CREATIVE
Wealth Maximization Strategies

Certified Financial Services, LLC
600 Parsippany Road Suite 200
Parsippany, NJ 07054

Richard Aronwald
Financial Specialist

SEPTEMBER 2012

SANDPILES, LUCK AND LOGIC

The Bak–Tang–Wiesenfeld (BTW) Sandpile

At a very simplistic level, avalanches were both foreseeable *and* random.

Remember going to the beach as a kid and making a sandpile? Scoop by scoop, you kept adding sand to the top of the pile, trying to add height. But sometimes, the next scoop would result in an avalanche. The cone of the pile would collapse, and a portion would slide down, shrinking the hill and expanding the base. Did you ever wonder which scoop caused the avalanche, and why?

Well, even if you weren't this inquisitive as a kid, some people are. In 1987 three physicists, Per Bak, Chao Tang and Kurt Wiesenfeld, from the Brookhaven National Laboratory in New York, developed a computer model to replicate the avalanche behavior of sandpiles. Their findings have been a reference point for multiple theories attempting to explain, and even predict, seemingly random events. Many of the insights from the BTW sandpile research have found their way into diverse fields, including geology, psychology and economics.

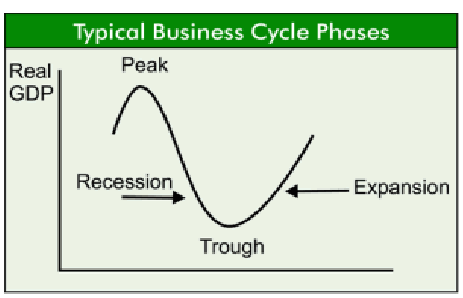
Because their computer program could account for the unique position of individual grains of sand, the BTW sandpile model could identify grains of sand that were in a stable state in the pile ("normal") and those that were unstable ("critical"). The normal grains were color-coded green, the critical red. This analysis produced a spider-like illustration where the pile was predominantly green, but veined with red sections. Avalanches tended to occur when a new grain of sand hit a red area, but where the additional grain landed was a random event. **At a very simplistic level, this meant avalanches were both foreseeable *and* random**.

BTW data also revealed another interesting insight: The longer the time between avalanches, the greater the magnitude of the slide. In contrast, more frequently-occurring collapses tended to produce smaller avalanches.

An Economic Application from the Sandpile

The Business Cycle is an economic model with a history dating to the middle of the 19th century, which identifies fluctuations in production or economic activity over several months or years. While these fluctuations are not fixed as to their length or intensity, they do appear as four distinct stages that occur in a particular sequence. Thus, at any point in time, the economy is in one of the following states:

1. **Contraction** - When the economy starts slowing down.
2. **Trough** - When the economy hits bottom, usually in a recession.
3. **Expansion** - When the economy starts growing again.
4. **Peak** - When the economy is in a state of "irrational exuberance."



Most politicians, economists, bankers and financial commentators accept the validity of the general concepts embodied in the Business Cycle model. The differences come in how these people propose to respond to it. Some wonder if it might be possible to "flatten" the cycle, lowering the peaks and raising the troughs. Others see opportunities to extend the length of the peaks while shortening the troughs. The most optimistic see a utopia where the Business Cycle morphs into a straight line, climbing ever upward.

In This Issue…

SANDPILES, LUCK AND LOGIC — Page 1
THE VALUE OF LIFE INSURANCE AS PROPERTY — Page 2
WHO WILL PREPARE YOUR TAX RETURN IN 2014? — Page 4
MAINTAINING RECORDS: The Statute of Limitations for Tax Returns — Page 5
AS EURO ECONOMIES STRUGGLE, CONSUMERS BUY LIFE INSURANCE — Page 6

All of these proposals to manipulate the economy are similar to attempting to place a new grain of sand in precisely the right point so as to avoid an avalanche and add to the pile's height. In theory, this is possible. In reality, there are so many interconnected variables, it's hard to tell if any "economic stimulus plan" will produce the desired result. Which is why some free-market economic thinkers recommend letting the economy run its course through the Business Cycle.

