

# CREATIVE

## Wealth Maximization Strategies

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## Decreasing Debt, Increasing Liquidity

“Financial management” is an amorphous term. Because it has no clearly defined meaning, this phrase can be used to describe many activities. In the financial services industry, financial management may be associated with a range of diverse items, such as...

- making investment portfolio decisions
- using special accounts to receive and transfer assets
- adopting analytical and planning models to shape future plans, and/or
- employing bookkeeping and accounting services

Since the phrase is so easily adaptable to a wide range of financial actions and programs, how about adding two more: **decreasing debt and increasing liquidity**. When properly executed, these two financial activities are hallmarks of a truly well-managed financial program.

Furthermore, for almost every individual or household, decreasing debt and increasing liquidity are *lifelong* financial management tasks. While some debt may be necessary, even inevitable, dollars used for debt payments are enriching someone else’s financial condition instead of yours. This wealth transfer is not only the interest cost of borrowing, but also the opportunity cost that accrues because money that was used to pay interest cannot be saved or invested. Over one’s lifetime, decreasing debt should be a constant financial priority.

In contrast to debt, a strong liquid position maximizes opportunities to prosper. First, liquid assets can often decrease the need to borrow – you can pay cash for the item instead of financing it. Second, people with a strong liquid position can properly invest other assets. They can ride out ups and downs in stock markets, they do not have to sell early, or low, because of financial pressure. How much liquidity is needed? The answer will change according to circumstances, which requires ongoing “financial management.” Get the idea?

But because there aren’t many financial products or sophisticated services that can be marketed to consumers in this area of personal finance, decreasing debt and increasing liquidity often end up being do-it-yourself financial activities. **However, if you decide to take the initiative on these topics, you may find your trusted financial professional can be of valuable assistance.**

### Decreasing Debt: Get Your Priorities Straight



**Stop borrowing for the wrong reasons.** Prevailing attitudes toward debt tend to change according to economic conditions. When things are booming, debt is often seen as an engine of growth, allowing more people to participate in the current surge of prosperity. Taking on debt allows people to become homeowners, start businesses, acquire assets – and spend more than they have in their pockets for vacations, newer cars and big-ticket consumer products. This scenario of expanding debt is ideal for some economists – and most politicians – because everyone seems to be prospering. As long as everyone can pay the “carrying costs” of their increasing debt, very little attention is paid to whether the borrowing is prudent.

A simple question to clarify borrowing decisions:

**“Will debt help move me from being a laborer to a capitalist?”**

- Charles J. Farrell,  
*Your Money Ratio\$*

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But if (or when) the economic cycle turns, debt can become a financial anchor instead of a wealth accelerant. As profit margins decline and/or incomes disappear, debt obligations from the past can make it difficult to change directions, pursue new opportunities or even stay solvent.

Charles Ferrell, an investment advisor, attorney, and author of *Your Money Ratio* (Penguin, 2010) has a simple question to clarify borrowing decisions:

**Does this debt help me move from being a laborer to a capitalist?**

If borrowing helps you acquire an asset that makes it possible for you to transition from “working for money” to “having your money work for you,” the debt is justified. If not, avoid it. Using this question as a guideline, borrowing for an advanced education makes sense if the degree will lead to greater income. If travel is a critical part of your work, borrowing for reliable transportation makes sense. But taking on more debt to dabble in art enrichment classes or “reward yourself” with a nicer car – even if you can afford the extra monthly payments – isn’t financially prudent. The first step in sound financial management of debt is to *stop borrowing for the wrong reasons*.

**Establish a plan.** By the time they recognize the value of decreasing debt, many people find they have lots of it, and in many different forms. There are mortgages, student loans, car payments, credit cards and personal notes. Where to start?

There are also multiple ways to reduce, restructure or pay off financial obligations. The most direct approach is to simply reduce your standard of living. But you may also be able to refinance, transfer balances, or consolidate debts. A coordinated approach to debt reduction can dramatically increase your progress. Here are a few guiding principles:

 **Identify your most expensive debts.** This means the debt with the highest interest charge and/or highest monthly payment. Typically, these are credit cards and unsecured personal loans. Focus on clearing these accounts first.

 **Renegotiate the interest rate.** Lenders need borrowers, and they will compete for good borrowers, the ones who repay their loans. If you have a solid credit history, you may find that lenders are willing to reduce the interest they are charging in order to keep you as a customer. Ask your current lender, and shop around.

