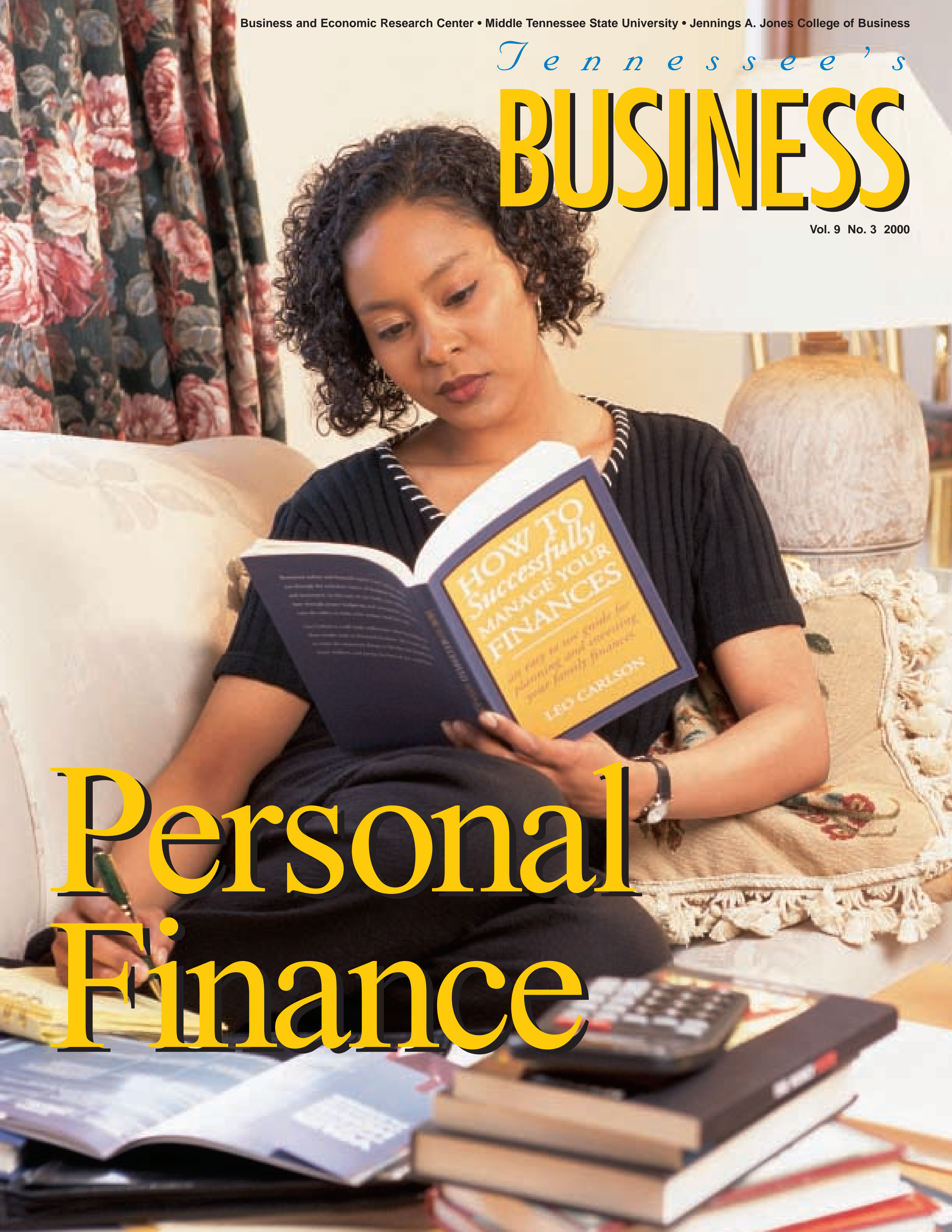

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HOW TO Successfully MANAGE YOUR FINANCES
an easy to use guide for planning and investing your family finances
LEO CARLSON
Personal Finance

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Notes

Financial planning for individuals, families, and businesses continues to grow in importance. Hampering planning are the complexity and volatility of tax laws. Because a higher age is required for receipt of full Social Security benefits, it is imperative to strategically maximize private savings for retirement. Since contributions and earnings are not taxed until retirement, retirement investment plans are a first-line defense against untimely taxes. This *Tennessee's Business* describes strategies related to key financial planning issues as helpful general guidelines for solving an increasingly complex problem. ("Tax and Financial Planning for 1995 and Beyond," Brown, Jake, and McDaniel, Knoxville, TN).

— Horace E. Johns, Editor

We at Olde South Trust understand the importance of estate planning. Many people considering estate planning procrastinate, assuming everything is taken care of or that they are invincible. We know this is true from the more than 450 cases we have handled in the past two years and the number of last minute "death-bed requests" in hospital rooms throughout Tennessee.

AARP states that eight out of ten Americans over age 40 have not done any estate planning. When selecting an estate planning firm, one must be careful to ask questions about how many trusts the planners have drawn up and settled this year and whether they are up to date on tax consequences regarding IRAs and other investments. Some pitfalls in estate planning include having a poorly written document, not understanding one's trust and other documents, improperly transferring and funding assets into one's trust, having a document that fails to meet one's specific needs, and not understanding that this process requires yearly updates (which one should check to see that the firm offers at minimal or no charge).

We at Olde South Trust find it an honor and a privilege to serve families throughout the Tennessee area and their generations to come.

— Michael S. Casper, CEO and president,
and Michael D. Verble, COO, of Olde South Trust, Murfreesboro

MTSU's Department of Economics and Finance and Chair of Insurance are pleased to cosponsor this issue of *Tennessee's Business* on personal financial planning, an increasingly important topic. Our patchwork system of Medicare and Social Security needs substantial overhaul to maintain financial stability; neither system was designed to handle the massive influx of potential recipients resulting from extended longevity and the explosion of the retirement-age population. Further, recent federal legislation indicates an increasing propensity of Congress to rein in social welfare spending and shift the burden of health and living costs of the elderly to individuals and their families.

Studies repeatedly show most families have modest net worths and relatively low levels of savings. We believe one reason for the general failure to achieve financial security is the lack of knowledge about personal financial issues. We present the following articles to assist readers in accumulating and conserving assets in their lifetime and passing wealth to heirs and beneficiaries at least cost at their death. We are happy to refer anyone needing additional information to a competent personal financial planning professional.

