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***"Should you find yourself in a chronically leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks." -- Warren Buffett***

# The Financial Survivor Test

***How do you know if you are saving enough for the future?***

It's a tough question to answer, made harder because a lot of people take the wrong approach by focusing on the future. By various mathematical calculations, they arrive at a target number for some point in the future. Then, making another series of assumptions (about rates of return, taxes, inflation, etc.) they determine how much should be set aside today to match the target number.

While this approach may provide a sense of purpose and a specific number, it is not an accurate way to know if you are saving enough. Too many unknown and uncontrolled variables went into both calculating the target and plan, and too many unknowns can disrupt the plan.

Instead, a better way to save enough for the future is to base it on your situation today, and make your savings target a percentage of what you are currently earning. While you cannot zero in on a specific target in the future, you can be relatively certain that if your financial life operates in a balanced fashion today, it can deliver what you need for tomorrow.

Here's a simple formula to arrive at your "financial survival number," i.e., the number at which you can help ensure financial solvency, regardless of what happens with the stock market, interest rates, inflation, or whatever other financial variable beyond your control.

**Before continuing, please complete the form on the right.** →

"Step 6" is your financial survivor number. If you could restructure your financial situation to meet all financial obligations and maintain an adequate standard of living, you pass the test. While there are no guarantees, you should be in a position to save enough

## The Financial Survivor's Test

Using this year's tax return….

**Step 1:** Write down your Adjusted Gross Income (AGI)* *(Line 37 on the 2006 Form 1040).*

$ _________________________

**Step 2:** Write down your total income tax due *(Line 63 on the 2006 1040)*.

$ __________________________

**Step 3:** Multiply your AGI by 0.2

**"Step 1" x 0.2 = $ _______________**

**Step 4:** If charitable giving is a significant aspect of your financial life, write the amount from Line 18 Schedule A.

**$** __________________________

**Step 5:** Subtract Steps 2, 3 and 4 from Step 1.

**$** __________________________

**Step 6:** Divide Line 5 by 12.

$ __________________________

**Step 7:** Answer this question: **How well can you live if the number on line 6 represents your monthly income?**

☐ I could manage this.
☐ *Yikes!* No way!

*NOTE: This amount does not include tax exempt interest, stock appreciation, or deferred income. AGI is a tax based amount and may not accurately reflect your true income.

money to handle most financial crises and also retire comfortably. Even in tough times, you can be a financial survivor.

***Notes and Explanation:***

**Step 1.** Especially if you own a business or are self-employed, gross business earnings can be misleading. That's why the Adjusted Gross Income (AGI) number may be a more accurate baseline from which to begin your calculation.

**Step 2.** Taxes reduce everyone's disposable income, and usually the slice gets bigger as AGI goes up. But other factors, such as dependents and itemized deductions, can impact your overall tax rate. For example, a couple with $100,000 in AGI, renting an apartment, may pay more in income taxes than a couple with $100,000 AGI, two kids and a mortgage. Because of these variables, some financial commentators estimate the range of "average" total income tax as a percentage of AGI is between 10-25% for many Americans.

**Step 3.** This is 20% of your AGI. This is the amount you should strive to save for the future. As will be elaborated further, being able to consistently save 20% of AGI has a positive ripple effect through every part of your financial plan.

**Step 4.** The financial effect of your charitable giving is only partially accounted for in the calculation of your tax rate. If you are a serious giver (5% or more of AGI), you need to include this number.

**Step 5 and 6.** In theory, this is what your cost of living should be (on a yearly and monthly basis) if you are paying your taxes, giving according to your convictions, and saving 20% of AGI.

**Step 7.** For many people this number is approximately 50-60% of their AGI. Right now, could you live on this number? Or are your current obligations much higher?

***Some additional commentary:***

If your current standard of living is 50-60% of AGI, several things are happening. First, if you can live below your income, you make regular saving possible. "Duh," you say. But for many Americans, the reason they don't save even if they want to is because they can't manage their standard of living. (And if they can't manage it now, they probably won't be able to manage it in retirement either.) Keeping your current standard of living at 50-60% of AGI also leaves quite a bit of income available to respond to financial crises. Some people's expenses so nearly match their income that even the smallest unexpected crisis ("I have a flat tire") forces them to increase their debt or go broke.

