Creative
wealth maximization strategies*

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Overcoming Economic Inequality with Financial Alliances

"Two are better than one, because they have a good return for their labor."

Ecclesiastes 4:9

Economic inequality, defined as the difference in the distribution of personal income and economic assets within a social group, is a hot topic for sociologists, economists and politicians. Some see a relatively high degree of income inequality in the United States, and many believe the inequality is growing; a small group of Americans are getting richer while the rest are getting poorer. Further, economic mobility – the prospect of rising to a higher level of financial standing – also appears to be getting harder. A highly stratified culture in which a small minority controls most of the wealth is considered a negative for both the social and economic well-being of a country. These conditions prompt the above-mentioned experts and policymakers to consider programs and regulations that might discourage or reverse the trend.

But as more research emerges on economic inequality, the harder it becomes to identify its root causes. Because while many factors may seem to correlate with the differences in wealth across America, it is less certain that mandated changes, such as tax laws or entitlement programs, can address the perceived imbalances.

Blame the Baby Boomers (again)

At all levels of society, income and wealth accumulation in America follow a distinct pattern connected to age (Fig. 1). In his March 29, 2014, issue of *Thoughts from the Frontline*, financial commentator John Mauldin writes:

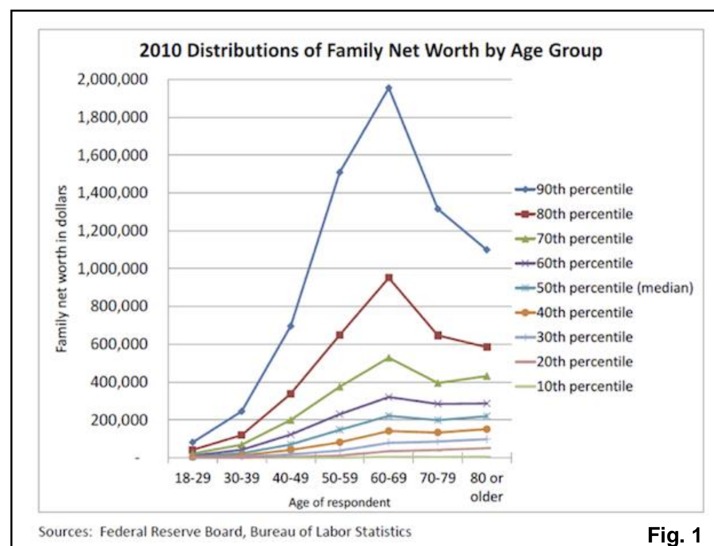

Fig. 1

"The most significant factor in income inequality, which some research suggests is close to 75% of the problem, is that human beings get older. And the older you get, the more money you make and the more net assets you typically have… At every point across the net worth curve, the older you are the more likely you are to be wealthier, up until the time you cross into serious retirement and begin to consume your savings."

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The Baby Boom generation has distorted any number of demographic norms over the past 60 years, and right now is smack-dab in the middle of its peak income and net worth years. In Mauldin's opinion, "I think you can make the case that rising income inequality is significantly attributable to Baby Boomers reaching their peak income years."

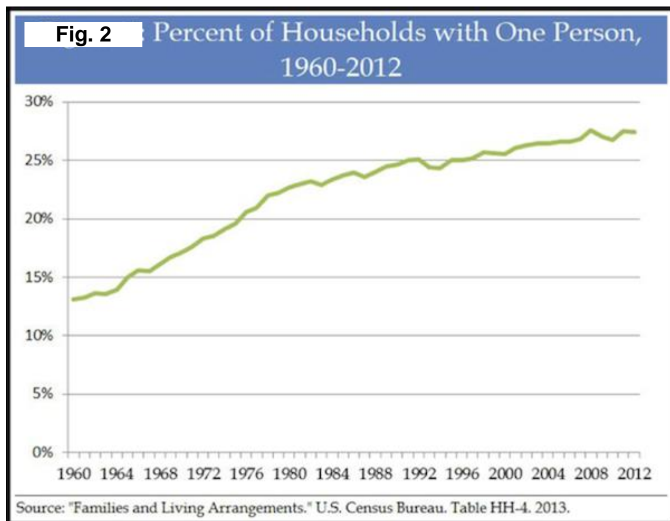
If this is true, the magnitude of economic inequality will diminish as Boomers retire, die and transfer remaining assets to future generations. Given current life expectancy rates, this change should become apparent within the next decade. On the other hand…

Smaller Households = Fewer Earners = Less Income

Many studies of income inequality use households as a unit for comparison. A problem with this standard is the number of individuals and earners that comprise a household may vary, and this variance has a big impact on household income. The math is stunningly simple: the more income earners in a household, the higher the household income.