 **Consolidate cautiously.** Combining two or three debts into one payment may or may not be to your advantage. Rolling a credit card balance into a home equity loan may provide both a lower interest charge and a tax advantage.

 **Prepay the smart way.** Debt reduction isn’t a stand-alone financial project. In order to work, it has to fit with the rest of your financial life. One of the reasons people end up with ill-advised or costly debt is because they weren’t prepared; they didn’t save or have cash reserves. If all your “extra” money is applied to debt reduction, what will you do

when the next unforeseen financial event occurs, take on new debt? A better approach might be to save in a separate account, then transfer “chunks” on a periodic basis to retire debt.

It may also be important to consider the potential opportunity costs of clearing a debt. If you have a \$10,000 student loan balance with an annual interest of 3%, is there an advantage to making a payoff from an account *earning* 5%? These are the types of questions that a trusted financial professional can help you answer.

## Increasing Liquidity: What Type, How Much

**Liquid assets: Convertible, certain, with minimal restrictions.** Liquid assets are cash, or financial instruments that can easily be converted to cash, for a known amount, with limited conditions or fees. Currency, savings accounts, and other bank instruments are the most basic types of liquid assets. There are other asset classes that may meet the easily-convertible-to-cash requirement as well, such as cash values from life insurance policies and some mutual fund accounts, because they can be redeemed for cash on the owner’s instruction. But not all easily-converted-to-cash instruments meet either the certainty or minimal restriction criteria.



A mutual fund account holder may have the privilege of cashing out his position in the fund at any time, but because of the non-guaranteed and volatile nature of some funds, the account holder may have limited certainty as to the value that will be received. For some, a home equity line of credit might be considered a liquid asset because of the ability to write checks against the collateral in the residence. But this immediate cash convertibility comes with a future obligation to “replace” the withdrawn equity – with interest. (Loans from life insurance policies, as opposed to partial surrenders, may or may not require regular out-of-pocket payments as well.) Taken a step further, some might want to classify the balances in their qualified retirement accounts as liquid assets, even though liquidation to cash may incur taxes and/or penalties.

Because the “purest” liquid assets usually offer low rates of return in exchange for their liquidity, there is often the temptation to reposition them to obtain a higher yield. For example, it can be frustrating to have \$50,000 deposited in an account earning less than 1% annually. But increasing the yield on these liquid assets usually comes at the expense of either certainty or free access. This is where knowledgeable financial professionals can be a valuable resource, because they should have access to a range of alternatives to meet your liquidity requirements.

**How much liquidity is enough?** When the conventional paradigm for individual finances was to work 40 years for one employer, then retire with a watch, Social Security and a pension, the standard advice was that cash reserves, typically defined as savings in a bank, should equal 3-6 months of

income. But when the definition of liquid assets is broader, the career track is less certain, and the national economy is more volatile, the old standards are not workable.

Having 3-6 months of income in a savings account is still a good idea. But another valid guideline for liquidity may be your unsecured indebtedness. Suppose you have the following debts:

Mortgage: \$250,000  
Auto: \$15,000  
Credit Cards: \$10,000  
Personal note: \$25,000

Now, what if a change in circumstances – the loss of a job, a relocation, a major medical incident – forced you to move in a radically different direction? What would it take for you to make the adjustment?

Let's say you are one of the fortunate individuals whose home's market value exceeds the mortgage. You could sell the house and walk away. The car has value, but even if you sell this one, you'll probably need another one. And the credit cards and personal note still need to be repaid, even if circumstances change.

If current family income is \$100,000, a cash reserve for living expenses of \$30,000-\$50,000 would be appropriate. And in order to make a financial "fresh start," it would be helpful to eliminate the auto, credit card and note. That's another \$50,000. Add it up, and the desirable liquidity number is \$100,000.

Some might say, "If I have the \$100,000, why not use \$50,000 to pay off the auto, credit cards and personal note right now?" True enough, but that leads to another question: What happens if the day after you pay everything off you either experience a financial setback or encounter a great opportunity? There is a constant interplay between keeping liquidity for future events and using it to tidy up past financial decisions. Part of the "financial management" in reducing debt and increasing liquidity is maintaining that balance as your circumstances change.

