CREATIVE Wealth Maximization Strategies

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Savings With No Strings Attached

On July 18, 2013, William Elliott III, a professor at the University of Kansas, posted a column on politico.com, titled **"Student loans are not the answer."** The column was a summary of a 147-page report recently released by the university's School of Social Welfare on the connection between financial assets and academic achievement at the college level. One of the report's provocative conclusions:

"The financial-aid model that American college students depend on is broken. Unfortunately, media coverage and political skirmishes focus on student-loan interest rates and rising student indebtedness, while ignoring the one strategy that can increase personal responsibility, educational outcomes and long-term financial health for students: college savings."

Elliott asserts that one of the strongest indicators of whether a student will receive a college degree is whether or not the student's family has saved money for college expenses. And it doesn't have to be a lot of money:

"…Research finds that students from low- and moderate-income households who have college savings of even $1 to $499 are ***three times more likely*** to enroll in college and ***four more times likely*** to graduate than their peers."

What's the magic of saving? Elliott suggests the following:

- Parents and children feel more invested in the college-application process when they are spending their own money, their own savings.
- Building savings during a child's lifetime helps them focus on the value of a college education and on options for where to attend.
- The availability of savings earmarked for college makes college seem near and thus requiring action in the present.
- College savings offer a much firmer foundation for students and parents, allowing them to focus on what they have and not what they'll owe.

These compelling conclusions prompt Elliott to encourage greater participation in College Savings Accounts (CSAs), such as state-administered 529 plans. Besides the current tax advantages, he proposes additional incentives such as matching contributions and automatic enrollment. Instead of "loading more debt on our college graduates…," increasing college saving "is a conversation we should be having."

Expanding the savings conversation

Mark Horne, another columnist, picked up Elliott's conversation – and expanded it. On July 22, 2013, he issued an article titled **"Savings! A 'Solution' to College Debt? Or to Everything?"** After agreeing with Elliot's main points about the value of saving for college, Horne opined that perhaps CSAs weren't the best approach. His reasoning:

As is, the (CSA) saving plan encourages tuition inflation to keep climbing. If everyone saved a certain amount for college, and colleges knew about this, then their prices would tend to rise even more.

In This Issue…

Horne's argument follows the old economic adage "If you want more of something, subsidize it; if you want less, tax it." Subsidies for college education (whether in the form of loans or tax-favored savings) will result in more students seeking a college education; an increase in demand usually results in increased prices.

Recent history tends to support Horne's thesis, as subsidies, tax breaks and lax lending standards are often credited/blamed for fueling the real estate boom prior to the Great Recession. And, in the past 35 years, two highly-subsidized fields, health-care (through employer-paid insurance) and education (by loans with below-market interest rates), have seen costs increase greater than the rate of inflation (see Fig. 1).

"SUBSIDIES INFLATE PRICES"

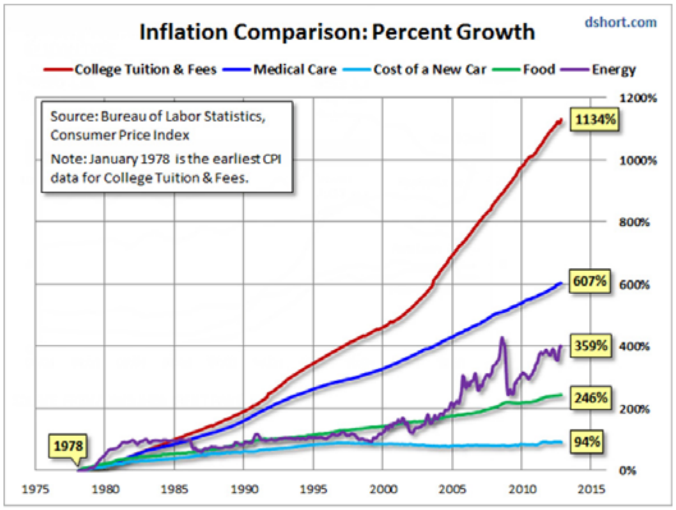

FIG. 1

To blunt the tendency toward rising education costs, Horne proposes that when students, "get to college age, they get to decide how to spend the money" -- perhaps for tuition, to cover the cost of an unpaid internship, or to supplement living expenses while taking an entry-level job. But Horne believes giving prospective students (and their families) the option of spending the money elsewhere would force colleges to compete for these savings, resulting in lower tuition costs.

