover from a prior employer of the amount in his or her qualified plan to an IRA or a 401(k) plan to be established by the new business. The IRA or qualified plan then uses

the rollover money to purchase the business, such as a franchise operation.

This arrangement results in the IRA owning shares of a company, much like the IRA might own shares in any publicly-traded company. This is a capital transfer, not a distribution; there is no tax cost for buying the business.

However, qualified plans also have a lengthy list of "prohibited transactions." And users of the ROBS concept are prone to violations, because the financial activities of the owners and operators of the business cannot be co-mingled with the financial activities of the stockholders – who are frequently the same parties.

These issues were highlighted in a recent U.S. Tax Court case involving two Colorado taxpayers who used $309,000 from each of their IRA accounts to buy 50-percent shares in a fire-safety business in August 2001. In addition to funds from the IRA, the two owners also borrowed additional funds, using their homes as collateral, to complete the transaction. The funds from the IRA were considered a legitimate transaction, but the loans were not because, according to IRS regulations, "any direct or indirect lending of money or extension of credit between a retirement plan" and insiders is prohibited.

The penalty for this violation: As of the date of the loan (in 2001), the IRAs were considered fully distributed and terminated, making the entire account taxable. In this case, the Tax Court determined the individuals owed nearly $300,000 each in tax and penalties – and the number would have been higher if the statute of limitations had not expired for some of the earlier taxes.

The transaction in question was both complex and significant in terms of dollars. But even a minor misstep can result in voiding the tax-favored status of a ROBS IRA asset. If a rental property is held in the owner's IRA, a violation can occur for something as simple as an owner making a repair. As one tax lawyer put it in a May 18, 2013, *Wall Street Journal* article, "Do you want to have to call your lawyer before you replace a sink?"

Beyond the regulatory challenges of properly executing and maintaining a ROBS asset, these examples should prompt a much more basic question:

Should a qualified retirement account be your exclusive (or primary) savings vehicle?

If it were possible to guarantee steady employment, job satisfaction and an absence of better opportunities, along with predictable tax rates, the answer might be "yes." But the only real guarantee is change. If you are serious about saving, you should seriously consider saving in accounts that provide the flexibility to respond to unscheduled events and opportunities. An over-commitment to a qualified retirement plan means you may have to pass on an opportunity – or be at risk for committing a financial acronym violation, one that includes the letters IRS.

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