Smaller household units with lower incomes aren't as financially profitable. A single mother with a young child makes a two-person household. Because of childcare responsibilities, she may not be working full-time (this equates to less than one earner in a household), and probably at a lower wage. By contrast, an older professional couple with grown children may have close to two earners per household – and be in their prime earning/accumulation years. An American Enterprise Institute report highlights this measurement disparity, concluding "high income households are far more likely than low-income households to be well-educated, married, working full-time, and in their prime earning years."

And two trends - one social, the other economic - are pushing the number of earners per household downward. Changing views on marriage, divorce and single-parenting, coupled with increased life expectancies has doubled the percentage of one-person households in the past 50 years (Fig 2). In addition, the change from a manufacturing- to information-based economy and the need for more education means the earnings curve for younger workers is starting later.



While the above-referenced statistics aren't the whole story, the trend toward smaller household units is a big factor in economic inequality. Today's economy makes it hard, both psychologically and materially, to make it on your own. In fact, going it alone seems to be a divergent path, one that tends to move Americans farther from financial success. As much as we may value individuality and personal freedom, the potential economic consequences should cause us to consider possible alternatives.

Economic Alliances: A Formula for Success

Social and economic history offers examples of how individuals and societies have effectively addressed income inequality in the past. One of the best strategies for establishing, growing and preserving wealth has been combining human capital for mutual advantage. These economic alliances share strengths, cover weaknesses, and their coordinated efforts often deliver greater benefits than the parties could accrue separately. Some conventional economic alliances have a long history:

Marriage. Two hundred years ago, the farmer took a wife for more than companionship; marriage doubled the farm's workforce, and children could deliver additional returns as laborers in the field. A large family meant more earners, all focused on improving the collective enterprise.

Today, marriage is still well-suited to positive economic alliances. A couple usually shares the same values and goals, and is in a similar phase of life. Child-raising and expenses can be shared, and the possibility of two incomes makes for greater accumulation potential. From the start of a career through retirement, marriage offers a blueprint for a profitable lifetime economic alliance. While they may not be the only reasons, the enduring economic benefits of marriage are certainly a factor in many second marriages that follow a divorce or death of a spouse.

Multi-Generational Family Alliances. Extending the harmony of interests that begin in a marriage, current and future generations can benefit greatly from economic alliances. Parents can use their accumulated resources to establish their adult children, and the adult children can look after their parents in old age. Assets acquired in one generation (properties, businesses) can be transferred to heirs in formats that give founders full value for their efforts, and provide successors income-generating employment. Multi-generational economic alliances preserve legacies and offer a leg up to future generations.

Organizational Affiliations. Historically, one of the purposes of many religious and fraternal organizations has been providing economic assistance to their members in times of need. An early modern pension by the Scottish Widows' Fund (established in 1815 and still in existence) began as "a general fund for securing provisions to widows, sisters and other females." Even today, member insurance benefits may be attractive incentives for joining service organizations. And although their number has diminished, many service clubs and fraternal organizations operate retirement communities for their members. A contemporary example is Nalcrest, Florida, a retirement community operated by the National Association of Letter Carriers, the union for US Postal Service workers.

The Next Wave of Economic Alliances: Friends, Partners – and Insurance?

These traditional economic alliances are still valid, but contemporary lifestyles may make it harder to implement them. Blended families can diffuse and complicate the emotional elements in family alliances. Greater mobility creates geographic distance – it's hard to live in grandma's house when your job is 1,000 miles away – and the resulting transience means younger generations have weaker affiliations to churches or service organizations. Still, the benefits of economic alliances should

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challenge individuals to consider the possibilities, both conventional and creative.

- Can't afford a house on your own, and don't have parental assistance? Consider partnering with a friend or co-worker.
- Concerned about the cost of elder care, and having to leave your home? Perhaps a personal services agreement for a hospice worker, one that includes living in a separate rental unit on the property would work.