Thus, while Horne agrees that saving for college is a good idea, those "savings accounts MUST NOT BE locked into education." Rather, "What will really help people afford college is giving tax advantages to savings in general." Tax advantages for all savings: what a novel idea.

The Case for Unrestricted Tax-favored Savings

What would happen if anyone could save for any reason on a tax-favored basis?

Well…if you subsidize something, you get more of it. Eliminating or decreasing taxes on savings are forms of subsidies, and combined with a removal of restrictions on how the accumulation can be spent, it seems likely that general saving would increase. Unfettered options on how or where the money can be spent would promote competition among retailers and service providers; competition usually drives prices down.

Does your financial program include an unrestricted, tax-favored savings component?

Besides the practical macro-economic benefits of increased saving and lower prices, there is also the psychological value of saving. As Elliott's research indicated, people who use their savings to purchase something are more invested in the process, and by extension, more likely to make value-based decisions as consumers. This attitude even carries over to times when savers must borrow. A prospective home-buyer is more likely to be committed to meeting a mortgage obligation if the purchase includes a substantial down payment. Conversely, a buyer with little personal equity at stake may find it easy to walk away if things get tough.

This simple analysis seems to indicate encouraging unrestricted tax-favored saving would be beneficial for consumers, for providers of goods and services, and even for lenders. However, lawmakers have historically been loath to give tax breaks to undesignated savings; they want to be sure the money is spent wisely. So tax advantages are closely tied to how (and when) the accumulations are spent. IRAs and 401(k)s are intended to be spent after age 59½, 529 Accounts are for college expenses, and Flexible Spending Accounts reimburse out-of-pocket medical costs. For those over age 59½, assets held longer than 5 years in a Roth IRA accumulate and can be distributed without additional taxation. But Roth IRAs have contribution limits and eligibility conditions – the more you make, the less you can contribute. In general, the US government seems reluctant to allow unrestricted tax-favored saving.

What About You?

In general, every American household would benefit from a sizable unrestricted savings account. And there are a few financial instruments that, depending on individual circumstances, can function as "***less-restricted*** tax-favored savings." But the unique nature of these products also limits one's investment choices to a narrower range of risks and returns. However, even from this limited menu, households may find these products are a good fit, simply because they allow for substantial tax-favored accumulation and distribution at any time. While the potential for investment returns may be higher with other instruments, the value of these accounts is their tax-efficiency and ready access. And cash in hand – available for any reason – creates financial possibilities, usually at the lowest prices. ❖

Does your financial program include an unrestricted, tax-favored savings component?

Quite Possibly, The World's Perfect Financial Choice?

In 1989, Chiquita Brands International hired the W.B. Doner & Co. advertising agency to create a promotional campaign for bananas, their primary product. The result was a slogan so successful, Chiquita registered it:

Quite Possibly, The World's Perfect Food®

It is, quite possibly, the best advertising phrase ever; a strong statement of ultimate value, paired with a modest disclaimer. It's a statement a promoter can love and a litigation-conscious legal department can accept. Chiquita was smart to trademark it, because the variations are infinite.

Besides the marketing genius encapsulated in this slogan, it also helps that bananas have significant nutritional value. While no dietician would assert that one could live on bananas alone, they are a healthy food, rich in vitamins and minerals. So depending on your definition of nutritional perfection, bananas can legitimately make a case for deserving the title.