—Kenneth Hollman, Martin Chair of Insurance,
and John T. Lee, chair of Department of Economics and Finance, MTSU

The Business and Economic Research Center at MTSU gratefully acknowledges the sponsorship of Olde South Trust and MTSU's Department of Economics and Finance and Martin Chair of Insurance for this issue of Tennessee's Business.

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Estate Planning

Getting Started

by Michael S. Casper
and Michael D. Verble

What Makes Up Your Estate?

Many people wonder how federal estate taxes will affect them. The federal estate tax is a transfer tax on the value of assets in your net taxable estate at the time of your death. Federal estate taxes will generally be due if the sum of your net taxable estate and taxable gifts exceeds $675,000 (in 2000). The first step in understanding the federal estate tax is to understand what constitutes your estate.

Treasury regulations relating to the taxation of property owned at death contain a catch-all definition that the "gross estate of a descendent who was a citizen or resident of the United States at the time of his death includes the value of all property, whether real or personal, tangible or intangible, and wherever situated, beneficially owned by the decedent at the time of his death."

Among those often overlooked items that are includable in your estate are your rights to future income, such as your right to payments under a deferred compensation agreement or partnership income continuation plan. These rights are commonly referred to as "income in respect of a decedent" and are included at their present commuted value. Likewise, your interests in any business you own at your death, whether as a proprietor, a partner, or a shareholder in a corporation, are includable in your gross estate. In addition, your personal property, investments, real estate, retirement plans, and proceeds of life insurance policies that you own are also included.

The value of Social Security survivor benefits, either lump sum or monthly annuity, are not included in your gross estate. This is one significant benefit of the Social Security system.

The actual task of determining what is includable in your gross estate can require some in-depth analysis. A planning professional who has the technological capability to project and forecast your estate tax liability under a variety of scenarios and timetables can assist you. Your estate should be reevaluated each year so your beneficiaries and heirs will not face agonizing decisions over your wishes and federal estate tax requirements. Consulting with professionals can help ensure your planning decisions are consistent with your overall goals and objectives.

We have only touched upon a few initiatives you can take *now* to start managing your estate.

Smart Steps for Estates

Even if you are just starting to build your estate, there are several steps you should consider taking immediately in order to protect your family and to reduce potential expenses in the event of your death.

- **Draft a trust.** A formal legal document directing the settlement of your estate provides for the distributions of your assets according to your wishes. A living trust funded with specific assets can allow those assets to pass to your heirs outside of probate.
- **Title assets properly**. The simplest and least expensive estate planning technique for married couples is to take title to assets as "joint tenants with rights of survivorship."
- **Plan for the unexpected**. First, consider granting a durable power of attorney for financial matters and a living will and health care proxy for health matters.
- **Keep your family informed.** Many families subscribe to limited "need to know" policy between parents and children. However, at some point, all family members should be apprised of financial, medical, and estate arrangements that can affect the entire family.

Life Insurance Trusts

The primary objective of an irrevocable life insurance trust is to exclude the insurance proceeds from the estate of the insured. Secondary objectives are creditor protection and providing a source of liquidity to the estate via loans or the purchase of estate assets. Liquidity may be necessary for payment of estate taxes and to provide income to the surviving spouse and children.

The insured individual can create an irrevocable life insurance trust (the insured is the grantor or creator of the trust) and appoint a trustee in order to prevent inclusion of an insurance policy in the insurer's estate. Customarily, the insured/grantor appoints a family member, friend, lawyer, accountant, or institution (bank or trust company) as the trustee or trustees. The IRS does allow the insured to have the power to substitute one independent trustee for another (Rev. Rule 95-58-, 1995-2 CB191). However, it is generally advisable not to give the insured any other rights in the trust so as to avoid the possibility of estate inclusion.

The beneficiaries of the trust are typically the children or grandchildren of the insured. The trust instrument usually will provide protection from creditors in the event of divorce, bankruptcy, or a lawsuit.

Existing life insurance policies may be assigned to the trust, or the trust may be created to purchase new life insurance policies. If an existing policy is assigned to the trust, the assignment of the policy is treated as a gift. The value of the policy for gift tax purposes depends on the type of insurance product. A term insurance policy has a gift tax value equal to the unearned premium. A whole life policy on which premiums are still being paid has gift tax value equal to its interpolated terminal reserve plus any unearned premium. A single premium whole life policy on which no further premium payments are required has a gift tax value equal to its replacement cost.

If the trust is purchasing a new life insurance policy, then the grantor makes gifts, usually of cash, to the trust to fund the premium payment. In general, gifts made to a trust for the benefit of the insured's children will be treated as gifts of a future interest and thus not eligible for protection under the annual gift tax exclusion of $10,000 per donee. In order to take advantage of the annual gift tax exclusion, the beneficiaries are given the right to withdraw money from the trust for a limited period of time each year. This withdrawal right is called Crummey withdrawal power, named after the family that originally litigated this issue with the IRS (D. Crummey, CA-9, 68-2 USTC 12,541,397/F2d 82). The beneficiaries of the trust must be given notice of any contributions to the trust so that they have the opportunity to exercise their withdrawal right, usually for a period of at least 30 days each year.

An important aspect of the plan is to make sure the trust is able to supply insurance proceeds to the estate to help fund the estate taxes. In order to do this, the trustee is authorized to lend money to the estate or purchase assets from the estate at the time of death. When the estate sells property to the insurance trust, there will be no capital gains tax because the assets will receive a step up in basis at death. ■

Michael S. Casper is chief executive officer and president of Olde South Trust, Murfreesboro, and Michael D. Verble is its chief operating officer.

New Millennium

Planning Defined

Will the "supermarket" approach expand the industry's client base?

By Patrick D. Crowley

The financial advisory business, as it is currently structured, faces many of the same external competitive challenges as most other industries. It is in a state of flux resulting from the increased use of the Internet by consumers, a demand for an increasing level of services, and a downward pressure on fees and commissions. Additionally, new compliance concerns, the proper use of Internet tools, and the changing face of retirement planning (a core service and marketing concern) need to be addressed as well.