Emotional or philosophical alignments in conventional economic alliances often make the financial details easier to resolve. A decision to assist in the old-age care of one's parents, or leave an inheritance to one's children is usually motivated by love as much or more than the financial rewards. So while the financials of "non-traditional" alliances can work just as well, these are business deals, not family agreements. Consequently, **these alliances should have well-defined financial terms, and quite likely require contracts, exit agreements, and insurance protection.**

To be profitable, all parties in these financially-focused alliances must have their affairs in order. And they must bring tangible financial value to the table. No one wants a broke partner with credit problems, solvency issues, or other money woes. In many ways, insurance – property and casualty coverage, liability protection, cash reserves, buy-sell agreements, etc. – becomes vital because it replaces the good intentions and personal trust that often motivate traditional economic alliances.

Should you consider an economic alliance? It's getting harder to make it on your own, but in order to take advantage of potential synergies of assets and human capital, you need to be a worthy partner. If you already have economic alliances, are they strengthened with documentation and insurance provisions? ❖

Mrs. Howell & Mary Ann: A Real-Life Economic Alliance

Natalie Schafer was an American actress who regularly appeared in movies from the 1930s on, but is probably best known for her role as Mrs. Howell ("Lovey") in the 1960s sitcom *Gilligan's Island.* Born in 1900, Schafer was married once, from 1934 to 1942, and had no children. Prudent investments, particularly in real estate, made Schafer a multi-millionaire.

Dawn Wells was also on *Gilligan's Island*, in the role of Mary Ann. Thirty-eight years younger than Schafer, her personal life was quite similar: Married for only five years, Wells also had no children and did not remarry. She continued to work as an actress, mostly in off-Broadway productions.

Schafer was secretive about the personal details of her life; her true birth date wasn't public knowledge until her death in 1991. Another surprising revelation: In a television interview, Wells acknowledged she was Schafer's personal caretaker for the last years of her life. The bulk of Schafer's assets was transferred outside the probate process, but "reliable sources" suggest most of her fortune was bequeathed to Wells. If so, this is an excellent example of a creative economic alliance. ❖

Financial Aid for Delayed-Onset Adulthood

"You've heard of 'boomerang kids"? You try to throw them out, but they come right back."

If you're a parent of a 20-something, that one-liner might strike you as funny, and possibly true. By many accounts, children are taking longer to become adults; they can drive, vote and drink, but they're still not "grown up." Call it delayed-onset adulthood.

Traditionally, sociologists used five milestones to delineate a transition to adulthood: Completing school, leaving home, becoming financially independent, marrying, having a child.

There was statistical basis for these markers. In 1960, the US Census Bureau found that 77% of women and 65% of men had passed all five milestones by age 30. In the 2000 census, "fewer than half of the women and one-third of the men had done so," according to an August 2010 *New York Times* feature. In fact, cultural and economic factors make it common for many 20-somethings to not reach even one milestone before 30.

Higher levels of education mean more time in school, and full-time employment following college is often a multi-year process of internships, trial periods and short-term assignments. One study found Americans between 20 and 30 will have seven different employers. The subsequent lack of financial stability, combined with changing social values regarding relationships and family make for delayed marriage and children. A 2012 Pew Research Center analysis of U.S. Census Bureau data determined that 36% of the nation's young adults ages 18 to 31 were still living at home.

Considering these issues, sociologist Jeffrey Arnett has begun calling the 20s a period of "emerging adulthood," characterized by "identity exploration, instability, self-focus, and a sense of possibilities." Like the recognition of adolescence in the early 20th century, Arnett sees this as a distinct phase of personal development.

But Arnett also issues a caveat: You can't postpone adulthood forever. While today's 20-somethings may not have to grow up as quickly, they must make progress toward adulthood. Arnett sees an "age 30 deadline" after which "options close off and lifelong commitments must be made."

Financial Assistance: Helping, not Enabling

One of the dilemmas for parents is determining how involved they should be in the finances of their emerging adult children. Does financial assistance move them forward, or allow them to procrastinate? Two broad guidelines: Find ways to help that promote "adult" responses, and minimize financial handouts.

There is a difference between offering a discount and giving money. If your emerging adult child is going to live at home, charge rent. It doesn't have to be a lot, but rent reinforces long-term financial expectations, requires budgeting and establishes habits. It might be cheaper to include your children on your insurance policies (for automobiles or medical care), or your service plans (cell phones), but make sure they pay their portion.

