

Ernst & Young's Financial Planning Essentials

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Tables of the following: Investment Mix—Expected Return, Standard Deviation; Low-Medium-High Risk on Asset Allocation for Young, Mid-Life Individuals, Preretired, and Retired Individuals; Historical Average Returns; Value of \$1 Invested in Various Assets; and Comparing Two Portfolios that appear in Chapter 4 of this book are © *Stocks, Bonds, Bills, and Inflation™*, Ibbotson Associates. Chicago (annually updates work by Roger G. Ibbotson and Rex A. Sinquefeld). Used with permission. All rights reserved.

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INTRODUCTION

For most people financial planning is a challenge. Resources are limited and needs can seem endless. As with most challenges, achieving financial security is very much a matter of understanding concepts, organizing information, and developing a workable process. Rather than thinking about financial planning as a one-time activity, at Ernst & Young we think of financial planning as a series of steps that will help you reach the goals you set for yourself.

WHY DO FINANCIAL PLANNING?

While you can never predict how life's uncertainties will affect your financial well being, you can anticipate problems and take advantage of opportunities. You can save money and invest wisely. You can protect your family through estate planning and purchasing insurance. Financial planning can help you strengthen your control over the impact that life's "curve balls" can have on you and your family's finances.

Consider retirement planning. Like most people, you probably look forward to enjoying your retirement years. However, you may be unsure about how and when you'll accomplish this goal. How much money will you need each year? What happens if you outlive your resources? To what degree will Social Security supplement your own retirement savings? These are difficult questions. But careful financial planning can help you size up your individual situation, calculate what you need for retirement, analyze sources of income and means of investment, and design a plan to meet your short- and long-term goals.

Divorce is another example. No one would deny that it's an emotional event; however, it's also a financial event. Many people acknowledge the financial issues, but few see financial planning as part of their response to an impending divorce. Unfortunately, ignoring the situation can have far reaching, significant effects, while good financial planning can help secure the future.

In short, financial planning gives you options for dealing with the future. There are many ways to approach financial planning. Some people feel more comfortable receiving their information from books. Some like to use computer software programs. Others prefer watching financial planning videos, attending seminars, or seeking help from a personal financial planner. What matters most is that you take an active role in managing your finances.

OUR APPROACH

We've created *Ernst & Young's Financial Planning Essentials* to help you take charge of your finances. This book introduces the fundamentals of financial planning. It will help you set your goals, understand investment vehicles and concepts, develop and implement a strategy, and monitor your investments. Important tax issues are also addressed, along with such other traditional financial planning disciplines as investments, insurance, and estate planning. The overview that *Ernst & Young's Financial Planning Essentials* provides will give you the basic information you need to take action.

THE ERNST & YOUNG DIFFERENCE

Ernst & Young's long-standing expertise in the field of financial planning sets it apart from others in the field. For many decades, our specialists have counseled a wide range of clients—from individuals and couples, to small businesses, to employee groups of some of the major corporations in America—about retirement, investments, insurance, estate taxes, and all other financial planning disciplines. This book reflects our collective knowledge and experience.

RECENT ISSUES

The Taxpayer Relief Act of 1997 became law in August 1997. As part of this Act, changes were made in the tax law that influence not only how you file your taxes but also how you conduct financial planning throughout your life. Significant revisions were made to the laws governing paying for college, the tax impact of selling a home, and Individual Retirement Accounts (IRAs).

Incorporated into this text are explanations of these new provisions and what you need to know in order to make sound financial decisions. Among the highlights of the Act:

- Education IRAs
- Deductible IRAs
- Roth IRAs
- Long-term capital gains
- Treatment of home sales

The IRS Restructuring and Reform Act of 1998 modified many of the provisions of the Taxpayer Relief Act. Those modifications are also incorporated in the text.

REGAINING CONTROL, PROVIDING FOR THE FUTURE

Financial planning is, first and foremost, a way to build for a secure financial future and deal effectively with ongoing financial needs. It's not a cure-all. Rather, it's a disciplined way of achieving control and providing for yourself and your family in an organized manner.