Taken as a whole, the personal financial services industry, including investment advisors, insurance companies, banks, and broker/dealers, has generated profits which far exceed those of many other industries. From 1993 through 1997, this industry achieved growth and returns with an average balance growth rate of 8.2 percent and an annual profit growth of 6.9 percent. Aggregate profits within this business significantly exceed those of most industries. By 1997, the financial industry virtually matched the U.S. manufacturing sector in this regard.

However, it should be noted that much of this performance was driven by the bull market of the last ten years. The accelerated compounding of household assets created most of this growth. It is not attributable to an increased savings rate, a dramatic increase in customer base, or dramatic reductions in the cost of manufacturing or

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The "supermarket approach" combines banking, brokerage, and insurance.

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delivering products. This favorable market conduct cannot carry an industry forever. (Market activity during the first two weeks of April, 2000, verifies this statement.)

One study indicates that if the stock market were to fall by 20 percent (against 1997 levels), profits from investment products would drop by 30 percent and overall profits by 10 percent. If interest rate spreads on deposit products were to fall to 1993 levels, profits in the industry could shrink by 15 percent. In a credit crunch, profit from all liability products would drop by 30 percent and overall industry profits by eight percent. Obviously, two or more of these conditions could occur simultaneously. If so, the competition within the personal financial services industry to expand sales and profit would heat up significantly.

The common belief is that the *"supermarket approach"* to financial services, epitomized by Citigroup, will be the prototypical financial services industry answer to the need for an expanded client base. This supermarket approach, where banking, brokerage, and insurance products are offered under one roof, has been officially sanctioned with the demise of the Glass-Steagal Act restrictions on this form of activity. The central question is whether financial advisory entities will be able to gather all prospective clients at the supermarket level.

Typically, client markets are segmented into net worths under $2 million (Tier l), from $2 million to $10 million (Tier ll), and over $10 million (Tier III). A recent evaluation of industry trends met with some surprise when it addressed how that second tier market will be serviced. While most industry insiders felt that this report's conclusions were as obvious as a network sitcom joke, independent financial planners were apparently caught off guard by the report's conclusions. The suggestion that small firms will be forced out by 40 to 50 full service industry giants should come as no surprise to anyone familiar with the fate of "mom and pop" retail operations after Wal-Mart comes to town.

Essentially, the report outlines that the Tier I clients will be serviced with advice and products through boilerplate calculations and retail packaged products. This suits the supermarket format approach. It also works well for the competent amateur, the "do-it-yourselfer" who only wants basic guidance on integrating elements of information, such as tax law changes, into his existing plan.

For Tier III, the private banking and family office approach will continue to hold sway. Family offices allow individual families to accomplish such tasks as having their assets pooled together for more efficient management, as they see the management of their net worth as a business in itself. In addition to investment advisory services, a typical family office service agenda might include bill paying, tax preparation, education of younger family members in values and objectives, debt management, and occasionally picking up the dry cleaning.

It is Tier II where the battle among industry competitors will take place. These clients are increasingly familiar with Internet access to trading and advice. They are familiar with the "give" available in fee schedules and, at the same time, demand a higher level of services. Providing asset allocation and investment monitoring alone will no longer meet the clients' needs or expectations. As they are estimated to control $7 trillion dollars in assets that could generate $50 billion dollars in recurring advisory fees, Tier II clients will be courted by a variety of competing financial advisory firms.

Echoing most industry experts, this report suggests that the new millennium advisor will have to become a solutions provider. Areas such as taxation (estate and income), insurance needs, charitable giving, and family needs analysis will all be addressed under one roof. In the era of financial supermarkets, the investment advisor will have to become like Jeeves (P.G. Wodehouse's butler, not the Internet site): someone who is familiar with the client's goals, financial situation, family issues, and tax liabilities while remaining discreet about it all. It will become just as important to know that the client has heirs who may be aggressive spenders and in need of a spend thrift trust as it is to know that the client himself is a moderate investor.

While this multi-user family office approach will be central to the relationship, it will come at a cost to the client well below what most advisory firm's charge now for fewer services. In order to compete, the investment advisory firms must be able to leverage their capital on behalf of their front line marketing personnel. The relationship officer (broker, agent, trust officer, planner) will be responsible for soliciting more clients and assets to manage. The service aspect will be met through back office expertise in such diverse areas such as estate planning, investment management, insurance, hedge funds, private placement investments, and tax preparation, to name but a few. Added to that list will be the services of attorneys, CPAs, valuation experts, and, where needed, family therapists. (Whether this last professional category is for the relationship officer's use or the client's is yet to be determined).

The model for this arrangement exists, to a degree, within the broker/dealer sector of the financial services industry. Wrap fees for

investment consulting have been offered for years. Originally priced at three percent, this product has seen its average fee drop to one percent. This, along with C share mutual funds and the recently introduced flat fee for transactions, reflects the industry's acquiescence to lower fees. Financial and estate planning, offered with or without fees, has been available from these firms for many years. The addition of trust services is common. Asset allocation incorporating financial simulation models will be offered by most firms within the next few years. All of this is being offered during a period of increasingly discounted fees as an attempt to capture market share, especially within the middle tier group.

The driver in this client relationship has been and will continue to be the broker/investment advisor. This relationship officer will remain the key contact with all clients and ultimately responsible for the delivery of services and products. The surviving financial firms will train their relationship officers to focus on creating solutions to client problems. In order to expedite this change, firms will alter the compensation for these individuals, paying less for transactions and more for asset gathering and capturing additional business from new and existing clients. The point of emphasis between the client and the advisor will be based less upon the return from investments and more upon the relationship itself.

The trick for the firms involved will be either to transfer the relationship from the investment advisor to the firm or to solidify the firm's contact with the relationship officer through financial handcuffs. (Shifting the relationship from the advisor to the institution has been adopted by many firms through the use of Internet account access, online calculators, proprietary products, and national advertising campaigns.)

Fundamentally, one effort that will be required of the firms will be the extensive training of the relationship officers and their supporting departments. An investment advisor with a Certified Financial Planner (CFP) designation on his business card will be extremely common. There will be an increasing crossover from other professions, such as CPAs and attorneys seeking to increase their own fee streams and markets.