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Debt is a stickier issue. According to government data analyzed by Edvisor, the class of 2014 college graduate has an average student-loan debt of $33,000; should parents pick up monthly payments to build or preserve their child's credit rating? A decision to co-sign a loan for a home or a car requires discretion. (Does a better car make it possible for your son to get to work, or is a co-signer necessary because he has no job prospects?) A parent and a 20-something on the same credit card could build the child's credit rating – or tear down the parent's.

Whatever parents decide, clear communication is essential. If you are going to be the Bank of Mom and Dad, *act like one*. Set payment dates, keep records, and if necessary, make your agreements in writing. Financial discussions that include "But Mom, I thought you were going to pay for it," are not good for parents or children.

Emerging Adulthood: A Sweet Spot for Insurability

In real life, the five milestones for adulthood are often catalysts for "adult" financial planning. Your first car or apartment prompts the need for auto and property insurance. You start working, and are eligible for a retirement plan or group benefits. You get married, have children, and realize you have financial responsibilities beyond yourself.

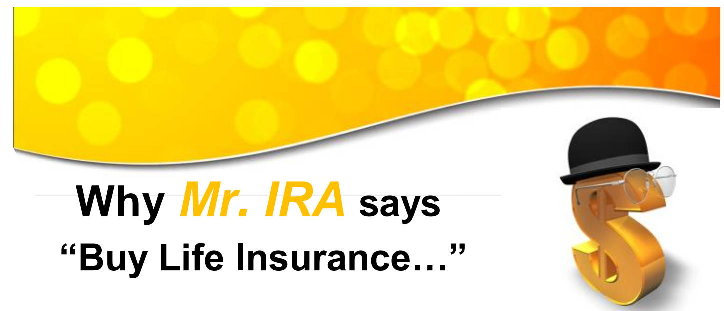
The emerging adult years can be a prime time to insure human life value; one's health is usually the best it will be, and premiums are the lowest. Even if your child hasn't yet passed any adult milestones, locking in insurability is so cost-effective and valuable that parents might consider paying for it.

For example: a 20-year term life insurance policy for $500,000 from a highly-rated company on a non-tobacco-using 28-year-old male in excellent health is $31/mo., and includes options to convert the coverage to whole life insurance without underwriting, for the entire 20-year period. Parents also might consider a contract which offers options for additional insurance without examination at specified intervals (every three years) or when a major "life event" occurs (marriage, purchase of a home, birth of a child, etc.).

Typically, parents are the owners and beneficiaries of these policies. At a later date, ownership can be transferred, with the child presumably taking on the premium obligations, as well as controlling the benefits. (In policies with cash value, a transfer may involve some gift tax issues. As always, expert assistance is recommended.)

For parents, life insurance for their emerging adult is affordable financial assistance that anticipates a positive, productive future when their son or daughter finally grows up. While many of the "adult" reasons for buying life insurance may not be current concerns, getting the protection in place today can be a prudent decision, because whatever adult milestones they eventually reach, life insurance benefits can be repositioned to their benefit. Adulthood may be delayed, but insuring human life value doesn't have to wait. ❖

Emerging adulthood can be a prime time to insure human life value.



New York Yankee baseball player Reggie Jackson was known as Mr. October for his clutch performances in the World Series. Hall of Fame center Gordie Howe had the title Mr. Hockey. If he wanted a similar title, Ed Slott could be Mr. IRA.

Slott, a CPA from Rockville Center, New York, is the author of *The Retirement Savings Time Bomb...and How to Defuse It*. As an "IRA consultant," his expert commentary appears frequently in the financial media. When it comes to IRAs, Slott knows the rules and strategies to maximize the benefits from these pre-tax retirement accounts. He also has an ear to the ground regarding potential relevant legislative changes.

A planning issue for IRAs is how best to transfer undistributed balances at the death of an account holder, particularly if the beneficiary is not a spouse. Lump-sum transfers to non-spouses usually are immediately taxable. Depending on the tax bracket of the recipient, this can reduce the net proceeds by 40% or more. An alternative distribution plan, known as a "stretch IRA" allows a beneficiary to receive the proceeds as a series of payments, using a formula based on the *beneficiary's life expectancy*. Drawing smaller amounts over a long time may significantly reduce the tax rate on distributions, and for 20 years, Slott has been a proponent of the stretch IRA as a way to maximize the amount heirs can receive from undistributed IRAs. But this may be changing.

