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**“A feast is made for laughter, and wine makes merry;
But money answers everything.”**

- Ecclesiastes 10:19

ART LESSONS

Here's a story with a lesson:

On a trip to Europe, John bought a painting. He really didn't know much about art, but he shelled out \$25,000 because one of his trusted friends told him it was a good buy. “Hold on to it for 10 years or so, and it will probably triple in value,” the friend said.

It seemed like the friend was right. A few years later, John started seeing reports of similar paintings selling for \$50,000 or \$60,000. Out of curiosity, John had an art gallery owner appraise his painting. The appraiser gave an estimated value of \$65,000. “Imagine that,” said John, “I've got \$65,000 hanging on my wall. That's pretty cool.”

As John considered the \$65,000 hanging on the wall, another thought occurred to him: Why not buy a few more paintings? After all, he'd made a nice profit when he didn't know a thing about art. Now that he was starting to understand the market, he'd probably do even better. Over the next few years, John dipped into his savings and bought a few more paintings.

Pretty soon John's home had become a small art gallery. Not that he was bragging, but his art collection was valued at over a million dollars! “Wow. This really changes my net worth and gives a boost to my retirement plans,” said John. “And since the price of art just seems to go up, imagine what the values will be 10 years from now!”



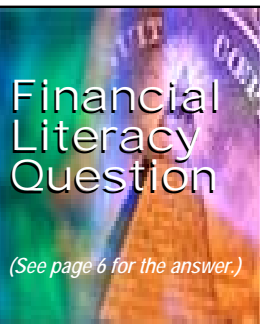
But while John might have paintings worth one million dollars, he didn't have a million dollars. And there was a difference.

As his net worth continued to grow, John had an opportunity to buy a summer home for \$250,000. It was a great deal, and on paper, John could afford it. The question was how to pay for it.

“Hey,” thought John, “One of my paintings is worth about a little over \$250,000 right now. Maybe the homeowner would consider a trade – I'll give him my painting for the house.”

John was slightly surprised when the homeowner declined his offer. “I want my settlement in cash,” said the homeowner. “A painting hanging in my living room can't pay for groceries or a vacation.”

John really wanted the house, so he decided to sell



Here's a quick quiz on a basic financial concept. Do you know the answer?

At age 25, you are given two choices:

Option #1: Save \$3,000 annually in a tax-deferred account for 40 years. You will, however, pay tax on all the earnings when you withdraw the money after age 65.

Option #2: Save \$3,000 annually in a taxable account for 40 years. You will pay the tax each year from your gains, but no additional tax will be taken when you withdraw the ending balance at age 65.

(Assume the annual rate of return is the same for both accounts. Also assume tax rates do not change.)

>>> After taxes, which account will result in the larger amount available to spend?

the painting. He called the art gallery owner and made arrangements for a sale. The gallery owner agreed that John's asking price was reasonable, and began soliciting some of his patrons.

A month went by, and the painting remained unsold. In fact, John didn't receive a single offer. "What's the story?" John asked the gallery owner. "Why isn't the painting selling? Is it overpriced?"

"The price isn't the problem," said the gallery owner. "I've had several people say the price was fair. It's just that they weren't interested in buying right now. You have to remember, buyers of high-end art represent a very small percentage of the populace. *Just because something is worth the price doesn't mean there's a buyer that will pay it.*"

John considered his options. Even if he cut the price, there was no guarantee he would find a buyer. So if the painting was really worth \$250,000, he would be better off waiting until he found a buyer willing to pay it. And since good art just seemed to keep increasing in value, he might as well hold the painting. He told the gallery owner to continue listing the painting, but stay firm about the price. John also told the owner of the summer home that he couldn't meet the cash terms.

And then something completely unexpected happened. The painting he was trying to sell was found to be a forgery. It still looked nice hanging on his wall, but the painting was worthless as an investment. John was stunned and frustrated. He'd paid quite a bit for that painting. Not that he wanted to pass off the forgery on anyone else, but he couldn't help thinking he would have been better off accepting any offer in the past year instead of deciding to keep the painting.

Disillusioned, John decided he was done with art as an investment. He contacted the gallery owner and arranged to auction his entire collection. Unfortunately, the general economy was in the tank; housing values were down, the sub-prime mortgage mess had squeezed the financial markets, and gas prices were up. The gallery owner called the night before the auction to say there simply wasn't enough interest to justify holding the auction.

John faced a sobering reality: For all the money and time he'd invested, all he had to show for it was some canvasses on his walls.

Lesson 1: Dollar value is not the same as money.