Regional and national accounting firms have been entering the field in droves as their markets and revenues are compressed by the client's use of Internet tools and software. This trend continues as estate and trust attorneys create alliances allowing themselves to offer a full service advisory approach. All of these professionals have come to realize that it is far more profitable to charge recurring fees for comprehensive advice and planning than it is to maintain a profitable product-centered business, such as tax return preparation or will drafting.

The merger of these interests is reflected in the purchase of CPA firms by American Express, which now employs more accountants than some national accounting firms. This trend continues with the sale of a 50 percent share to Legg Mason, a brokerage firm, of an investment management company which was created and owned by a Boston law firm. When a client comes in to discuss estate planning, will they leave the lawyer's office with a managed money account agreement? How will lawyers be compensated for this cross-selling? What level of disclosure will be required?

THE DILEMMA FOR CLIENTS AND ADVISORS LIES IN THE ASSUMPTION THAT THE FINANCIAL PLANNING TOOLS AVAILABLE ON THE INTERNET, SUCH AS CALCULATORS AND ASSET ALLOCATION PIECES, ARE CORRECT AND COMPLETE.

These questions lead to a discussion of the micro changes that will occur in planning beyond the larger restructuring of the financial advisory industry. Compliance issues, Internet use, and the changing face of retirement and retirement projections all must be considered and revised.

Compliance officers for investment advisory firms must find themselves reeling in this new age. How is it possible to control the information flow between the firm and its client when information is being blasted at the client faster than water through a fire hose? Associations between brokers, CFPs, attorneys, and CPAs are more prevalent and murkier than ever before. Increasingly, regulatory lines are crossed with no clear designation as to which professional code should be applied. In the example above with our cross-selling lawyer, do the disciplinary rules of the ABA's Code of Professional Responsibility apply or the NASD's compliance edicts? Should it be revealed to the client that his attorney was provided with luxury accommodations and a golf outing while on a "due diligence" trip promoted by a mutual fund company seeking to do business with the firm's investment management company?

Clients seeking independence from these too-cozy relationships often find themselves attracted to the freedom and flexibility of the Internet. Real-time stock quotes, low transaction costs, and online advice are but some of the opportunities available to the high-tech investor. With financial services being hailed as the third fastest growing category on the Web, it is unlikely the trend will stop.

The dilemma for clients and advisors lies in the assumption that the financial planning tools available on the Internet, such as calculators and asset allocation pieces, are correct and complete. In regard to estate plans, the individual who stumbles upon an estate tax calculator is unlikely to gain much insight into his need for liquidity planning, proper IRA beneficiary designations, or available charitable giving techniques.

These limitations are less important than the fact that much of the information on the Internet is simply inaccurate. For example, one Web site offering from a mutual fund company is a calculator for determining 72(t) distributions. This section of the Internal Revenue Code allows for distributions from IRAs and other retirement accounts prior to age 59.5 without a 10 percent penalty tax being applied by use of various formulas. An IRS mandated actuarial table is to be used in one of the available formulas. Unbeknownst to the Web site user, the sponsor has failed to provide an update to the table even though the IRS has required its use for many months now. One need only mutter the phase "Internet Roth Conversion Calculator" to produce shudders down the spines of planners, CPAs, and clients alike. These devices steered so

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many people toward inappropriate IRA conversion decisions that the IRS extended the period of reconsideration several times.

The IRA and other retirement vehicles will factor prominently in the development of the "new retirement" and the planning surrounding it. Numbers alone are driving the change in retirement planning. In the year 2000, 2.05 million Americans will turn 65. By the year 2015, this number will exceed 3.4 million. Currently, one in eight Americans is over age 65. By the year 2025, this number will be one in five.

The old paradigm of work followed by a brief retirement and then death is no longer acceptable. In the area of retirement planning, this means planners may be asked to develop financial recommendations incorporating retirement as early as a client's late 30s, a retirement that includes second careers beyond age 65, and a reluctance to accommodate any reduction in lifestyle expenses.

The rules of thumb utilized in retirement planning will no longer suffice: a defined level of income (70-80 percent of prior compensation), constant rates of return on investment, and a defined period before mortality have been typical projection assumptions in retirement planning. These are also openings used to undermine the planning community by Web-based insurgents seeking to capture the attention of a more sophisticated and educated investor class. This group, best represented by Nobel Laureate Bill Sharpe's Financial Engines firm, argues that these assumptions give Americans a false sense of security about their retirement.

The assertion being made is that with calculations based on averages there is a 50 percent chance the client will earn more and a 50 percent chance the client will fail to meet his goals. As an example, a client who is asked to assume an eight percent average return might be told he would expect to have $500,000 left at age 95. The odds are 50/50 that this figure will be wrong, and there is a 20 percent chance he could run out of money at age 75. The variables used typically do not accommodate the fact that investment returns and inflation rates actually vary from year to year.

To illustrate this using the period from 1969 through 1998, an 8.5 percent withdrawal rate would have caused a retiree to run out of money 17 years early. Why? Stocks lost money for the first six years, despite an average annual return of 11.7 percent over the 20-year period.

Planning firms will be using a forecasting method that models random events, known as Monte Carlo simulation. It mimics the roll of a die. Rolling the die ten times, with each side reflecting a potential stock market performance, would simulate one possible history of returns for the ten-year period. Because each roll produces a random result, your next ten rolls should produce a different set of returns. Duplicating the prior ten-roll sequence is unlikely.

A TYPICAL FAMILY OFFICE SERVICE AGENDA MIGHT INCLUDE BILL PAYING, TAX PREPARATION, EDUCATION OF YOUNGER FAMILY MEMBERS IN VALUES AND OBJECTIVES, DEBT MANAGEMENT, AND OCCASIONALLY PICKING UP THE DRY CLEANING.

The purpose of a Monte Carlo simulation is not simply to recreate random events. Its real value comes from analyzing the simulation's outcomes, which can reveal the event's expected value and the dispersion of results around that value. For planners, these results can aid the discussion of risk and uncertainty with clients.