When the topic is financial protection and accumulating cash values, Participating Whole Life insurance companies can make a Chiquita-style claim for "cash value" or Whole Life policies. Granted, the standards of financial "perfection" need some clarification, and there are some qualifying conditions. But on the whole, cash value life insurance provides enough attractive benefits to merit serious consideration as a financial choice. In addition to the obvious benefit of a payment at the end of one's life, especially if the end comes unexpectedly early, the cash accumulation account adds many attractive "living benefits".

Whole Life Insurance: The "Living Benefits" and Unique Features of Cash Values

As part of a Participating Whole Life insurance policy, cash values aren't a stand-alone accumulation product. But more and more, the financial universe is recognizing these accounts as a unique way to accumulate money.

A whole life insurance policy may be thought of as a uniquely designed, multi-dimensional contract; in exchange for regular premiums, the policy's owner or designated beneficiaries will receive a guaranteed sum when the contract is completed. "Completion" of a life insurance policy occurs in two ways:

1. The insured attains his/her "whole life" age (typically between 95 and 100), and the insurance company pays the designated amount. Or…

2. The insured dies before reaching his/her whole life age, and the insurance company pays a death benefit to beneficiaries.

To achieve this balance between long-term accumulation and a guaranteed payment in full at any time, a portion of each premium is allocated to cover insurance costs, with the remainder applied to the policy owner's cash value account. The insurance component of the policy is amortized similar to a mortgage or installment loan. This means a portion of early premium payments (1 – 5 years) is allocated to the cost of insurance, and the balance goes to cash values. Over time, this ratio reverses. As a result, cash value accounts are "slow starters" from an accumulation standpoint.

Depending on performance, the insurance company may add dividends* to the cash value account. Dividends are derived from the investment returns on the company's cash reserves and/or favorable operating expenses (such as fewer claims or improved administrative efficiency). Not-withstanding the slow accumulation rate in a policy's early years, cash value accounts have many attractive features:

- **Guaranteed accumulation.** Even in the worst financial conditions, life insurance companies are contractually obligated to make guaranteed deposits to cash values and pay insurance benefits.

- **Expectation of steady dividends.** Dividends are not guaranteed, but the actuarial assumptions are so generous (to ensure benefits under the worst circumstances…such as the Great Depression) that many life insurance companies have lengthy histories of annual dividends. And dividends are not purely dependent on investment results; a well-managed insurance company can pay dividends from operational savings as well. Because dividends are derived from more than investment returns, cash values may be less volatile, even compared to other assets classified as "conservative."

- **Tax-deferred accumulation, tax-favored distribution.** For tax purposes, dividends are recognized as a return of excess premium, so dividends added to the cash value accumulate tax-deferred. Withdrawals don't become taxable until they exceed the policy's basis (which is the sum of premiums paid, including the portion allocated to insurance costs). In addition, most policies have loan provisions, another way to access funds without incurring tax. **

- **Liquidity – Ready Access.** Cash value accounts don't require waiting to age 59½ to make penalty-free withdrawals, and there are no required minimum distributions at age 70½. While universal life policies impose surrender charges on withdrawals made in early years (10 – 20 yrs), Whole Life DOES NOT impose any surrender charges. There are no penalty taxes on early distributions. And withdrawals don't require documentation that the money was used for education, a primary residence, or medical expenses.

For secure, profitable, tax-favored and accessible cash value, a whole life policy meets all of the requirements. Compared to similar conservative accumulation options, cash values are quite possibly…well, you know.

Some Qualifying Provisions

To receive the benefits of cash values, you must buy whole life insurance, and pay the up-front costs for establishing the policy. Further, to fully maximize the accumulation features of cash values, the underlying policy must remain in force until completion. This means regular premium payments. (Once the Dividends and Dividend Account Value have reached a sufficient accumulation, it may be possible to offset premiums for the remainder of the insured's life.)