In any society, money is a commodity or token that serves as a medium of exchange. This could be anything from shells and beads to coins or cattle. While there are

many items or commodities that can serve as money, the best kind of money is something that everyone will accept in exchange for the things they have to sell.

The official "money" that everyone accepts in the United States is Federal Reserve Notes, denominated in dollars. And while there are many assets that can be valued in terms of dollars, very few of those items can serve as money. A single share of stock may have a current value of \$10/share, but you can't pay for lunch at a fast food restaurant with a stock certificate, and a bank isn't going to allow you to make your monthly mortgage payment in baseball cards or bottles of wine. Most of the time, transactions will require the purchaser to pay in dollars.

If you look behind the curtain of the art analogy, you can make an application to the stocks, real estate and other financial assets. On paper, the dollar values are there. But it's only when the assets are turned to money that you can determine their real

value.

This distinction between dollar value and money is receiving increasing attention as a critical issue in individual financial programs. It's not enough to accumulate an impressive portfolio; there must also be the assurance that those assets can deliver a consistent source of money when needed.

Lesson 2: If something can't go on forever, it'll stop.

The statement, "**If something can't go on forever, it will stop**" is known as "Herbert Stein's Law." (Stein was an economics professor, senior fellow at the American Enterprise Institute, and chairman of the Council of Economic Advisers in the 1970s under presidents Nixon and Ford.) His statement is often rephrased as: "Trends that can't continue, won't."

At various times, some financial commentators observed a trend, then decided it would continue uninterrupted into the future. There was a certainty about their opinion, as if the outcome, while not guaranteed, was still a sure thing. It was the realtor who said "the residential housing market is a great investment. Homes will always go up in value." Or the stock market analyst who said "stocks will fluctuate on a daily basis, but the general long-term trend is always up."

This certainty provided the justification for financial experts to make financial projections about fluctuating assets.

- Because homes would "always increase in value," it was possible to justify making loans for 100% of the purchase price; the future appreciation would



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negate the risks taken by both the borrower and the lender.

- Because savvy investors had been able to deliver double-digit annual return from the stock market, it became reasonable to think it was possible to retire sooner and receive more income; the inevitable upward trend would make any concerns about stability irrelevant.

But as certain as the experts might have been, there were never any guarantees. The trends in real estate and the stock market were influenced by other variables – interest rates, baby boomer demographics, tax laws, etc. When those variables changed, the trend could not continue.

The result of ignoring Stein's Law: Often a bad case of SWILS – Sudden Wealth Loss Syndrome, a term coined in a March 18, 2008 *Wall Street Journal* article. (See inset about an extreme case of SWLS resulting from the AIG meltdown.) This isn't just a "bad year" – it's a wipeout.

Lesson 3: Asset stability is important.

For perhaps the past two decades, "safe" in the financial world has often been associated with "boring" and "stupid." The thinking was "Why settle for a 5% annual return when there's an opportunity to earn 15%?" But in light of the recent financial turmoil, the stability that is a primary feature of safe financial instruments has taken on a new luster.

When the fluctuations are minor and you don't need the money, it's psychologically and mathematically possible to ride out the downturn. But when the losses are huge and you need the money, it's a different story.

The ultimate objective of any investment decision is to acquire more money. Nobody buys shares of stock so they can hang the certificates on their wall. They don't invest in real estate because they want their mail delivered to a different address. The end result of all investment is to have more money – the kind you can spend, not the dollar values that add to your net worth.

Some asset classes are well-suited to delivering money in a reliable fashion. Their dollar values are fixed, and they can be quickly converted to Federal Reserve Notes, the kind of money that's accepted everywhere.

The knee-jerk reaction to recent events in the financial markets might be to swear off all investment opportunities and keep your remaining money in a safe at home. That's probably an over reaction. But because of Lessons 1 and 2, it's important to understand the place asset stability has in your personal financial program. If the ultimate goal of any financial program is to deliver money, there must be a consideration of stable, liquid financial assets. Otherwise, you run the risk of acquiring a lot of financial "art" that might look impressive on a balance sheet, but in the end, isn't worth

what you paid for it.

CONSIDERING THE EVENTS OF THE PAST MONTH, DOES YOUR FINANCIAL SITUATION NEED A BETTER PERSPECTIVE ON MONEY vs. DOLLAR VALUES?

THIS IS ONE OF THE SERVICES WE OFFER.

QUOTES ABOUT MONEY:

The more things change... the more the fundamentals remain the same.