The Monte Carlo simulation approach to retirement projections calculates not only the best- and worst-case scenarios, but also the entire range of outcomes, to determine the probability of clients' attaining their goals. These simulations are a way to show ranges of outcomes based on minor changes in variables such as inflation and tax rates.

Retirement planning will not be the only application for these simulation tools by advisory firms. The most popular leveraged gift techniques used by estate planners often include the use of discount rates. The use of a uniform rate of growth is assumed here as well. Volatility associated with the asset's value can have a tremendous effect on the success or failure of the wealth transfer strategy selected. The use of simulation tools to select the optional portfolio for transfer will be critical.

All of this underscores the need for ongoing planning using sophisticated computer modeling tempered with the relationship officer's understanding of the client's personal risk profile, family situation, and nonfinancial goals.

This leads back to the central product which investors seek: unbiased advice. If advice today is built on human relationships, in the near future it is likely to be built equally on science. The use of accurate Internet tools and advanced back-office support should allow the well-trained relationship officer to provide more services to an increasing number of wealthy (Tier II) clients under a multi-user family office approach. This extra volume will be required to make up for the declining fee structure. Advisory firms which expend capital to improve their technology and train their relationship officers to deliver comprehensive financial and estate plans will prevail in the future. Given all that, the financial service industry future is best represented by the Chinese word for "crisis," which blends the symbols for danger and opportunity. Those advisory firms left standing will be those which recognized the dangers and still managed to seize the opportunities. ■

Patrick D. Crowley is the director of Planning Services for Morgan Keegan, a regional broker/dealer firm headquartered in Memphis, Tennessee.

Notes

1. Dorlisa K. Flur. 1999. "New Rules, New Game: Personal Financial Services and the Insurance Industry." *Journal of Financial Services Professionals* (November): 69.

2. Ibid., p. 70.

3. Mark Hurley et al. "The Future of the Financial Advisory Business and the Delivery of Advice to the Semi-Affluent Investor." http://www.undiscovered-managers.com.

4. Ibid., p. 1.

5. Ibid., p. 3.

6. Deborah L. Jacobs. 2000. "Dangerous Liaisons: The Increase in Multidisciplinary Practices Brings a New Era in Service—And in the Potential for Conflict of Interest." *Bloomberg Wealth Manager* (April): 86.

Advance Medical Directives

Comparisons and Critique

by Lara Womack

Increasingly, estate planning recognizes the possibility that individuals might suffer periods of physical impairment or dementia prior to death. An advance medical directive is a document that allows an individual

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SUCH DOCUMENTS ARE EVIDENCE OF A SHIFT AWAY FROM THE CONCEPT OF PHYSICIAN PATERNALISM, IN WHICH IT WAS PRESUMED THAT THE PHYSICIAN ALWAYS KNEW THE BEST TREATMENT FOR THE PATIENT, TOWARD THE CONCEPT OF PATIENT SELF-DETERMINATION, IN WHICH PATIENTS PARTICIPATE IN AND CONTROL TREATMENT DECISION-MAKING.

instructions about his (or her) future medical care. The document becomes effective in the event that the individual becomes unable to speak for himself.[1] An advance medical directive is never effective when a patient is competent to make decisions about his own health care.[2]

The inclusion of advance medical directives in estate plans has become more prevalent for two reasons. One is the increasing likelihood that individuals will suffer periods of physical impairment or dementia prior to death, rather than experience sudden death.[3] Also, such documents are evidence of a shift away from the concept of physician paternalism, in which it was presumed that the physician always knew the best treatment for the patient, toward the concept of patient self-determination, in which patients participate in and even control treatment decision-making.[4] Despite these factors, however, it is estimated that less than a quarter of U.S. citizens have executed directives on future medical treatment.[5]

A federal statute, the Patient Self Determination Act, requires that certain health care providers inform individuals of their right to direct their own medical treatment, but the documents which are collectively known as advance medical directives are creatures of state law and thus vary from one jurisdiction to the next. Such documents can be classified as instructional directives, health care proxies, or a combination of the two.[6] This paper discusses instructional directives, such as living wills; health care proxies, which delegate decision-making power to another person; and those documents that combine elements of both.

Types of Advance Medical Directives

Living Wills

The first type of advance directive that an individual should consider incorporating into his (or her) estate plan is a living will. This document determines what measures will be taken when there is no reasonable expectation of recovery from serious mental or physical disability.[7] This type of instrument is an instructional directive. It dictates the measures to be taken or withheld under certain circumstances, rather than delegating that decision to a third party. Living wills are now authorized in forty-nine states and the District of Columbia.[8]

Living wills are generally used to direct that life-sustaining procedures be terminated. They apply when an individual suffers from a terminal illness or is in a persistent vegetative state.[9] At least two states, Maryland[10] and Florida,[11] also recognize an end-stage condition as a basis for withdrawal of life support. This allows a patient who does not face imminent death, but whose condition is advanced, progressive, and irreversible, to dictate some of the terms of his treatment.

This document addresses two primary issues. First, it addresses the administration of medication and performance of procedures necessary to provide the individual with palliative care, that which is necessary to insure comfort. Second, it states whether the individual authorizes the withholding or withdrawal of artificially provided nourishment or fluids.[12] The living will may also incorporate instructions from a woman on how to proceed in the event that she is pregnant at the time the directive becomes effective. Women should be advised, however, that the state's interest in preserving the life of an unborn child may take precedence over the right of the individual to determine her own treatment.[13]

Several organizations offer forms that can be used for living wills. One such organization, Aging with Dignity, makes available a form that is effective in 33 states and the District of Columbia. It is titled "Five Wishes" and deals with end-of-life care in a more comprehensive way than the living will previously used by most individuals. It not only offers the individual an opportunity to make known his wishes on life-extending care, but it also addresses quality of dying issues, such as the comfort level of an individual, the way in which he wants people to treat him, and what he wants his loved ones to know.[14]

Powers of Attorney

The health care power of attorney is distinct from a living will in that it names an individual to act in the place of the patient rather than expressing the wishes of the patient directly. The job of the individual named, sometimes referred to as a proxy, is to make the decisions he believes the patient would have made for himself had he been competent. Thus, it is crucial that the person executing this document convey his beliefs and wishes to the proxy.[15]