A lot of retirement literature focuses on what retirees can expect as a reasonable decrease in their standard of living expenses in retirement. Usually, the number given is 60-75% of working income. Guess what? If you are already living at that level, retirement isn't a reduction in your standard of living! And when they retire, savers have also accumulated more money.

If you are saving 20% of AGI and living on 50-60%, you accumulate a "year" of living expenses every three years. A person with a $100,000 AGI who saves $20,000 a year has $60,000 in three years. That equals one year of living expenses – even if the savings had been kept in a mattress. If a 40-year-old saved 20% for 30 years, he/she could be fairly certain of having enough money on hand for at least the next 8-10 years – and probably a lot longer, assuming even a minimal rate of return on the savings.

Using averages derived from the guidelines above, an even simpler way to frame the how-do-I-know-if-I'm-saving-enough questions is:

**Can you live on 50% of AGI? Can you save 20%?** If you can do both, you have the financial balance that almost assures success under any circumstance.

**Controlling your standard of living and boosting your savings are two things over which you have a large degree of control.**

**On the other hand, you have *no control* over the big issues (interest rates, inflation and the like) that can undo financial plans.**

***"Live on 50% of my AGI? Are you nuts?"***

At first, the idea of living on 50% of your AGI and saving 20% may seem radical. But is it really extreme? Or is it just that you haven't had it spelled out quite so bluntly?

Here are the financial realities. Everyone loses a sizable chunk of their earnings to income taxes. Even average upper-middle class Americans have had to borrow for their education, their transportation, and their home – and they are going to have to keep borrowing to pay for their children's education, and their aging parent's home care. If nothing changes, they are going to remain in debt the rest of their lives. If that happens, they better hope every fair-weather financial scenario comes true. Otherwise, they are one big stock crash or bursting housing bubble away from losing it all.

In contrast, this "50-20" plan is designed to succeed ***under nearly all circumstances.*** If things go well, you succeed in a big way. If things go bad, you'll be equipped to deal with that as well. It might sound extreme, but it will likely work.

It's also worth noting that *this isn't just about getting the numbers right.* Speculation and hand-wringing about financial matters can become compulsive and stressful, because there's always a little more analysis that can be done, always another reason to worry. While saving enough money and having your living expenses under control won't automatically eliminate every money stress, it sure alleviates the biggest ones. And that means less tossing and turning at night, and better mental health.

Concentrating on controlling your standard of living and boosting your savings are two things over which you have a large degree of control. On the other hand, you have no control over the big issues (interest rates, inflation and the like) that can undo financial plans based on generating higher rates of return with greater risk. Before you start trying to guess the stock market or find a real estate hot spot, take care of the things that you can control.

Most people probably can't rearrange their financial lives to immediately reduce their standard of living to 50% of AGI, or increase savings to 20%. But the earlier you aim high, and start to move toward these percentages, the easier it gets. Once you get the savings momentum going, you might be surprised how fast you catch up.

One of the best ways to reach the 50-20 benchmark is to *grow into it*. C. N. Parkinson, a British economist said that for most people, "expenses always expand to meet income," and added "a luxury once enjoyed soon becomes a necessity." It's hard to cut back on the lifestyle you've become accustomed to. But when your earnings increase, it's a prime time to make a conscious decision to overcome Parkinson's laws. Make a commitment to save more of your next raise or bonus. Resist the urge to spend up to your income limit. Do this consistently and you will inevitably move toward a position of greater financial success and security.

If you can hit the 50-20 benchmarks, you can have the expectation of thriving in good times and surviving the bad times.

## How Life Insurance can help address the Long-Term Care Issue

For many consumers, the question of whether to purchase long-term care insurance presents a serious dilemma.

On one hand, the potential costs of nursing home care, hospice service, or medical expenses associated with terminal illness represent a major threat to financial security in old age. On the other hand, buying long-term care insurance can seem like a steep price to pay for protection against this financial threat.