As part of a comprehensive program, a whole life insurance benefit can be a valuable financial asset, serving several different functions over time. Under State Insurance laws in some states, the Cash Value and/or Death Benefit is protected from creditors. If a Waiver of Premium Rider is added, in the event the Insured becomes disabled, the Insurance Company will continue to fund the premiums for as long as the Insured remains disabled…providing a self-completing savings plan. Also, there are many ways to "recover" the cost of insurance. The slow-growth aspect of whole life cash value accounts can be accelerated by additional unscheduled premiums*** to purchase paid-up additions.

In a larger perspective, regular premium payments provide insurance companies with a steady stream of liquid assets, which allows them to make loans and distributions without requiring portfolio turnover. This permits the insurance company to take a long-term approach that **historically delivers superior returns from conservative investments.**

An interesting observation: Some financial commentators are reluctant to recommend starting a whole life plan because they think the entry costs are high. Yet those same advisors may tell existing policyholders to maintain their whole life contracts, saying something like, "You've paid the up-front costs, so don't drop the protection and tax deferred returns of cash value life insurance." In other words, once established, a whole life policy may quite possibly be your perfect financial choice. Or, they may suggest Term insurance which will eventually terminated unless a "pre-mature" death occurs. Most often, the amount of term premiums paid to the Term Insurance company will be similar to the up-front costs incurred in Whole Life…The only difference being when the term expires your family ends up with $-0-.

How "Perfect" is Done Right

Building the right cash value account within a life insurance policy requires a customized plan tailored to your unique circumstances. As a long-term financial asset, it means planning for future use as well as immediate objectives. Even if you understand the concepts, it usually takes a competent life insurance professional to flesh out the details. And to make sure what may be the world's perfect financial choice keeps purring along, regular reviews and adjustments should be scheduled. ❖

DO YOU OWN (QUITE POSSIBLY) THE WORLD'S PERFECT FINANCIAL CHOICE?

IF SO, WHEN WAS THE LAST TIME IT HAD A TUNE-UP?

* Dividends are not guaranteed and are declared annually by the company's board of directors.

** Policy benefits are reduced by any outstanding loan or loan interest and/or withdrawals. Dividends, if any, are affected by policy loans and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses, or is surrendered, any loans considered gain in the policy may be subject to ordinary income taxes.

*** The option to make unscheduled premium payments must be set up at the purchase of the whole life policy.

Post-recession Job Posting: "Household HR Director"

In the aftermath of the Great Recession, many observers see the US economy experiencing a "jobless recovery." Businesses are growing again (albeit slowly), but this renewed activity has not resulted in a rejuvenated job market. The government's official unemployment figures remain above 7 percent, and several commentators propose the number is really higher, primarily because there is conjecture that the recent recession has been the catalyst for a fundamental shift toward decreasing full-time employment. In a July 15, 2013, *Wall Street Journal* commentary, Mort Zuckerman elaborates:

> In June, the government's Household Survey reported that since the start of the year, the number of people with jobs increased by 753,000 – but there are jobs and then there are "'jobs."' No fewer than 557,000 of these positions were only part-time. The June survey reported that in June full time jobs declined by 240,000, while part-time jobs soared to 360,000 and have now reached an all-time high of 28,059,000 – three million more part-time positions than when the recession began at the end of 2007.

Research analyst Doug Short, in an August 5, 2013, article for seekingalpha.com, uses Bureau of Labor Statistics data to present some graphic evidence of this shift away from full-time employment (Fig. 1). The blue line represents full-time employment, and uses the scale on the left, the red line for part-time employment correlates to the right side, and the gray shaded areas represent times the economy was in recession.