One issue that must be addressed by those wishing to incorporate advance medical directives into their estate plan is the potential for conflict between the living will and the health care power of attorney. Should such a conflict arise, the living will would take priority.[16] In order to account for a possible change in circumstances, the individual should consider including in the health care power of attorney a provision allowing the proxy to supersede the terms of the living will as long as his actions remain consistent with the terms of the power.[17]

Anatomical Gift Donations

The Uniform Anatomical Gift Act sanctions the gift of all or any part of an individual's body by will.[18] Given the possibility that the individual's will may not be referred to until some time after death, it seems preferable not to use this method of communicating a desire to make an organ donation. The uniform act also sanctions documents other than a will, specifically referring to drivers' licenses, donor cards, living wills, and durable powers of attorney,[19] and obviates the need for any written

documents at all by authorizing gifts made by recorded telephonic or other recorded message.[20]

It is not necessary that the document or other evidence of a desire to make an organ donation have been delivered in order for the gift to be effective, although the act seems to encourage such action when there is a specified donee.[21] The gift becomes irrevocable upon the donor's death, and at that time it is not necessary to gain the consent or concurrence of any other person.[22] In the event that a patient has not previously given consent to organ donation, but has been determined to be a suitable candidate, the act establishes a procedure for initiating the process of making a request. Among other things, the process discourages multiple requests for consent.[23]

Whether by terms of the uniform act or otherwise, all states recognize anatomical gifts, and several incorporate directions for anatomical gift donations into the living will document.[24] This combination is especially helpful since continued care, which would otherwise be inconsistent with the patient's wishes, may be necessary to preserve the organs.[25] In those states in which the organ donation instructions are not included in the living will document, a separate document can be executed, but the health care power of attorney should incorporate some reference so that measures can be taken to preserve the organs.

Mental Health Advance Directives

The rule that an individual has the right to control his own treatment is not suspended because the individual suffers from a mental illness. That right is not suspended until the individual becomes incompetent, whether as a result of the mental illness or otherwise. The involvement of the mentally ill patient in the treatment decision may be the greatest expansion of the general trend away from physician paternalism to patient self-determination.[26]

Those who suffer from a mental illness can address treatment issues in a durable power of attorney for health care, but this only allows the appointment of an intermediary to make decisions he believes are consistent with the patient's wishes. It does not maximize self-determination by allowing the patient to direct his treatment in advance. In order to fully exercise his rights, the mentally ill patient must be allowed to execute an instructional directive.[27]

Minnesota was the first state to specifi-

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The living will addresses two issues: (1) the administration of medication and performance of procedures necessary to insure comfort and (2) the authorization of the withholding or withdrawal of artificially provided nourishment or fluids.

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cally authorize the advance psychiatric directive.[28] At least four other states now have statutes approving these measures: Hawaii, Illinois, Maine, and Oregon.[29]

The value of this instructional directive is that it not only allows patients with mental illnesses to refuse unwanted treatment, but it also acts as consent for treatment to which the patient agreed during times of competency but subsequently refused during relapses of his illness. By allowing a doctor to ignore the patient's incompetency-based refusal of treatment, the time, money, and suffering attendant to an incompetency hearing in court can be avoided.[30]

Appointment of Conservators

A conservator is a person appointed by a court to supervise, protect, and assist a disabled person, that person's property, or both. A person is disabled when he is in need of supervision by reason of mental illness, physical illness or injury, developmental disability, or other mental or physical incapacity.[31] Because this process gives one individual authority over both the person and his property, it is broader in scope than either the power of attorney for health care or the more traditional power of attorney, which applies to financial decisions.

Many states include in their living will forms a provision allowing the patient to nominate his conservator.[32] Since the living will is effective only when a person is terminally ill or in a persistent vegetative state, the provision is more appropriately included in the health care power of attorney. This will facilitate use of the nomination if the individual becomes temporarily incapacitated. Also, the power of attorney should specify that the person nominated to be conservator has the power to amend or revoke any trust agreements executed by the patient since failure to do so will result in those agreements becoming irrevocable.[33]

Do Not Resuscitate Orders

A *do not resuscitate* order is one which directs "health care personnel not to initiate or continue medical treatment or artificial ventilatory support for a terminally ill patient whose heart has stopped beating or whose respiration has ceased."[34] Like many other forms of directives, the DNR order must be signed by the patient and a witness. Unlike other forms, however, a physician must also sign the DNR order.[35] Further, it is usually the physician who initiates the discussion concerning such an order.[36]

When a patient has been admitted to a nursing home, hospice, or hospital, there should be little problem with DNR compliance. When the patient is at home, however, communication as to the existence of the DNR order is crucial. Statutes dictate that emergency medical service personnel honor the order,[37] but only if it is presented to them upon their arrival at the scene.[38] In order to facilitate this communication, some states issue DNR bracelets.[39] The best practice by the family of a patient who has been taken home to die, however, may be just *not* to call 911.[40]

When the existence of a DNR order has been adequately communicated to the appropriate personnel, it must be honored unless the attending physician or a person acting under a power of attorney requests that resuscitation measures be initiated,[41] a provision which seems to compromise the whole idea of patient self-determination.

The Patient Self-Determination Act

The Patient Self-Determination Act was passed by Congress in 1990 and became effective in 1991. It was enacted because so few people were using advance medical directives. The purpose of the act is to promote education of patients and the public about the right to direct their future medical care through the execution of such documents. The act does not create any new directives; it simply recognizes those created by state law.[42]

The basic requirement of the act is that all health care providers that participate in Medicare and Medicaid provide written materials to patients about advance directives.[43] This requirement applies even if the patient is not involved in a situation in which a directive is likely to become necessary. Nothing in the act requires that patients execute an advance directive, only that they be advised that such measures are available and asked if they wish to execute one.[44] Further, the health care provider cannot refuse care to those who have not executed an advance directive.[45]

There is debate over the effectiveness of the Patient Self-Determination Act. Some argue that the act is ineffective because health care providers comply strictly with the law by making patients aware of advance medical directives, rather than initiating any meaningful discussion about those documents. While this may increase the number of directives executed, it does not insure that those who execute them fully understand them.[46] Others cite a better appreciation of patient rights by the medical profession as evidence that the act has been successful in promoting awareness of an individual's right to participate in treatment decisions.[47]