Our hope is that *Ernst & Young's Financial Planning Essentials* will serve you well in meeting *all* your financial goals.



TAKING CHARGE OF THE FINANCIAL PLANNING PROCESS

If you're concerned with keeping control of your financial future, you have lots of company. Investments, inflation, taxes, and other money matters concern nearly everyone. Yet even if you recognize the importance of financial planning, you may have trouble taking action, sizing up your situation, and putting all the pieces of a plan together. You may find the planning process itself difficult. You may have trouble following the plan you've created. Or you may feel unsure even where to begin.

Ernst & Young's Financial Planning Essentials will help you take control of your finances, determine which financial goals best suit your purposes, and plan to meet those goals for your own well-being and your family's as well. If you're completely new to financial planning, we'll give you a method for getting started. If you have some ideas but no clear sense of how to coordinate them, we'll suggest ways to develop those ideas into a consistent, comprehensive financial plan. And even if you've already designed a plan, we'll explain how you can make it better.

First, however, you should take stock of your situation, determine your financial strengths and weaknesses, and start to decide what you want from financial planning. Chapter 1 is a starting

point for everything else in this book—a sequence of steps for taking charge of the financial planning process.

These are the steps:

- *Step 1:* Determine where you are financially.
- *Step 2:* Set goals.
- *Step 3:* Develop a plan.
- *Step 4:* Keep simple records.
- *Step 5:* Make an informal budget.
- *Step 6:* Deal with shortfalls, credit, and debt.
- *Step 7:* Review your progress.

STEP 1

DETERMINE WHERE YOU ARE FINANCIALLY

Your current financial position is the starting point from which you should measure progress toward your financial goals. To understand your financial position, however, you need a practical means for taking stock of the situation. A standard device for this purpose is the *net worth worksheet*. This worksheet allows you to estimate your assets and liabilities as a first step to financial planning.

Net worth: *what's left after you subtract your liabilities from your assets.*

Calculating Your Net Worth

Take a few moments to complete the net worth worksheet below. As you fill it in, make sure that you indicate your assets in terms of their current fair market value, not in terms of what you paid for them. For example, let's say that 5 years ago you bought some shares of stock for \$1,000. That stock is now worth \$2,000 (i.e., its current fair market value is \$2,000). Put \$2,000 rather than \$1,000 on the worksheet. Similarly, you should assess the value of any real estate you own as

accurately as possible. One way of doing so is to check with local realtors for the recent sale prices of properties similar to yours.

One final consideration before you fill in the worksheet: This is *not* a financial "report card." There are no right or wrong answers. Don't be judgmental of yourself as you assess your situation. What you discover as you calculate your net worth may or

YOUR NET WORTH AS OF _____

ASSETS

Cash equivalents	
Checking accounts	\$ _____
Savings accounts	_____
Money market accounts	_____
Money market fund accounts	_____
Certificates of deposit	_____
U.S. Treasury bills	_____
Cash value of life insurance	_____
Total	\$ _____
Investments	
Stocks	_____
Bonds	_____
Mutual fund investments	_____
Partnership interests	_____
Other investments	_____
Total	\$ _____
Retirement funds	
Pension (present lump-sum value)	_____
IRAs and Keogh accounts	_____
Employee savings plans (e.g., 401(k), SEP, ESOP)	_____
Total	\$ _____

Personal assets

Principal residence	\$ _____
Second residence	_____
Collectibles/art/antiques	_____
Automobiles	_____
Home furnishings	_____
Furs and jewelry	_____
Other assets	_____
Total	\$ _____
Total assets	\$ _____

LIABILITIES

Charge account balances	_____
Personal loans	_____
Student loans	_____
Auto loans	_____
401(k) loans	_____
Investment loans (margin, real estate, etc.)	_____
Home mortgages	_____
Home equity loans	_____
Alimony	_____
Child support	_____
Life insurance policy loans	_____
Projected income tax liability	_____
Other liabilities	_____
Total liabilities	\$ (_____) _____
Net worth	\$ _____

may not please you; you may come away from the exercise either reassured about your financial situation or concerned about it. *But only by assessing your financial picture in an open-minded fashion can you see where you stand and take control of the situation.*

Note: Be sure to list all assets at their current value without reducing them to reflect any indebtedness. For example, if your home is currently worth \$100,000 and you have a \$70,000 mortgage, list the house at \$100,000 in the asset section; show the \$70,000 mortgage in the liability section that follows.