First, the coverage may be expensive, especially for those whose sole source of income is a pension or Social Security, or derived solely from the earning on accumulated assets. According to a February 25, 2007 article in the *New York Times*, "Those Multiple Choices in Long Term Care Policies," the annual premium for a typical long-term care insurance policy purchased at age 65 from one of the major insurance companies is currently $2,845. (Some details: The insured is a male, non-smoker, rated "standard," and the policy promises to provide benefits of $150/day for three years. Worse health, tobacco use, and longer benefit periods would all increase the annual premium.) While a husband and wife buying the coverage together would probably receive a discount on the second policy, it's not unreasonable to expect a couple to pay between $4,000 and $5,000 a year in premiums, since, according to the article, the majority of long-term policies are currently initiated by those in

## YOU DON'T NEED TO BE AN EXPERT


One of the great principles of capitalism is that the division of labor results in greater efficiency and more profits for all. In the personal financial arena, that means letting the experts – accountants, tax preparers, insurance agents, stock-brokers, financial planners, etc. – focus on their areas of expertise for you, their client. And you? If you want to succeed financially, you just need to focus your efforts on one thing: saving money.

- **Save money by regularly "paying yourself first."**
- **Save money by controlling (but not necessarily restricting) your standard of living.**
- **Save money by avoiding debt.**
- **Save money by using programs with tax advantages.**
- **Save money by structuring your insurance programs properly.**

**A tongue-in-cheek reminder: Make sure you *actually save the money*, instead of allowing the "savings" to add to your lifestyle.** (Honestly, does it make sense when someone says, "I saved $4,000 on this car – I got it for $20,000."? They didn't save $4,000 – they spent $20,000!)

their mid-60s. Even on a $100,000 annual retirement income, the cost of long-term care insurance in the above example would be 5% of one's budget. For this reason, some insurance experts acknowledge that buying long-term care insurance is a tough decision. As Melissa Millan, a senior vice president at Mass Mutual Group, noted in a December 18/25, 2006 article in *National Underwriter*, that insurers "recognize that not everyone can afford a stand-alone LTC policy"

And in many cases, the premium rates may be subject to future increases. Unless policyholders choose a higher "10-pay" premium (in which a lifetime of coverage is guaranteed after 10 years of premium payment), most LTC insurance contracts have provisions that allow the insurer to increase premiums to offset adverse claims experience. Some first-generation LTC policyholders have faced the decision of paying higher premiums or lapsing the coverage – just as they are more likely to need it.

Even though increased longevity and changing demographics have upped Americans' likelihood of needing long-term care, no one wants to make a LTC incident their optimal retirement scenario. No one says, "Well, we thought we would travel for the next ten years, then find a nice assisted-living community and let the insurance kick in." Unless you are willing to pay higher premiums for the feature, LTC policy doesn't have return-of-premium options. So, if you don't have a reason to use the LTC insurance, you aren't getting any money back. Thus, every dollar spent on long-term care insurance is one that can't be enjoyed in retirement, or added to an inheritance.

Take the example described above: If our hypothetical couple pays $5,000 in premiums for 20 years, that's an out-of-pocket cost of $100,000. Of course, regular readers know there's also an opportunity cost to consider – what the money could have earned if it hadn't been used to obtain LTC insurance. At a conservative annual rate of return of 5%, those 20 years of premiums would add up to almost $172,000. (At 8 %, the 20-year total is $247,000.)

Even if a long-term situation does occur, there's still the issue of what happens if the incident exceeds the benefit period. For example, what happens if a chronic or debilitating condition lasts seven years, but the LTC coverage only pays for three?

Given these long-term care issues, how can consumers balance what they can afford against their risks? One overlooked asset may be found in your life insurance policy.

Many life insurance companies offer riders that delineate terms under which the life insurance benefit can be distributed before death to pay costs resulting from a long-term care situation. Because of new provisions in the 2006 Pension Protection Act, these benefits could be received on a tax-favored basis in many circumstances. In terminal situations, the amount paid could equal up to 80% of the life insurance face amount. In chronic situations, the amount paid usually varies with the age of claimant – the older the policyholder, the higher the percentage.