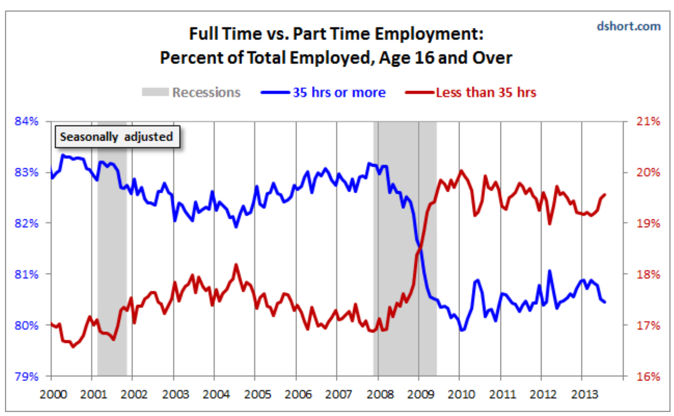

FIG. 1

The 2000 full-time/part-time employment ratio was 83/17. In the aftermath of the dot-com bubble of 2001, this ratio declined only slightly, to 82/18, then bumped back to previous levels. But the last half of the Great Recession appeared to precipitate a significant move away from full-time employment, one that gives the appearance of a permanent shift to about 80/20. Further supporting this idea, Short produces another chart from BLS numbers, illustrating job creation since the recession (Fig. 2). The startling numbers: since 2007, full-time employment growth is down -3.0%, while part-time is up 14.4%.

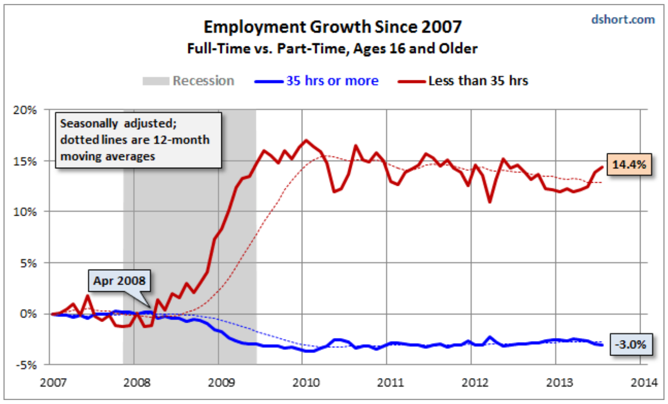

FIG. 2

The Impact of Decreasing Full-time Employment

Evaluating economic data is more art than precise science. For example, the determination that 35 hours a week equals full-time employment is arbitrary. And "official" government numbers for unemployment come from a variety of sources, and are frequently revised several months later. So one could argue that a change to 80/20 full-time/part-time from 83/17 isn't a big move. But when enough analysts see the same thing, it's prudent to consider why full-time employment is decreasing.

In the moment, some see the new health insurance requirements imposed on employers in the Patient Protection Affordable Care Act as a driver toward part-time employment. (The PPACA considers anyone working more than 30 hours/week for one employer to be full-time.) Other observers see a longer-running trend where technology and global competition compel many employers to opt for part-time or contract employees in order to minimize the cost of employee benefits.

Regardless of the reasons, many American households will face some daunting financial challenges if the move away from full-time employment continues. In a two-income household, the "second" income is often the one that provides both saving and discretionary spending. If that second income is no longer full-time, not only will savings and spending decline, but employer-provided benefits (such as group life and disability insurance, and employer-sponsored retirement plans) may disappear.

Even if a second income remains steady because someone works two part-time jobs, the lack of benefits remains an issue. A change to part-time or contract employment means each household assumes the role of a Human Resources Director, securing benefits, coordinating coverage, and evaluating costs. It adds time and money to the costs of working.

Is there a Government Solution?

The decline in full-time employment is another signal that employers are backing away from long-term employee obligations. The first indicator was the phasing out of defined-benefit pension plans, which were replaced by employee-funded 401(k)s. The next marker was requiring employees to share the cost of company-sponsored health insurance, or in some cases, pay the entire premium.

As corporate America has backed away from providing ancillary benefits for its employees, one response was that government should "do something." By mandating that all citizens obtain health insurance, PPACA intends to ensure all households have basic medical benefits. It is possible to foresee a time when legislation may expand the PPACA mandate to require all workers to obtain a more comprehensive menu of employment-related benefits, giving all workers a portable personal benefit package that would travel with them from job to job.