Later in the book we'll look at the various categories of assets; we'll separate them into long-, medium-, and short-term categories; and we'll consider which of these assets appreciate the most reliably. For now, let's focus solely on the issue of net worth.

The net worth worksheet has three possible outcomes:

- Assets equal liabilities
- Assets exceed liabilities
- Liabilities exceed assets

The hope, of course, is that your assets exceed your liabilities. This means that you have a net worth. If your assets equal your liabilities, or if your liabilities exceed your assets, your financial position is obviously weaker than it should be. Whatever the outcome, though, it's crucial for you to face it straight on. There's no advantage in denial. Refusing to acknowledge a less than ideal net worth will limit your ability to overcome the obstacles before you.

Analyzing Your Cash Flow

In addition to preparing a statement of assets and liabilities, you also need to look at your expenses and sources of income. This is your *cash flow analysis*. In financial planning, determining your cash flow is extremely important. There are four reasons why. Assessing your income and expenses will:

- Indicate your ability to save
- Let you size up your standard of living

- Indicate if you're living within or beyond your means
- Highlight problem areas

All of these issues affect your ability to do financial planning, but they're especially significant as you proceed to plan for retirement.

Here's an example of why cash flow is so important. Let's say that you're 45 years old. You intend to retire at age 60, and you feel you're ready to start planning for retirement. To start the planning process, however, you should ask yourself a series of questions that identify your options.

- What do I want my retirement to be like?
- What will my sources of income be during retirement?
- What standard of living would I like to enjoy at that time?
- Will I work?
- Do I intend to move, or will I stay in my current residence?
- How will I cover health care expenses?
- What kinds of insurance coverage should I maintain?
- What is my likely life expectancy, and will my resources suffice if I reach or exceed that expected age?

These are among the many questions that will determine how much retirement income you'll need and what assets you'll have to accumulate to provide that income. By implication, you need to look at how your *current* standard of living will influence your *future* standard of living.

One measure of your current standard of living—perhaps the most important measure, too—is the living expenses you now incur and your ability to pay for them. Performing a cash flow analysis will help you with this assessment. To do this cash flow analysis, you must set forth all the various expenditures you incur on a regular or erratic basis, compare those with your income, and by this means define your current standard of living.

In assessing your current expenses, here are three rules to follow:

- Set forth your expenses in categories.
- Be complete.
- Don't guess too low.

Many people approach this exercise simply by recording the numbers more or less off the top of their heads. However, you may prefer to proceed in a more systematic way. You may actually need to track the figures, either historically (perhaps for the past 6 months) or prospectively (perhaps for the next 3 months), to create a good, detailed record of what the expenses really are. Regardless of your method, you can use the following cash flow worksheet to help you organize your data.

CASH FLOW WORKSHEET		
INCOME	MONTHLY	ANNUAL
Salary	_____	
Bonuses	_____	
Self-employment income	_____	
Dividends	_____	
Capital gains	_____	
Interest	_____	
Net rents and royalties	_____	
Social Security	_____	
Pension distributions from trusts or partnerships	_____	
Other income	_____	
Total cash available	_____	\$ _____
Uses of cash		
Home mortgage (or apartment rent)	_____	
Utility payments	_____	
Gas/oil	_____	
Electricity	_____	
Water	_____	
Sewer	_____	
Home maintenance	_____	

CASH FLOW WORKSHEET (continued)

INCOME	MONTHLY	ANNUAL
Property taxes		
Car payments		
Car/commuting expenses		
Maintenance and repairs		
Gas		
Commuting fees/tolls		
Credit card/loan payments		
Insurance premiums		
Life		
Health		
Disability		
Car		
Home		
Liability		
Other		
Income taxes		
Employment taxes		
Clothing		
Child care		
Food		
Medical expenses		
Education		
Vacations		
Entertainment		
Alimony		
Charitable contributions		
Gifts		
Personal items		
Savings/investments		
Vacation fund		
Emergency fund		
Investment fund		
Other		
Other payments		
Total expenses		\$ (_____)
Net cash inflow(outflow)		\$ _____