These riders (sometimes referred to as Accelerated Death Benefit riders) are not intended to serve as a replacement for the stand-alone long-term care insurance mentioned earlier. Usually the rider's definitions of what constitutes an "LTC event" for which a claim can be made are not as generous or comprehensive as those in a long-term care contract.

It is also possible for life insurance policyholders to achieve some of the same effects by selling their life insurance policy in a life settlement or viatical agreement. In these transactions, the owner of the policy may sell or collaterally assign the death benefit and receive a lump sum payment, regardless of physical condition. But having an accelerated benefit rider feature as part of your life insurance has distinct advantages. Robert Lehmert, a Vice President of Life Marketing Services for a well-established insurance company explains in the June 2006 issue of the *Life and Health Advisor, titled* "<u>Evolution of Permanent Insurance – Accelerated Beath Benefit vs Life Settlements and Viaticals</u>":

*"Life settlement amounts are generally negotiable and often are substantially less than the potential death benefits. Accelerated benefit riders do not require the negotiations associated with life settlements; the formula is predetermined and the entitlements can be taken at will.*

*"The distributions from an accelerated death benefit are currently tax-free. By contrast, life settlements are taxed as ordinary income…"*

Lehmert goes on to note: *"in an era of dramatically increased longevity, permanent life insurance has the potential to play a critical role in helping individuals live out their days with enhanced financial security."*

**If your existing life insurance policy has an accelerated benefit rider, it may help play a major role in addressing your long-term care issues.**

**First, the life insurance policy can stand as LTC "back-up," making additional funds available should the need arise. This may make it easier for you to consider "real" long-term care insurance, even for shorter benefit periods.**

**Second, if you have to liquidate other assets to assist in paying LTC costs, the insurance benefit guarantees money will be left for a surviving spouse or heirs.**

## AN "OUT-OF-THE-BOX" THOUGHT:

***What if you financed your own car purchases?***

Here's a broad statement intended to get your attention (even though it isn't true in all circumstances):

**You will have a car payment the rest of your life.**

Let's get the disclaimers out of the way. Some people don't drive, even if they could. Others live in urban areas, and walk, or take the train, etc. A lucky few get a company car their whole lives. But, for the vast majority of American adults…

**You will have a car payment the rest of your life.**

Here's the way it works: You take out a loan to buy a car. You drive the car. It wears out. You take out another loan, buy another car. Lather, rinse, repeat, from age 20-25 to 70 (or whenever the DMV takes your license). If you replace your car every four years, that's 10-15 cars in your lifetime!

Right away, the sharp-minded observer says, "Yeah, but that's only if I borrow to buy my cars. If I pay cash, I don't have a car payment." Not so fast. The money you must accumulate or keep on hand to pay cash for your next car is your "payment." It may not be as regular as the one you make to a bank, but it's a payment all the same. In other words,

**You will have a car payment the rest of your life.**

Ever stop and think how much money you spend doing this? For example:

Suppose at 25 you buy your first "real" car for $20,000, financing the purchase through your local bank. A $20,000 car, financed for 48 months at 8% interest results in monthly payments of $489/mo. Four years later, you trade in Car #1, and buy Car #2, also at $20,000. (Because of inflation, Car #2, costs more than Car #1, but your trade-in allowance makes up the difference, so you end up financing the same amount.)

If you decided to pay $20,000 out-of-pocket for each car, then repay yourself over 48 months, $417/mo. would replace the $20,000. But $417/mo.wouldn't replace what could have been earned by the $20,000 over 4 years if you hadn't used it to buy a car. So even if you are making payments to yourself, you should pay $489/mo.

For the next 36 years (to age 65) you buy a new car every four years for $20,000. That's 480 months of $489 payments, for 10 cars. Total cost of vehicles: $200,000 Total outlay: $235,200, reflecting the interest cost of financing the purchases through the bank.

Take this example one step further: The bank receives the money it lent at interest. But as each payment comes back, it is also used to generate more interest. What would happen if you did the same thing?