And remember, based on the previous discussion of what qualifies as a liquid asset, the \$100,000 calculation for liquidity doesn't have to be held entirely in a low-yield bank savings account. Similar to an investment portfolio, a financial professional can help you allocate and rebalance your liquid asset holdings.

**Can you see how reducing debt and increasing liquidity have a symbiotic relationship?** Prudent borrowing makes it easier to accumulate liquid assets, and sufficient liquidity either dramatically reduces the need to borrow or minimizes the risks. Coordinating the two activities creates a financial synergy.

Ultimately, you are the one who determines your parameters for reducing debt and increasing liquidity. If you believe there would be benefits from this form of financial management, use the resources of your financial professional to maximize your results. Continually reducing debt and increasing liquidity make for a deeper and stronger financial foundation.

**DON'T MAKE REDUCING DEBT AND INCREASING LIQUIDITY A DO-IT-YOURSELF PROJECT!**

- **GET AN EXPERT ASSESSMENT OF YOUR CURRENT DEBT POSITION.**
- **LOOK FOR LIQUID ASSET ALTERNATIVES.**
- **LEAN ON THE KNOWLEDGE AND RESOURCES OF OTHER FINANCIAL PROFESSIONALS.**



## Estate Tax Rules for 2010 Still Up in the Air

There are so many tax issues under discussion and so many regulations in flux, it can be hard to keep up with the changes. The challenge is even greater when Congress gives taxpayers two choices, then doesn't get around to providing the paperwork to document your decision.

As a result of legislation passed in 2001, the federal estate tax lapsed on December 31, 2009, but was scheduled to be reinstated on January 1, 2011, with rates and exemptions reverting to 2001 levels. This created an ironic window of opportunity for people who died in the 2010 calendar year when no federal estate income taxes would be assessed.

This curious provision was intended to provoke substantive change in estate taxes, but a combination of philosophical disagreement and political reluctance to impose new taxes during a recession left the estate tax in limbo. Under the current law, people who passed away in 2010 would incur no estate tax, but some assets would be subject to capital gains taxes upon the transfer of the estate. Meanwhile, many observers felt it was likely that new estate tax legislation would invoke a retroactive assessment against many estates.

In late December 2010, Congress finally crafted a short-term estate tax bill that modified both the exemption amount and the tax rates for 2011. But what to do about those estates that were settled in 2010? Considering the lateness of the legislation, "Congress allowed estates of taxpayers dying in 2010 to choose between the 2010 and 2011 systems," according to Arden Dale in a May 21-22, 2011, *Wall Street Journal* report.

For heirs and beneficiaries, the question of which tax law to choose often turns on an estate's size and the number of assets that would be subject to capital gains tax. Dale reports that some analysts have concluded there is a "crossover point" where one method is favored over another, but this point varies on a case-by-case basis. Estates with significant long-term holdings but total assets under \$5 million might do better under 2011 rules because they would avoid large capital gains taxes. But for estates over \$5 million, the decision becomes much more dependent on the unique composition of the assets held by the estate.

Even with the complexity that is involved, giving heirs and beneficiaries the opportunity to choose which estate tax scenario benefits them is a notable bit of largesse on the part of legislators. But it would help if the government could

provide the paperwork. The original date for 2010 estate tax return filers to notify the government of their decision to be assessed under the 2010 or 2011 provisions was April 18, 2011. One problem: as of mid-May 2011, the Internal Revenue Service still hadn't issued Form 8939 which taxpayers need in order to file.

## 529 Plan Withdrawals: the Devil is in the Details

Parents (and grandparents) who used 529 plans to save for college expenses were often attracted to the programs because they offered tax-free accumulation on deposits and no taxation on withdrawals, provided the funds were used for educational expenses. And because of the special tax treatment of the deposits, it is no surprise that withdrawals require some careful handling to make sure they meet government qualifications. Here is a short list of withdrawal issues of which 529 account holders should be aware, because, as Jaime Lev Pessin reports in an April 4, 2011, *Wall Street Journal* article,



**Withdrawing funds from a 529 plan may seem simple, but timing and tax-planning issues can complicate the equation.**

### Calculation of qualified expenses

In general, qualifying educational expenses include tuition, room and board (the student must be enrolled at least half-time), computers (only if the school requires them), and books and supplies (as required by the university). However, the amount of qualifying expenses may be reduced if a parent claims the American Opportunity for Lifetime Learning tax credit because they paid some of their child's tuition. It's a convoluted calculation; the essence is that parents can't use money from a 529 account to earn the tax credit. Depending on how much was withdrawn from the 529 account, it is possible that a portion of the distribution could have adverse tax consequences.