In an article on www.lifehealthpro.com, reprinted May 1, 2014, Slott notes:

(T)he stretch IRA may be on the chopping block. Congress is constantly looking for new revenue and may soon replace the stretch IRA with a 5-year rule: Instead of extending distributions from inherited IRAs over a beneficiary's lifetime, the beneficiary will have to withdraw the entire inherited IRA by the end of the 5th year after the year of the IRA owner's death. This will diminish the long-term benefits of leaving an IRA or a Roth IRA to beneficiaries.

Slott is referring to legislation proposed in the summer of 2013. While these changes weren't enacted, the tone of the discussion gave strong indication that something will change. (In the words of one senator: "Millionaires, billionaires can pass on millions in their IRAs to their heirs without paying taxes for years, if not decades. That was never what IRAs were for. That is a loophole. It has to be closed.") In light of these issues, Slott concludes: **"Now is the time to help clients plan to replace the stretch IRA with something even better — life insurance."**

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Mr. IRA recommends life insurance? Why? Slott gives three reasons for considering life insurance as a replacement for a stretch IRA.

1. Life insurance distributions to beneficiaries are income tax-free*. Even in a stretch format, inherited IRA distributions will generally be taxable. Removing taxes from the equation gives beneficiaries more leeway with distributions. With an eye toward maximizing the amount to heirs, Slott says better financial leverage is achieved by using the funds to buy life insurance.

2. Life insurance is not subject to required minimum distribution (RMD) rules. The beneficiary of an inherited IRA is required to begin annual withdrawals and pay taxes on the distributions, whether the funds are needed or not.

Proceeds from life insurance are income tax-free, and may be reallocated to other financial vehicles to continue accumulating, including instruments that permit further tax-free growth. The spending of the inheritance is at the discretion of the beneficiary.

3. Life insurance is not buried with complicated tax rules. Slott's comment: "Inherited IRAs are subject to confusing and tricky tax rules that make it more likely that an IRA beneficiary will blow the stretch IRA and end up with a tax problem instead."

By comparison, life insurance proceeds are received tax-free. Even if the beneficiary is a trust, the funds can be distributed to the designated heirs or remain in the trust for their future benefit, according to the owner's wishes.

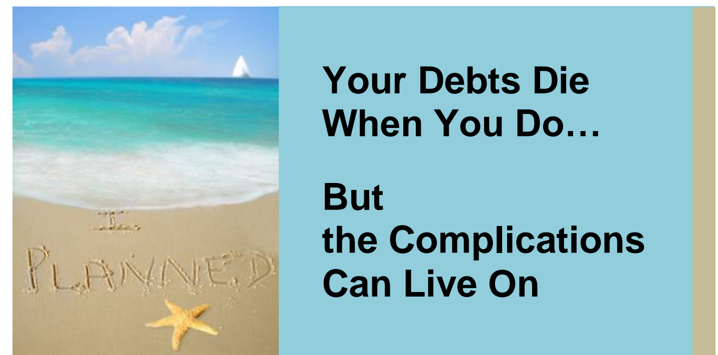
Do a "Stretch" while You're Still Alive

For IRA account holders who want to pass as much as possible to their heirs, Slott says, "Look at life insurance instead – starting now." This is accomplished through modest withdrawals from the IRA to pay the insurance policy premiums, and can begin well before the IRA owner reaches 70½ because "It pays to draw down IRA funds, pay the tax at today's low rates, and then use the funds to purchase life insurance." Another strategy is to postpone funding the IRA to pay for the life insurance premiums.

For those who want their IRAs to be transferred to heirs, Slott finds:

> **"Life insurance is a better, more efficient post-death planning vehicle than an inherited IRA… Beneficiaries will most likely end up with more than they would have inherited from the IRA, and without all the tax rules to comply with. Best of all, the life insurance proceeds will be income tax free."** ❖

*Policy benefits are reduced by any outstanding loan or loan interest and/or withdrawals, Dividends, if any, are affected by policy and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses, or is surrendered, any loans considered gains in the policy may be subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first, subject to ordinary income taxes. If the policy owner is under 59½, any taxable withdrawal is also subject to a 10% penalty.