The Effectiveness of Advance Medical Directives

Communication in general seems to be the key to the successful use of advance medical directives. This includes not only communication between the patient and the proxy, but also between the patient and the doctor. Conversations about issues

ONE ISSUE THAT MUST BE ADDRESSED BY THOSE WISHING TO INCORPORATE ADVANCE MEDICAL DIRECTIVES INTO THEIR ESTATE PLAN IS THE POTENTIAL FOR CONFLICT BETWEEN THE LIVING WILL AND THE HEALTH CARE POWER OF ATTORNEY, IN WHICH CASE THE LIVING WILL WOULD TAKE PRIORITY. AN INDIVIDUAL SHOULD CONSIDER INCLUDING IN THE HEALTH CARE POWER OF ATTORNEY A PROVISION ALLOWING THE PROXY TO SUPERSEDE THE TERMS OF THE LIVING WILL.

Communication in general seems to be the key to the successful use of advance medical directives, not only between the patient and the proxy, but also between the patient and the doctor. During the time these conversations are taking place, the patient should also consult with his family, friends, clergy, and lawyer.

addressed by advance medical directives should begin when patients are healthy. There should be several conversations between the patient and the doctor, and during the time that these conversations are taking place, the patient should also consult with his family, friends, clergy, and lawyer.[48]

The patient who wishes to incorporate advance medical directives into his estate plan must carefully consider the persons who will be named to make decisions on his behalf during times of incapacity. In order to guard against the possibility of disagreement, the same person should be named a proxy under any health care power of attorney and conservator under any document making such a nomination. Further, there must be clear communication to this person as to the wishes concerning health care wishes of the patient.

Once the directives are executed, it is important to communicate their existence to family members and friends as well as health care providers. The more the documents are circulated, the more likely it is that they will be followed when necessary.[49]

Conclusion

Advance medical directives represent progress toward allowing patients self determination. This goes beyond allowing the patient to participate in the treatment decision during times of competency. These instruments allow a patient to direct the treatment prior to times of incapacity; by so doing, they recognize that decisions made at those times are not purely medical.

As part of this trend toward patient self-determination, legislatures can be expected to reconsider state statutes on medical directives and adopt more flexible, comprehensive measures.[50] Also, the debate on physician assisted suicide will continue. Proposals on this issue would entitle those patients who are competent and terminally ill to request a prescription they could administer to themselves that would result in a peaceful death.[51]

The development of advance medical directives facilitates a discussion about important issues most people will face at the end of their lives. Professionals involved in the drafting, execution, and implementation of these documents must acknowledge that, while legal or medical expertise is relevant to the decision-making process, these are neither legal nor medical decisions, but quality-of-life decisions. Ultimately, better communication and cooperation among the professionals will benefit the patient. ■

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30. Id.

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33. See, e.g., T.C.A. section 35-50-116.

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CDs
MUTUAL FUNDS
IRAs
STOCKS
401K
T-BILLS
BONDS

The Selection of IRAs

Current Rules and Practical Considerations

by John T. Lee and Duane B. Graddy

The Individual Retirement Account (IRA) was established under the Employee Retirement Income Security Act of 1974 with a $1,500 maximum contribution if restrictive qualifications were met. To further encourage individual savings for retirement, availability was extended to everyone in 1982, regardless of income level or coverage in other retirement plans. In response, during the period 1982-87, over $165 billion flowed into IRAs. Given the huge loss in tax revenue, Congress reversed direction in 1987 with eligibility for a tax deductible IRA contribution based on income limits that were set at a relatively low threshold, making it restrictive for most taxpayers who were participants in an employer plan.

An IRA is a tax-favored personal retirement plan set up through a trust or custodial account for the exclusive benefit of the contributor or his/her heirs. The owner determines the type of investment, the contribution up to the $2,000 maximum, and the investment risk profile. Further, the participant receives an investment accumulation substantially greater than that of a conventional savings vehicle having the same yield and time frame.

Two significant tax benefits enhance the yield: all interest, dividends, and capital gains accumulate in the IRA on a tax-deferred basis, and contributions to an IRA *may be* tax deductible for Federal Income Tax purposes if they qualify (IRS Publication 590).

With the passage of the Tax Reform Act of 1997, amended by the IRS Restructuring and Reform Act of 1998, Congress expanded the eligibility rules and created a new type of IRA. The Roth IRA, available since 1998, was named after its sponsor, Senate Finance Committee Chair William Roth, Jr. (R, Del.). A key difference between the new Roth IRA and the traditional IRA is the timing of tax benefits.

The primary focus of this article is to conduct a comparative analysis of the three types of IRAs that are available. Major differences exist in eligibility, contributions, deductions, and distribution rules. A second purpose is to develop guidelines for determining which of the tax-advantaged IRAs—traditional versus Roth—should be selected. Also considered is the complex issue of conversion of other IRAs into a Roth IRA.

> Three types of IRAs are available: the regular IRA, the nondeductible IRA, and the new expanded Roth IRA.

IRA Choices

The comparative analysis in this article is restricted to the three distinct types of IRAs that may be available: the regular IRA, the nondeductible IRA, and the new expanded Roth IRA. Exhibit 1 provides a summary of the essential features of these three choices. A spousal IRA is a variant of a regular IRA and will be addressed under that category. The misnamed education IRA will not be considered because it has no role in retirement choices.

Regular (Traditional) IRA

In the case of a traditional IRA, a tax savings occurs up front with a tax-deductible contribution, thus lowering the Adjusted Gross Income (AGI). Further, these pre-tax dollars continue to grow untaxed until withdrawals occur. This double tax break translates into a compounding-enhanced return that far exceeds a non-sheltered investment with the same nominal yield and time frame.

A person is eligible to invest in the regular IRA if he/she has earned income, is younger than age 70½, and is "not an active participant in an employer's retirement plan" or is an active participant in such plan but with an AGI below $42,000 single and $62,000 joint. Full eligibility ends at $32,000 single and $52,000 joint. Phase-out rules apply between these limits. These AGI ranges are being raised over the next few years. In 2005, the single range will be between $50,000 and $60,000. By 2007, the joint range will expand to phase out between $80,000 and $100,000. Eligibility is not affected by mere association with an employer-maintained plan unless a beneficial interest is provided.