When you read the financial headlines, every day seems to bring "new" revelations. There's a **new** reason why the stock market is up or down. There's a **new** product that replaces the old one or a new methodology that supposedly unlocks greater returns.

All this talk about "**new**" can make you think your financial program is old, out-dated. But if you've been around long enough to chase a few of the latest trends, you're probably a bit cynical about making changes, because quite often the end results aren't any better. **In the long run, it's the time-tested fundamentals that add up to financial success.** These are basic ideas with a long history, as these quotes will attest.

For example, when it comes to saving, Charles Dickens noted in his 1850 novel "David Copperfield" that

"Annual income twenty pounds, annual expenditure nineteen six, result happiness.

Annual income twenty pounds, annual expenditure twenty pounds, ought and six, result misery."

This doesn't sound much different than Thomas J. Stanley and William D. Danko in *The Millionaire Next Door* when they say...

"Most people have it all wrong about wealth in America. Wealth is not the same as income. If you make a good income each year and spend it all, you are not getting wealthier. Wealth is what you accumulate, not what you spend."

And yet, the best and most productive use of **saving** is not to accumulate a pile, but to find ways to make one's savings more productive – to generate more wealth, and more benefits – for everyone. In 1625, the English essayist Francis Bacon wrote:

"Money is like muck, is not good

except it be spread.”

On September 29, 2008, nationally syndicated columnist Cal Thomas echoed Bacon’s words, saying

“Wealth is best used when it becomes a river, not a reservoir; when it blesses and encourages others and does not solely feed one’s personal empire.”

A nice summary of successful financial practice penned in the mid-1700s by British theologian John Wesley, is still provides a solid basis for today:

“Make all you can, save all you can, give all you can.”

Life Insurance for Children

Soon after the birth of one of your children, you may begin receiving offers by mail to insure the life of your newborn. Usually the amount of coverage is small (\$10,000 or less) and the application consists of three or four questions.

Because you’re a smart consumer that views most unsolicited mail as “junk,” you probably send the mailer through the shredder. But the brochure might prompt a question: Even if I toss the offer, should I buy life insurance on my children?

Here’s a brief run down of some of the pros and cons of buying cash value life insurance on children (or grandchildren).

For every advantage stated by those who believe in insuring their children, opponents can put forward a contrasting perspective.



PRO: Establishing insurability. Many life insurance programs for children have minimal underwriting requirements. The policies may also include options to secure additional coverage at later dates without further proof of insurability; all that’s required to add more insurance is paying the additional premium. Since people become less insurable as they age (either because of health issues that develop, or the increased cost of premiums), choosing to obtain life insurance at an early age can greatly diminish the possibility of being uninsured later in life.

CON: There’s no need to secure insurability in childhood. The likelihood of death and the financial loss that would occur are both so low it doesn’t make sense to insure the risk. With the exception of child actors, most children are not wage earners, so some will argue there is no financial reason for insuring a child. Further, each premium, whether for a term or cash value policy, includes the annual cost of insurance. Assuming you can afford the premiums, this money might yield greater benefits if it was saved or invested, instead of used to buy life insurance.

PRO: Lower costs. The annual insurance rates for children are relatively low in comparison with the pricing for adults. Once past infancy, the mortality rate for children is low and doesn’t start to increase until late adolescence. In policies that have cash value accumulations, premiums are lower not only because of reduced mortality costs, but because they will be collected over a longer period of time. For some families, making smaller payments today will be more affordable than waiting to make larger payments in the future.

CON: The cost of insurance may even be cheaper as an adult. When seen through the prism of the **time value of money** and **opportunity cost**, some argue that paying lower premiums over longer periods of time results in the same overall costs as obtaining insurance at a later date. In addition, some insurers make underwriting distinctions with adults they do not make with children. For example, an insurance company may not differentiate between smokers and non-smokers in their juvenile policies. However, as adults begin to establish lifestyle and health histories, insurance companies begin to selectively offer better rates for those who fit a preferred profile.

PRO: Multiple uses for the cash value accumulations over a longer period of time. As an asset class, life insurance cash values have some unique characteristics. Under most circumstances, cash values accumulate on a tax-deferred basis, yet can be accessed without tax penalty before age 59½. Unlike Uniform Transfers to Minor (UTMA) or Uniform Gifts to Minors Act (UGMA) accounts, the ownership of the policy (and control of the cash values) can remain with the parent even after the child reaches adulthood. For purposes of college financial aid qualification, cash values do not have to be reported as qualifying assets. These unique financial attributes have prompted some financial advisors to recommend purchasing life insurance not only for protection but as a supplementary accumulation vehicle

CON: If the goal is accumulation, there's no need to buy life insurance as well. With UTMA's/UGMA's, 529 plans and other savings options, some argue it doesn't make sense to buy life insurance to save for a child's college education or other financial objectives. There are more choices (and opportunities for higher returns) beyond those offered in a life insurance policy.