The argument advanced by free-market advocates is that naturally occurring contractions and troughs will be shorter and lesser in magnitude than those that are delayed or manipulated. Just as the more frequent avalanches result in less damage to the sandpile, the long-term economic fallout from these more frequent non-manipulated contractions will be smaller.

While you can never eliminate the impact of random events, you have some control over the structure of your individual "sandpiles."

Again, in the abstract, this makes sense. But most of us have an aversion to pain, financial or otherwise. Unless faced with the absolute necessity to face the music, we will choose to delay a day of reckoning. But at some point, we choose (or are compelled) to make a decision to cut our losses, retrench our position and chart a new course.

Relying on Luck or Logic?

In regard to the national economy and the Business Cycle, an individual has no ability to influence either the decision-making or the outcomes. But individuals can make decisions about their personal financial circumstances. One of their choices may be to cut their losses from ill-advised decisions, and redirect their financial efforts. Another might be to keep on the same course, hoping the weaknesses in their financial condition will not result in a financial avalanche. The question: Which outcome will be more palatable - a small step back today, or continuing on with the risk of a bigger adjustment later? For example…

– Does it make sense to continue maximum contributions to a 401(k) if credit card debt has become unmanageable? Maybe debt reduction should become a higher priority, even at the expense of retirement saving.
– Should you let go of investments that remain depressed, instead of holding them, in the hope that you will eventually break even? Moving to a more conservative allocation might diminish up-side opportunities, but result in steady growth in accumulation.

When gamblers incur losses they typically default to one of two strategies: They step away from the table and stop the bleeding, or they double down, hoping the next win will overwhelm previous losses. If you are risk-averse by nature, you may see a step-back as the only "intelligent" choice. But those with a higher risk tolerance will make the argument that "fortune favors the brave," and the potential for great gain is worth doubling down. Who is right? If we consider the BTW model, the answer depends on your circumstances – and on luck. Sometimes the best result comes from stepping away, other times from doubling down.

The BTW sandpile acknowledges that luck (or random chance, fate, or whatever you call it) exists, yet cannot be explained or anticipated. This is because one of the characteristics of the sandpile is that its structure is inherently unstable; at various points in time, avalanches will occur. And remember, the longer the time between avalanches, often the greater the damage.

Life itself has some inherent instabilities. **But while you can never eliminate the impact of random events, you have some control over the structure of your individual "sandpiles."** If your financial sandpile has structural weaknesses (too much debt, not enough saving, incomplete estate planning, poor risk management), every day you don't address the issues is another grain of sand building toward a bigger avalanche. If you are hoping to get lucky, maybe you will – and maybe you won't.

Conversely, it must be acknowledged that building a better financial sandpile cannot guarantee success – unforeseen random factors will still come into play. But handling a small avalanche is better than being overwhelmed by a large one.

DON'T CONFUSE LUCK WITH GOOD PLANNING.

STRENGTHEN YOUR GOOD FORTUNE BY *STABILIZING* YOUR "SANDPILE."

The Value of Life Insurance as Property

A true story, which occurred more than a century ago:

John C. Burchard was the owner of a life insurance policy on himself. Burchard had made two premium payments on the policy, but was under financial duress and currently late on the third payment. Burchard also needed a surgical operation, but had no money for the procedure.

In an effort to solve both his financial and health issues, Mr. Burchard made the following proposal to Dr. A.H. Grigsby: Burchard would sell his life insurance policy to Dr. Grigsby in exchange for $100 and the operation. Dr. Grigsby also would assume the responsibility for paying future premiums. In doing so, Dr. Grigsby, as the new owner, could determine the beneficiary and take control of any other policy benefits, including the cash values. The two parties agreed to the arrangement, completed paperwork to define the terms, and executed the agreement.

About a year later, Burchard died.