### Payment of funds – it matters who gets the check

Funds from a 529 withdrawal can be made payable to the account owner, the student or the school. Each option comes with some tax and reporting ramifications.

If a parent is the account owner and receives the check, the 529 amount does not have to be reported on one's personal income tax return, but because the IRS receives reports on withdrawals from 529 plan custodians, it may ask the account holder to provide documentation verifying the funds were used for qualifying educational expenses. In the event it appears some portion of a 529 plan distribution will be taxable, some tax planners advise making the check payable to the student, thus adding the tax obligation to the student's return, which presumably will be in a lower tax bracket.

Making a check payable to the educational institution simplifies any reporting issues, but raises another potential problem. Some schools may adjust their financial-aid awards based on 529 payments. While 529 plan assets are considered as parental assets when calculating federal financial aid, schools can set their own guidelines for awarding scholarship funds from their own endowments. If a grandparent is the account owner, any money received by the student is considered assistance from a third party, and may reduce scholarship payments accordingly.

### Timing

It is important to take distributions and make payments for qualifying expenses in the same year. Since many colleges end their first semester before Christmas and begin the second after New Year's Day, timing of withdrawals can be an issue.

Suppose the school sends a bill for the second semester in December 2011, due January 15th of the next year. If the account owner withdraws the money in December 2011, but doesn't pay the bill until January 2012, the distributions and qualifying expenses are in different years. This mismatch between distributions and expenses could result in a tax liability, even though the funds were used for their intended purpose.

**If you have used a 529 plan to accumulate funds for college, getting expert assistance for distribution might be a prudent decision to help you fully realize these plan advantages.**

### Grandparents' ownership of the account

Answering a question in a May 9, 2011, *Wall Street Journal* special report, 529 expert Joseph Hurley, founder of [savingforcollege.com](http://savingforcollege.com), stated that when a grandparent owns the account, "the best outcome for one family's situation will not necessarily be the best outcome for another family's." Here's why.

Assets in a grandparent's 529 are not considered family assets in federal financial-aid formulas, but when a grandparent's 529 account is tapped to pay education expenses, the amount counts as student income for the year. Additional income reported by the student in the current year can impact financial aid for the *following* year. Thus, any scholarship or grant money could be reduced in the future. One possible solution: Use grandparent 529 funds to pay the final year in college, when the additional income would have no impact.

- **529 PLANS WERE INTENDED TO PROVIDE TAX INCENTIVES FOR FORWARD-THINKING PARENTS AND GRANDPARENTS.**
- **IN ORDER TO FULLY REALIZE THESE ADVANTAGES, YOU MUST KNOW THE RULES – AND UNDERSTAND THE BEST STRATEGIES TO FOLLOW.**

## Important Detail: Inform Your Beneficiaries!



Imagine this hypothetical scenario. John Smith bought a \$100,000 life insurance policy when he was 35. He named his wife Mary as the primary beneficiary. John paid premiums for 25 years. At 60, John made two changes to the policy. First, because he had accumulated enough dividends that future premiums were no longer necessary to keep the policy in force, he stopped making payments. Second, he named his only daughter, Caroline (Smith) Jones, as the secondary beneficiary.

Five years later, John's wife Mary died. After a year of adjusting to being on his own, John decided to move across the country to a retirement community in the Southwest. Three years later, he moved again. After the second move, he lost contact with his life insurance agent, and neglected to provide the insurance company with a forwarding address. Meanwhile, his daughter Caroline had divorced and remarried. She was now Caroline (Smith) Jackson.

Five years later, at age 65, John was killed in an auto accident. As the only heir, Caroline Jackson was left to sort out her father's estate. Guess what? She didn't know anything about a \$100,000 paid-up policy on which she was listed as the beneficiary.

What happens to the death benefit?