CONCLUDING COMMENTS

In considering whether you should buy life insurance on your children, your decision will depend largely on two issues: Your personal situation, and whether you see life insurance as an *asset* or an *expense*.

Everyone's financial priorities are different, and those priorities often change, depending on how much money is or isn't available. So for many families, a discussion about life insurance for children probably only happens after some other financial issues have been addressed – like life insurance on the parents, establishing a retirement plan, building an emergency fund, paying off debt, etc. Insuring one's children isn't necessarily an A-list financial topic for most families.

However, once the A-list financial topics are under control, many parents (and grandparents) begin to think long-term. When that happens, the decision about obtaining life insurance for those who don't yet "need" it will hinge on your view of life insurance in general.

A common mass media view holds that life insurance is really "death insurance" – the only reason for anyone having it is to protect others from the financial consequences that might occur from a premature or untimely death. From this perspective, life insurance is an **expense**, something purchased only when the financial need cannot be addressed any other way.

In contrast, there is a financial line of thought that views life insurance as an **asset**. In this mindset, owning a policy adds unique financial attributes to one's personal balance sheet, both short-term and long-term. Integrated with other financial components as part of a comprehensive plan, securing life insurance for children can be a logical and valuable addition to your assets.

WANT MORE INFORMATION ON HOW LIFE INSURANCE ON CHILDREN MIGHT FIT IN YOUR FINANCIAL PROGRAM? MENTION THE TOPIC IN YOUR NEXT REVIEW.



A Paint-by-Numbers Picture

From an article in the September 2008 *AARP Bulletin*, here's a picture of the average American household:

\$84,911
in mortgage debt



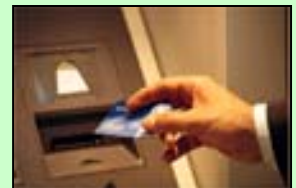
\$10,062
in home equity loans



\$14,414
in car and
educational loans



\$ 8,565
in credit card debt



\$ 392
in annual savings
for the average
American household



FINANCIAL LITERACY QUESTION

Here's the question from the bottom of page #1.

At age 25, you are given two choices:

Option #1: Save \$3,000 annually in a tax-deferred account for 40 years. You will, however, pay tax on all the earnings when you withdraw the money after age 65.

Option #2: Save \$3,000 annually in a taxable account for 40 years. You will pay the tax each year from your gains, but no additional tax will be taken when you withdraw the ending balance at age 65.

Assume the annual rate of return is the same for both accounts. Also assume tax rates do not change. After taxes, which account will result in the larger amount available to spend?

ANSWER:

- A. Option #1
- B. Option #2
- C. They will both be the same.
- D. In the real world, you can't tell.

Answer: A – and probably D. Here are the numbers to support the “A” response:

The calculation assumes a 6% annual rate of return, and a 20% tax on the earnings. The difference in the final net balances is a result of 40 years of annual taxation on option #2

as opposed to one-time tax assessment on Option #1. This mathematical calculation is a typical illustration of the advantages of tax-deferred accumulation.

But does this example “prove” tax-deferred saving is better?

In the real world, rates of return fluctuate and tax rates are **progressive** (i.e., the more you earn, the higher the marginal tax rate). These ever-changing variables could significantly alter the final net balances.

For example, suppose the marginal tax rate was 20% on the first \$25,000 of annual earnings from savings and investment, then 33% on the rest. This would not affect the annual taxation on Option #2, but the one-time tax on Option #1 would be \$119,557 instead of \$74,429. In this scenario, the net balance for Option #1 would be 372,586 – that's only a \$10,000 advantage, in comparison to the \$361,760 for Option 2 for 40 years of tax deferral.

This is a minor change in the tax calculation variables, one that doesn't factor income tax on other sources, nor is it a valid real-life illustration – it just shows how manipulating the variables can change the conclusions. In a perfect world, you could calculate your future tax obligations with certainty. In the real world, taxes seem to change just enough to make it difficult to plan to avoid them.

Since many tax-deferred accumulation options also have penalties for early withdrawals, the decision about how to allocate your savings isn't always about tax deferral.

There are several factors which must be constantly re-assessed to determine which type of account best meets your financial objectives. Want to discuss this for your situation? Give us a call.

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