Starting with $20,000 in an accumulation account, suppose you use all of it to buy Car #1. You begin making monthly payments of $489/mo. back to this account, which earns an annual net rate of return of 5%. At the end of 48 months, you have made $23,520 in payments – just like you would if you financed the purchase through the bank. Your account value? $26,032. Do this for 40 years and the account value is over $200,000!

Starting with $20,000, you bought a new car every four years from this account, each at $20,000, for a total of $200,000 in purchases. Yet, using only the deposits from your car payments, and earning a very conservative rate of return, your car payment account has an additional $200,000 in it!

Some of these calculations may seem like an accounting shell game. The scenario only works if you pay yourself interest for the use of your money, and why would anyone pay interest if they didn't have to? It's true, you don't have to pay interest to yourself, but it is logical that you would. After all…

If someone borrowed from you, wouldn't you expect to receive interest for someone using your money?

and…

If you borrowed from someone else, wouldn't you expect to pay interest for using their money?

so…

If you're willing to pay to borrow and expect to be paid if you lend, shouldn't you pay yourself?

This out-of-the-box discussion should prompt two observations. First, a lender makes more than just the interest charged for the loan, because each payment has the chance to accrue additional earnings. Second, it might be worth structuring some of your savings so that they can be used to "lend to yourself." After all, if you are willing to make interest payments to a financial institution, you might as well make yourself the financial institution of choice.

## Don’t Forget to Claim Your Phone Tax Credit

***(It only takes 13 hours to complete the paperwork)***

***“This year, everyone’s getting a $30-$60 credit on their 2006 tax return courtesy of the US government. That’s because the Federal Telephone Excise Tax on long distance and cellular service no longer applies and the government’s been ordered to refund taxpayers’ money all the way back to March 2003. Taxpayers don’t even have to provide copies of phone bills to qualify. If taxpayers claim 1 exemption (i.e., they’re single), taxpayers get $30, 2 exemptions - $40, 3 exemptions - $50 and 4 or more exemptions - $60.”***

Eva Rosenberg, *Tax Twist*, January 31, 2007.

Ever receive a notice about a class-action suit that you never knew you were a part of? You get five pages of legalese in small print and a postcard that entitles you to a settlement of some small amount, like $5.43. This is essentially the situation with the Phone Tax Credit, only every United States taxpayer is part of the class action!

If you believe your circumstances merit a larger payout than what has been offered to the group, there’s usually an option to reject the settlement, remove yourself from the class, and pursue your claim individually. Of course, taking this path means additional effort on your part, and evaluating whether the possible increase in the payout is worth it.

According to Rosenberg, “the actual refund should be about 1.4 -1.5 times an average pre-tax bill for long distance and cellular service. A consumer that’s on a $69.99 per month wireless plan is entitled to a credit of about $100. However, according to the government, it will take as much as 13 hours and 37 minutes to compute the full amount with interest. Hardly worth the effort.”

Yosef Rabinowitz, managing director of New York-based TBRC Cost Recovery, LLC, explains that in order to claim their full credit taxpayers must sort through their past 41 months of phone bills, total the Federal tax into 14 3-month periods, then fill out Form 8913, calculating the interest for each 3-month period separately. The Paperwork Reduction Notice accompanying Form 8913 estimates it will take 13 hours, 37 minutes to compute the refund, another 13 minutes to fill out the form. *(But what’s another 13 minutes when you’ve spent your entire weekend reading your phone bills?)*

Finding a need and filling it, Rabinowitz’s company created Phone Tax Refund Calculator, a Microsoft Excel spreadsheet that automatically calculates the interest as the individuals enter their phone bill data. According to Mr. Rabinowitz, this reduces the average work time to under 90 minutes, and for many individuals, under 15 minutes.

A Microsoft Excel spreadsheet? Doesn’t it seem like something that simple could have been put on the IRS’ web page?




C&A Financial Group
Wealth Management Strategies

2431 Atlantic Avenue
Manasquan, NJ 08736
732-528-4800
www.CA-Strategy.com