However, because these benefits would be paid through taxes, the economics of providing some benefits for everyone would most likely result in programs geared toward lower- and middle-income households. Those with higher incomes would receive a proportionally lower level of income and retirement protection. Households that wish to maximize their financial stability will most likely need to consider individual insurance and accumulation options.

Taking on the HR job

For some, having to manage a personal benefit package is a new experience. But self-employed households have been doing it for a long time. And being your own HR Director doesn't have to be a do-it-yourself project; professional assistance is readily available. Going forward, the key is recognizing the position needs to be filled and the job needs to be done. As employment becomes less stable, risk management of one's present and future income assumes greater importance. ❖

Statute of Limitations on Transferred Assets:

As Long As The IRS Needs It To Be

Tax attorney Charles Rubin authors a blog offering news and commentary on issues involving transferred assets, typically in the context of estate settlements or other generational transfers. It might be a coincidence, but two of Rubin's recent posts focused on how tax liability for recipients of estate assets may linger long after the estate has supposedly been settled.

On July 29, 2013, Rubin reported on the circumstances that led to an IRA beneficiary being declared liable for estate taxes ***12 years*** after the estate was assessed. The essential facts are as follows:

At his death in April 2000, a man left over $8.3 million in assets to his heirs, of which $3.85 million was held in an IRA account. Shortly thereafter, the estate filed an estate tax return, showing a liability of $2.47 million.

The estate's executors asked for several payment extensions, as many of the assets were publicly traded securities which had lost substantial value during the dot-com recession of 2000-2001. At the same time, the estate transferred the IRA to the man's daughter, as beneficiary of the account.

Presuming there was adequate value in the remaining assets to settle the estate tax bill, the IRS did not issue an estate tax levy against the IRA assets transferred to the daughter. Years passed, and the IRS received only $200,000 from the estate. However, a section of the Internal Revenue Code allows for the tax collection from transferees for up to 10 years after the estate tax assessment, and sometime after 2011, the IRS presented the daughter with an estate tax bill.

The daughter fought the ruling, saying she had never received a notice during the four years the estate was granted extensions, and that the 10-year window for assessing her directly had expired. The case went to court. The IRS prevailed, with a ruling that extensions granted to the estate also extended the 10-year period for assessing transferees who had received assets from the estate.

If it sounds complicated, here's Rubin's summary of the ramifications:

> The above result is bad for IRA and other beneficiaries for many reasons. First, it allows beneficiaries to be hit with estate taxes many years after death, and without knowledge that taxes were never paid and thus that the potential liability existed.

Rubin goes on to add that if the 10-year period for assessing transferees doesn't begin until all other extensions are ended, it is possible that a beneficiary's liability could last for 20 years or longer! Even worse, if the IRA assets are liquidated to settle the estate tax, the beneficiary also incurs a personal income tax liability for the amount distributed. In this instance, the daughter may see the entire IRA consumed by taxes.

A May 4, 2013, post by Rubin reinforces the long backward reach of IRS taxing authority. He relates the case of a business owner transferring some private stock to family members in 1972 to settle a dispute. In April 2013, the IRS filed a tax lien for $1.1 million, claiming the transfer was an unreported gift. Since a gift filing was never made, the IRS asserts the right to open an investigation and assess the tax.

Some observations

- The current estate tax exclusion is higher, meaning fewer individuals could encounter the problem related above. But the underlying issue remains: until the IRS has removed all liens from an estate, beneficiaries do not have unencumbered ownership of transferred assets. Effective estate planning must include a thorough examination of all tax issues, and their resolutions.
- Because it provides a guaranteed lump sum at death, life insurance can be a very valuable estate planning asset, either to pay estate settlement costs or to ensure there will be assets for heirs to inherit. Counting exclusively on variable assets for wealth transfers can be problematic.
- Unresolved taxation for IRA accounts in an estate can create headaches for beneficiaries. Individual circumstances will ultimately determine which assets should be consumed or preserved, but strong consideration should be given to systematically liquidating IRAs during one's lifetime rather than leaving them to beneficiaries.

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