Dr. Grigsby, as owner of the policy, attempted to file a claim and receive the death benefits. The insurance company initially declined the claim, saying Dr. Grigsby did not have an insurable interest. R.L. Russell, the executor of Burchard's estate, then filed suit to have the proceeds be paid to the estate. At first, Grigsby was vindicated, but Russell challenged the decision in Appeals Court and the ruling was reversed. This led to Grigsby appealing to the U.S. Supreme Court. On November 10 and 13, 1911, the Supreme Court heard the case, and on December 4, 1911, returned a decision – in favor of Dr. Grigsby.

Justice Oliver Wendell Holmes Jr. delivered the majority of the court. The essential issue at the heart of his opinion is contained in this brief excerpt:

> "…(L)ife insurance has become in our days one of the best recognized forms of investment and self-compelled saving. So far as reasonable safety permits, it is desirable to give to life policies the ordinary characteristics of property…To deny the right to sell except to persons having such an interest is to diminish appreciably the value of the contract in the owner's hands."

(You can read the entire opinion at: http://supreme.justia.com/cases/federal/us/222/149/case.html)

The Impact of Grigsby vs. Russell

Justice Holmes' decision formally established an important characteristic of life insurance: even though a relationship of insurable interest must exist between the insured and the owner of the policy ***at the time it is issued***, ownership privileges can be transferred or assigned ***at a later date*** to parties who do not have a relationship of insurable interest.

While most consumers have some awareness of the primary benefits of life insurance (the amount paid if a death occurs, and in some instances, the cash value accumulations), they may not be aware of the "property" advantages to owning life insurance.

Collateral Assignments

The inclusion of a life insurance policy in a transaction may have a significant impact on one's ability to borrow, because the policy can be used as collateral. Especially if the loan is unsecured by other assets (such as a house or auto) the inclusion of life insurance can be crucial to loan approval – if there is no life insurance, the lender may demand it as a condition of the loan.

In a collateral assignment, the policy serves as collateral for a loan, ensuring the lender will be repaid if the borrower dies before making full repayment. Collateral assignments can be attached to any type of life insurance policy, and the terms are subject to negotiation. In keeping with the Grigsby decision, the insurance carrier has no involvement or authority over the terms of the assignment and must honor the agreement's provisions. While collateral assignments commonly appear in transactions involving financial institutions, they can also figure prominently in transactions with private lenders.

There are two types of policy assignment: absolute and conditional. An absolute assignment transfers all the rights in the insurance policy to the assignee, including the responsibility to pay any remaining premiums. It essentially transfers ownership to a new party. A conditional assignment is temporary, and the transfer of ownership rights and interest in the policy is limited to the terms of the agreement. When the conditions of the agreement have been fulfilled (a loan has been repaid), the assignment is terminated.

Most life insurance assignment agreements focus on the insurance benefit, and make the lender the primary beneficiary, even ahead of a policy owner's spouse and/or children. The assignments will typically specify the amount of money the lender is entitled to if the borrower dies. (If the policy's death benefits exceed the loan amount, the excess money would be distributed to the owner's beneficiaries per the original provisions of the policy).

A policy's cash values may also serve as collateral for a loan. For example, an assignment may specify that the lender can withdraw a pre-defined sum from the cash value in the event the borrower defaults on the loan. Cash value assignments typically limit the lender's entitlement to accumulated cash value, the borrower's heirs still protected by the policy death benefit.

Life Settlements

Through most of the 20th century, the ability of the policy owner to assign benefits was rarely considered outside its use in lending agreements. But the AIDS crisis during the 1980s uncovered a new application for policy owners to assign their policies.

At that time, individuals diagnosed with AIDS faced an extremely short life expectancy. If the AIDS-infected individual owned a life insurance policy, there was the opportunity to make an absolute assignment of the policy in exchange for a lump sum cash payment representing a percentage of the death benefit. Under this arrangement, called a viatical settlement, a third party became the new owner of the policy, paid the premiums, and received the full benefit when the individual passed away.