You may, of course, need to adapt this cash flow record to reflect your particular situation. The main goal here is to note everything that's a regular expense. In addition, however, you should note erratic expenses as well, such as capital expenditures or purely discretionary items such as gifts and vacations. These include spending for:

- A new car
- Other vehicles (boats, campers, etc.)
- Electronic equipment (computer, satellite dish, etc.)
- Home improvements
- A second home

You should factor in these expenses, too, as you analyze your income and expenditures.

In later chapters of the book we'll explore how to refine your understanding of your assets. For now, your main task is to gain a general sense of where your money comes from and where you're spending it.

STEP 2 **SET GOALS**

Financial planning is by definition a prospective exercise. Since we can't foresee the future, we have to make certain assumptions about what may occur, then plan for contingencies. Here are some of the questions that influence these assumptions:

- How long will you continue to work?
- What will happen with your income—will it remain the same, rise, or fall?
- What will happen with tax rates?
- What investment rates can you reasonably expect?
- What about the rate of inflation?
- How much involvement do you wish to have in managing your investments?

Your answers to these questions will determine how you must respond to plan for your financial future. In later chapters of *Ernst*

• *Young's Financial Planning Essentials*, we'll examine each of the issues implicit here, and we'll sort through your options for responding to them. Before we do so, however, we should deal with a more immediate, personal issue: What are your financial goals?

The Importance of Setting Goals

Many people find goal-setting a difficult exercise. Here's an exchange similar to what many financial planners have with some of their clients:

Financial Planner: "What are your financial goals for the next 5 to 15 years?"

Client: "Well—I don't really have any."

Financial Planner: "Do you plan to retire?"

Client: "Of course. I'm just not sure when."

Financial Planner: "Do you intend to make any major purchases?"

Client: "Probably."

Financial Planner: "A new car? Maybe a second home?"

At this point, the client may become more specific.

Client: "Now that you mention it, I want to have a second home when I'm 55." And as the planner asks more questions, the client's financial goals begin to clarify. "My wife and I purchased a parcel of land in New Mexico, and we plan to build a house on the land and retire there."

Here are some goals typical of what people indicate to financial planners:

- "I'll need to fund my son's postgraduate education."
- "I want to become financially independent by the time I'm 55."
- "I'd like to buy a bass boat next year."
- "I love to travel, so I'd like to take a major trip each year once I've retired."
- "I'd like to quit my present employer and go into business on my own."

- "I want to have a large estate for my children."
- "I want to make significant gifts to charity."

This client's response—and any other response—implies a financial goal. And to meet any financial goal, you have to take action. First, however, you must take steps to determine what your own goals are and—just as important—what your priorities are in achieving them.

How to Identify Your Financial Goals

Most people never take time to identify their financial goals. They either just don't get sufficiently organized, or else they feel safe "winging it" and making financial decisions as each new situation arises. Yet a realistic framework is vital to the process of fulfilling your goals—not just the goals you're aware of, but also those you may not even have identified. To develop a framework of this sort, you should therefore try to define where you want to be, financially speaking, in the future. The worksheet on financial concerns that follows will help to clarify your thinking.

FINANCIAL CONCERNS

- | | |
|-------|--|
| _____ | To have adequate funds to cover both routine living expenses and foreseeable future needs, including education expenses for my children. |
| _____ | To minimize income taxes. |
| _____ | To be able to retire comfortably. |
| _____ | To increase the assets going to my heirs by utilizing various estate planning techniques. |
| _____ | To accumulate sufficient assets to enable me to increase my standard of living, acquire a business, purchase a vacation home, etc. |
| _____ | To have sufficient funds and insurance coverage in the event of serious illness. |
| _____ | To develop an investment program that will provide a hedge against inflation. |
| _____ | To accumulate a sizable estate to pass on to my heirs. |
| _____ | To enable my family to maintain their standard of living in the event of my death. |