Your Debts Die When You Do…

But the Complications Can Live On

What happens to your debts when you die? Do lenders just take the loss, or can they compel surviving family members to pay the outstanding balances? The answers to these questions vary according to the type of obligation, the participants in the borrowing agreement, and even one's state of residence. And correctly untangling a decedent's financial obligations may require legal assistance.

Generally, when someone dies, their personal debt is not passed on to surviving family members; all debts are either paid from the assets of the deceased's estate, or written off. However, several factors may result in exceptions to this broad statement.

"Personal debt" is debt incurred exclusively by an individual. For several situations, i.e. if the agreement includes a co-signer, the loan is titled as a joint account, or an asset associated with the debt is considered community property, other parties may find they are responsible for the outstanding balance.

In the probate process, personal assets are liquidated to satisfy creditors before heirs receive the remainder of the estate. If the debt was secured by another asset (such as a home or automobile), a lender may take the asset to satisfy the obligation. This doesn't require payment by survivors but may result in financial distress because they are deprived of the future benefits of these collateralized assets.

Consider this example from a letter to Steve Bucci, a credit counseling expert who writes a syndicated financial column as the "Debt Adviser."

Dear Debt Adviser:

My husband died and left behind a house with a mortgage payment. My name is not on the paperwork as a co-signer, but I do live in the house. This was on purpose. I was kept out of the mortgage so I wouldn't be held responsible if something happened to my husband. Now something's happened, and I'm not sure what I need to do to keep the house. I have not told the mortgage company of my husband's death, though I have been trying to keep paying the bill. What should I do? Do you have any advice for paying a mortgage after the death of a loved one?

– Linda

In a typical estate arrangement the surviving spouse inherits the home. However, because the husband was the sole borrower, his death means the lender could demand the outstanding loan be paid in full. If the husband's estate does not have other assets, the bank could take possession of the home to satisfy the loan, leaving the widow without a place to live.

Bucci tells the widow about a 1982 law that limits a lender's ability to enforce a due-on-sale clause for an up-to-date mortgage when the owner of the property changes. But he adds, that "doesn't mean that the lender won't try or that the lender might

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not try to tack on a fee when it shouldn't." And she needs to find an attorney right away.

An April 22, 2014, *New York Times* article reported another instance where lenders can demand full payment at the passing of a borrower – but in this situation, it's the co-signer who dies.

Because students usually have limited employment and credit histories, student loans from private financial institutions often require a co-signer, typically a parent or other relative. The expectation is that the student graduates, finds employment, and faithfully repays the loan; a co-signer only gets involved if the student/graduate fails to make payments.

But the repayment period for student loans can extend for several decades. During that time, what happens if a co-signer dies? Since the lender has lost an additional level of financial security with the co-signer's death, "even graduates who have good payment records can face sudden demands for full, early repayment of those loans, and can be forced into default."

On the other hand, there may be debts that heirs don't have to repay, even if they can. Another example:

A husband dies with $25,000 in credit card debt. He also owns an in-force life insurance policy for $250,000, with his wife named as the beneficiary. Since life insurance proceeds are distributed directly to heirs, and not subject to the probate process, creditors may not have a legal claim to these assets to satisfy a debt. Referencing Bucci's earlier comment, this doesn't mean creditors won't attempt to ask heirs to repay these debts – they have nothing to lose by asking. And heirs, not knowing the legal status of the debt, may comply.

To get a sense of the financial distress that often accompanies unresolved debts after a family member passes, you might want to read a few entries from the bills.com website (www.bills.com), especially the "Comments" sections that follow many articles.

Two recurring observations:

1. How a death might affect their debts is rarely part of consumers' decision to borrow.
2. In almost every situation, adequate life insurance protection makes it much easier to resolve debt issues in an estate.

Bucci goes directly to this at the beginning of his answer to Linda's letter:

"I'm sorry to hear that your husband passed away. I'm doubly sorry that you're now stuck in a financial bind. You're not alone, unfortunately. Women tend to outlive men, yet many fail to plan for this eventuality."

"In the best of worlds, your husband would have had mortgage insurance or a life insurance policy that would allow you to pay off or pay down the home loan. From the tone of your question, I gather this is not the case…"

If you have debt, not having life insurance to clean up whatever might be due on your passing may put your survivors under unnecessary financial duress. On the other hand, having life insurance gives them both the time and resources to handle the process correctly. ❖

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