Advances in medical treatments mean improved health prospects for AIDS patients, but the absolute settlement of life insurance has expanded to other groups of policy owners, particularly those over age 65. Now known as life settlements, older policy owners may consider receiving a lump sum payment today in exchange for assigning the future benefit to an investor or financial institution. Any decision to enter into a life settlement must be carefully evaluated, but integrated with other facets of one's financial program, the settlement option may offer significant benefits in some circumstances.

Policy Assignment: Not a D-I-Y Project

Assignments are legal documents, and expert assistance is

"So far as safety permits, it is desirable to give to life policies the ordinary characteristics of property…to deny the right to sell…is to diminish appreciably the value of the contract in the owner's hands."

- Chief Justice Oliver Wendell Holmes, *Grigsby vs. Russell*

recommended, both in their consideration and construction. While a life settlement is typically an absolute assignment, it may be possible to accomplish similar results using conditional assignments that allow the policy owner to retain ownership. Paying attention to detail is essential; for example, any fulfilled conditional assignment must be manually rescinded by instruction to the insurance company to remove any entitlements from the policy.

In addition, some variations of the life settlement concept push the legality of the Grigsby ruling and may have harmful financial repercussions. Stranger-owned Life Insurance, known as STOLI, is life insurance purchased with the intent of transferring ownership shortly thereafter to a third party, usually investors. In recent years, several STOLI transactions have resulted in legal cases, and while the courts have continued to uphold the right of the owner to assign the policy to a third party, there is concern that the concept of insurable interest is being violated. Even Justice Holmes addressed this issue in his 1911 opinion, saying, “A contract of insurance upon a life in which the insured has no interest is a pure wager that gives the insured a sinister counter-interest in having the life come to an end.” Further, obtaining life insurance for the purpose of selling it may impede one’s ability to obtain additional life insurance intended to benefit heirs.

As property, a life insurance policy has some unique characteristics. When integrated with other assets as part of a comprehensive plan, the collateral value of an insurance benefit can enhance other aspects of your financial life while providing essential financial protection. There may be potential tax consequences involved in the transfer or assignment of a life insurance policy.

- **A LIFE INSURANCE POLICY IS FINANCIAL PROPERTY, AND YOUR INSURABILITY IS A FINANCIAL ASSET.**
- **ARE YOU MAXIMIZING YOUR LIFE INSURANCE ASSETS?**

Who Will Prepare Your Tax Return in 2014?

Income tax compliance is an essential financial activity for almost every American. And for an overwhelming majority of the population, income taxes are too complex to be done by the individual taxpayer; IRS data indicates that over 80% of Americans use a tax preparer or tax software to file their returns. In consideration of the reliance of taxpayers on expert assistance, a series of new tax-preparer regulations have been implemented to bring standardization to the field.

The first change, which took effect on January 1, 2011, required all paid tax-return preparers to have a Preparer Tax Identification Number (PTIN). While some are exempted from the requirement (such as employees who prepare their employer’s company returns and preparers of several types of non-1040 tax returns), CPAs and Enrolled Agents, and most tax preparation service employees must obtain a PTIN. This identification is included as part of the preparer information recorded in the signature section of a return. Paid tax preparers must renew their PTIN each year.

In November 2011, the IRS unveiled a 120-question tax competency test that certain preparers are required to pass by Dec. 31, 2013, in order to stay in business. (CPAs, Enrolled Agents and attorneys are exempt from the test because they already have met other testing requirements as part of their credentials.) Preparers who meet these requirements will be given a new designation: Registered Tax Return Preparer (RTRP).

Even if they have not yet passed the competency test, paid tax-return preparers must also complete 15 hours of continuing education each year, beginning in 2012. RTRPs must also pass a compliance check regarding their own tax status, and be fingerprinted.