Unless the life insurance company does some extraordinary sleuthing, the ultimate beneficiary of the \$100,000 could be a state government. Quoting from a May 2, 2011, *Associated Press* article by David Pitt ("Cash-strapped states go after unclaimed benefits"):

**Although the money belongs to the beneficiaries, states have laws stipulating that the government becomes the owner of abandoned property after a period of time. Several states, budget-challenged California among them, are aggressively enforcing their unclaimed property laws to force insurers to hand over the money.**

**"It's a budgetary issue for additional revenue," says David Nolte, a principal at Fulcrum Financial Inquiry, a Los Angeles forensic accounting and investigations firm. Technically, states hold unclaimed property for the benefit of the owner, but in many cases the owner doesn't come forward.**

Right away, this must be clear: **It is the primary responsibility of a beneficiary to inform the insurance company of the death of an insured individual.** But because the circumstances of life can clutter up an already hectic, detail-filled existence, situations like the one experienced by the fictional Smith family can very easily take place. At two or three points, a detail slips through the cracks, and eventually, no one knows how to connect the dots.

**It is the primary responsibility of a beneficiary to inform the insurance company of the death of an insured individual.**

Because of scenarios like the one involving John Smith and his family, many life insurance companies also conduct regular cross-checks of their databases against publicly available records, such as Social Security, to see if the holders of inactive policies have died. If they find a policyholder is deceased, state laws require the insurance company to attempt to notify the listed beneficiaries. But if beneficiaries have also passed (like John's wife, Mary) or moved and changed names (like Caroline), it may be extremely difficult to locate the person and distribute benefits. This situation of unclaimed assets applies to other financial instruments which designate beneficiaries as well, including annuities and retirement accounts, such as IRAs.

After a certain period of time, state laws require these unclaimed assets be remitted to state treasuries. As many states are facing extreme budgetary pressure, and the amount of unclaimed assets can be substantial, several states have initiated vigorous action to stake their claim. Consumer advocates are also urging insurance companies, financial institutions and state governments to expand their efforts and upgrade the procedures used to locate owners of unclaimed assets.

### Proactive Steps (a Checklist)

While increased efforts by insurers, financial institutions and governments might result in fewer unclaimed assets, the best course of action is for owners to take some proactive measures to be sure their beneficiaries are aware of their status, and of the assets they stand to inherit.

**Tell your beneficiaries.** Make sure beneficiaries know who they are, particularly contingent beneficiaries. When the primary beneficiary is a surviving spouse, most assets end up where they should. But when a spouse predeceases the account holder, some contingent beneficiaries, such as children or grandchildren, may not be aware of their status. However, if you tell them, they might remember, and be prompted to look for assets.

**Review and update your beneficiaries.** Referencing the previous paragraph, some accounts or policies may have listed only a primary beneficiary when they were established. If this beneficiary is deceased, and no contingent beneficiaries are named, the asset will have to be probated before any distribution is made.

**Organize your financial affairs.** Collect documents, sort them, summarize your holdings, and file them in one place. If you have five insurance policies, provide an informational sheet that lists each policy with details such as company, benefit amount, etc. Our office can help you organize once you collect these items.

**Update your contact information with financial institutions.** If you move, provide forwarding addresses so you continue to receive statements. If distance or changes in

life preclude working with the old agent, rep or broker, establish new advisory relationships – and make sure they are authorized to receive copies of current statements.

**Add redundancy.** IT (Information Technology) professionals always recommend more than one backup, and storing them in more than one place. Besides a paper file at home, consider copies in a safe deposit box, or mailed to either a beneficiary or the executor of your estate. Many financial institutions offer on-line document storage and update programs -- use them! In addition, leave instructions with a select number of your financial professionals so they can find the paperwork and execute the details to speed the processing of claims and asset transfers.

- **DO YOUR BENEFICIARIES KNOW WHO THEY ARE?**
- **ARE YOUR FINANCIAL DOCUMENTS IN ORDER?**
- **HAVE YOU STORED YOUR DOCUMENTS ELECTRONICALLY?**

**Don't let assets intended to bless and sustain heirs languish with an insurance company or be seized by the government.**



## WHICH SOUNDS BEST TO YOU?

In April 2011, Invesco Van Kampen released the results of a survey of 800 Americans on “Finglish,” the survey’s name for financial jargon, to determine which words and phrases resonated with most consumers.

Among their findings: Given the choice between the phrase “financial security” and “financial freedom,” 85 percent preferred “financial security.”

**Financial Security vs. Financial Freedom**

**85**

**15**

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