The end result of these new standards:

- By 2014, only Registered Tax Return Preparers, Enrolled Agents, CPAs, and attorneys will be authorized to prepare individual income tax returns for compensation.
- The ethical requirements that previously applied only to CPAs, EAs and attorneys now apply to all paid return preparers.
- The IRS intends to compile a publicly searchable database that will allow taxpayers to see if their tax preparers have met IRS standards or to find a tax preparer in their zip code area.

Potential Impact to Taxpayers

As of May 2012, approximately 4,800 people had completed the requirements to be certified as Registered Tax Return Preparers. Yet the IRS estimates some 340,000 paid providers still have a testing requirement that must be satisfied by December 31, 2013. In March 2012, the Institute for Justice, a nonprofit group, filed a suit against the IRS, arguing that the effort to regulate tax-return preparers is unlawful. Although it is hard to objectively quantify, many independent preparers have indicated these new compliance standards may put them out of business. If the number of preparers decreases, most observers expect the cost of return preparation will rise.

With the potential for significant tax changes in 2013, an established relationship with an authorized tax preparer is a must for most financial households. If your current tax preparer does not meet these new certification standards, it would be prudent to begin the process of securing a new preparer as soon as possible.

CPAs, Attorneys, Enrolled Agents, RTRPs: What’s the difference?

In a March 20, 2012, article in the trade publication *LifeHealthPro*, Brandon Stuerke, president of a Colombia, Mo. independent advisory firm, made the following distinctions regarding tax preparers:

CPAs: A Certified Public Accountant’s professional designation covers a wide range of financial topics, including tax returns, alternate business entities, personal financial planning, business valuations, bookkeeping and accounting methods. Approximately 25 percent of CPA exam "pertains specifically to taxes and tax law," and in theory, a CPA's broad financial training helps integrate taxation into a client's larger financial picture.

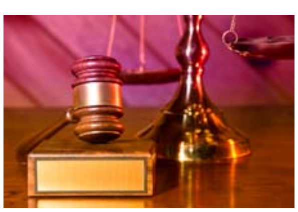
Attorneys: Attorneys, especially those who specialize in taxation, can provide valuable tax preparation services. In addition, some clients favor working with an attorney because they value the confidentiality aspects of attorney-client privilege. In theory, this relationship provides a higher degree of legal protection in the event of an audit, or other legal proceeding resulting from a tax issue. However, the legal boundaries of confidentiality in tax cases have been shifting, as courts have ruled that attorneys and CPAs may, in some cases, be compelled to reveal confidential information if it directly relates to public information presented on tax documents.

Enrolled Agents (EAs): These tax professionals receive their credentials from the IRS after completing an extensive education and examination process that focuses exclusively on taxes and tax laws. This means an EA's practice is typically solely related to taxes. Because they can represent their clients before the IRS in audits, an EA may develop niche areas of practice, such as offers in compromise or collection settlement.

RTRPs (or soon-to-be RTRPs): Sturke notes that while non-CPA accountants, bookkeepers and tax preparers may perform many of the same tax-related tasks as CPAs or EAs, "they do not have to meet the same level of education requirements." But the difference in education does not mean an accountant or bookkeeper is not competent regarding taxation. In fact, one of the loudest arguments coming from those opposed to the new RTRP standards (or that CPAs and EAs are exempt from the test and Continuing Ed. requirement) is that many of these tax preparers are the ***most competent***, because their work is almost exclusively connected to return preparation. And many independent preparers claim their current continuing education standards (mandated either by their state or employer) typically exceed the IRS' new standards.

Ben Franklin asserted the only two certainties in life were death and taxes. The complexity of current tax regulations results in another near-certainty: You require the services of a tax preparer. April 15, 2013, is a long way off, but if you haven't retained the services of an IRS-approved Registered Tax Return Preparer, now might be a good time to start your search.

Maintaining Records: The Statute of Limitations for Tax Returns



If you paid a tax professional to prepare your returns, the preparer will keep copies of his/her work done on your behalf. However, it is your responsibility to provide these records, should the Internal Revenue Service have questions or select your return for audit. How long you should maintain these records depends on several factors.

3 In general, the statute of limitations for most civil tax issues is three years. However, it is important to understand when the three-year time period begins. For those filing on or before the April due date for personal income tax returns, the three-year window begins with the April date – even if you file earlier. For those who file after the April date, the three-year period starts with the filing date. Thus, statute of limitations for a 2011 return filed on August 10, 2012, would not expire until August 10, 2015. The three-year rule also applies to late returns. The window for a 2002 return filed in 2012 extends to 2015. In addition, amendments to previously filed returns also start a new three-year period.

It is also important to maintain supporting documentation in addition to tax returns. This includes other "official" tax documents, such as W-2s and 1099s, as well as "bills, credit card and other receipts, invoices, mileage logs, canceled, imaged or substitute checks, proofs of payment, and any other records to support deductions or credits you claim on your return," according to Forbes columnist Kelly Erb in an April 18, 2012, article.

The three-year time frame applies to most civil tax issues on a return; i.e., the accuracy of the calculations, whether deductions are allowable, etc. However…

6 If the tax issue involved greater than 25% of the gross income on the return, the statute of limitations rises to six years. Since income is the basis for assessment, failure to report taxable income is arguably the most important item on a return, hence the longer statute of limitations. The six-year rule applies only to unreported income, according to Mark Matthews, a former top IRS official quoted in an April 14, 2012, *Wall Street Journal* article.

4 If you have employees, keep your employment tax records for at least four years after the date that payroll taxes become due or are paid. Records typically include forms W-2 and W-4, as well as related pay information and benefit forms. This rule applies to household employees as well.

7+ If you claim depreciation, amortization, or carryover deductions, you'll want to keep related records for as long as you own the underlying property or until the deductions have expired.

For property-related transactions this includes deeds, titles and cost basis records. If you claim special deductions and credits, you may need to keep your records a little longer than normal. (For example, if you file a claim for a loss from worthless securities or bad debt deduction, you should keep those records for 7 years.)

? In cases of tax fraud, there is no statute of limitations. A conviction for fraud means the taxpayer deliberately misrepresented information on the return for the purpose of avoiding or minimizing taxes. But the legal standards for proving fraud are tough. Says tax attorney Bryan Skarlatos, in the *WSJ* article, "With tax fraud, the government bears the burden of coming up with clear and convincing evidence the taxpayer had willful intent."

Records may be stored electronically, but these documents must be as accurate as paper records; it must be possible to index, store, preserve, retrieve, and reproduce the records, in hard copy form if needed.

Note: Even if some records aren't needed for taxes, it may still may necessary to keep them for other reasons. Be sure to check with your mortgage company and tax professional before disposing of important records.

If your tax record-keeping needs some tidying up, consider asking one of your financial professionals for assistance. They may have services, including electronic document storage, to help keep your house in order.

As Euro Economies Struggle, Consumers Buy Life Insurance

An August 3, 2012, *Reuters* article reported that:

Europe's two biggest insurers, Allianz and AXA, beat profit forecasts…as customers, weary of years of financial market volatility, shunned risky investments for the comparative safety of traditional life insurance.

The article went on to note that the insurers were boosted by "resilient sales of traditional life contracts which carry little or no investment risk…"

Put in historic context, this information is not surprising. During the Great Depression of the 1930s, the financial health of life insurance companies remained stronger than banks and other financial institutions. The relative financial health of life insurers reflected:

- conservative investment strategies designed to ensure benefits would be paid
- the continuing inflows of cash as policy owners paid premiums
- and a renewed appreciation for safety by customers nervous about the risks in other accumulation options.

With several European governments struggling to revive their national economies, Allianz financial chief Oliver Baete was blunt in assessing the reasons for his company's growth:

"The customer assumes correctly that Allianz is more stable than his own government."

Certified Financial Services, LLC
Richard Aronwald
Financial Specialist
raronwald@cfsllc.com

600 Parsippany Road Suite 200
Parsippany, NJ 07054
973 263-0622
Richardaronwald.com