In the case of a spouse with less than the $2,000 per year earned income, the revised rules permit the establishment of a spousal IRA based on the combined AGIs of each spouse. The combined contributions to both IRAs cannot exceed $2,000 per individual. Effective in 1998, the non-working spouse is not treated as an active participant in an employer's plan covering the working spouse. Instead, eligibility to contribute to a regular IRA is contingent on income limitations—MAGI between $150,000 and $160,000 [IRA and 401(k) Guide].[1]

The IRA owner is required by the IRS to begin taking distributions by April 1, following the year that he/she turns 70½. All distributions from a regular or spousal IRA are included as taxable income. Funds may not be withdrawn prior to age 59½ without a 10 percent penalty unless the distribution is allowed by specific exception. Authorized non-penalty withdrawals include death or disability, qualified first-home purchase, certain family education expenses, and deductible medical expenses.[2] Another non-penalty option is the lifetime annuitization of substantially equal payments. Health insurance premiums are qualified where the contributor is receiving unemployment benefits [IRA and 401(k) Guide].[3]

Nondeductible IRA

From a retirement planning perspective, this type of IRA is generally a poor choice. On a comparable basis, any qualified tax-deductible retirement plan will provide superior net returns. While a nondeductible IRA is not subject to income

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limits, the contribution is in after-tax dollars. Since the distribution is taxed only on the earnings portion, it is necessary to keep track of the contributed basis. As seen in Exhibit 1, the nondeductible IRA is subject to all other rules that apply to regular IRAs. Other things being equal, the sole benefit of establishing a nondeductible account is the untaxed earnings growth. This option would thus be recommended only in cases where individuals have fully utilized all other qualified retirement vehicles.

Roth IRA

The Roth IRA, created in 1998, has generated widespread interest in IRAs as retirement savings vehicles. A Fidelity survey from early 1999 estimates that only five percent of Americans with an IRA had a Roth.[4] As the public becomes more aware of the potential advantages of the Roth IRA, its popularity is sure to increase. This IRA provides tax-free income, as opposed to the traditional IRA's tax deferred income. Whereas contributions to the Roth IRA are *not* tax deductible, earnings in the account will be free of income tax if held for at least five years. Unlike the regular IRA where withdrawals include contributions and earnings, the Roth IRA is depleted in the following order: first, Roth IRA contributions, followed by conversion contributions, and finally earnings.[5] Any withdrawal of earnings that does not meet the criteria for tax-free treatment will be subject to income tax and the 10 percent early withdrawal penalty. The same requirements that determine a qualified distribution under a traditional IRA apply to the Roth IRA.

The Roth is designed to attract middle-income taxpayers that are active participants in employee-sponsored retirement plans and younger taxpayers in lower tax brackets. In order to qualify, taxpayers or their spouses must have earned income that is less than the maximum AGI cap. For single taxpayers, the phase-out range is $95,000-$110,000. Joint returns are phased out between $150,000 and $160,000. A non-working spouse or one with less than $2,000 annual income qualifies for a spousal IRA based on joint income.

One major difference between the Roth plan and regular IRA is the age restriction. Unlike the regular IRA, Roth contributions may be made beyond age 70½ if there is earned income. Similarly, there are no required distributions or minimum withdrawals. Contributions could continue until death, with the IRA distribution at death being subject to regular inherited IRA taxation rules except that there is no income tax due.

Major differences exist in eligibility, contributions, deductions, and distribution rules. Which IRA is the right choice for you?

A significant estate planning opportunity has been created with the Roth IRA. Traditional IRAs are subject to both estate tax upon death of the owner and a future income tax liability when withdrawal occurs. Initially, funds converted or contributed to a Roth IRA reduce the after-tax investment pool at work. Over a longer period, the estate benefits from a tax-free account that continues to grow as it remains a Roth or is paid out. Distribution rules and tax treatment favor the Roth as an estate planning tool.[6] While there are no mandatory distributions to the Roth owner or surviving spouse, there are numerous distribution rules for any other beneficiary.[7] The complex issues of estate planning and beneficiary designations are not addressed in this paper. It should, however, be observed that improper selection of beneficiaries and distribution methods or failure to take into account other legal, tax, and estate considerations often results in unexpected tax consequences and less family wealth.[8] Another valuable use of the Roth IRA is to fund a bypass trust or exemption trust to take advantage of the unified tax credit. This unified credit is set at $675,000 in 2000 and rises to $1 million in 2006.

IRA Selection and Conversion Decisions

Overview

Given the revised regulation, tax, and retirement/estate planning landscape, many investors are wondering which IRA is the best choice. The answer is that it depends on the specific circumstances and objectives. Any analysis is clouded by the fact that a number of the decision factors that impact the selection of IRAs have a high degree of uncertainty. Each case requires that relevant variables be specified through probability assumptions in order to receive the maximum lifetime benefit from IRA investments.

The nondeductible IRA yields a greater return than a regular taxable savings vehicle, with similar characteristics other than tax deferred growth. This IRA has limited appeal. One possible action is available that offers future benefits: if the participant fails the regular IRA test for eligibility, he/she can still qualify for a Roth conversion from a nondeductible IRA if within the higher income limit. Those who do not qualify are left with the nondeductible IRA or other investment vehicles such as life insurance products.

A comparative analysis of the legal qualifications and essential characteristics of available IRAs is presented in Table 1. Figure 1 illustrates how tax advantages can impact investment performance under strict, limited assumptions.

The Regular IRA versus the Roth IRA

A comparison of basic features between the regular and Roth IRAs reveals commonalties and a few major differences. Phase-out rules apply to both, but the Roth expands the AGI income eligibility limits to include all but higher income taxpayers. Another significant difference in the Roth is the choice of setting the distribution pattern (no minimum withdrawal required). The most critical difference is the timing of taxation: the Regular IRA benefits from tax deferral of contributions and earnings growth, whereas the Roth is funded with after-tax dollars, but all future growth and distributions are tax-free.

A standard comparative analysis of the choice between the traditional and Roth IRA is contingent on the following critical factors and assumptions:

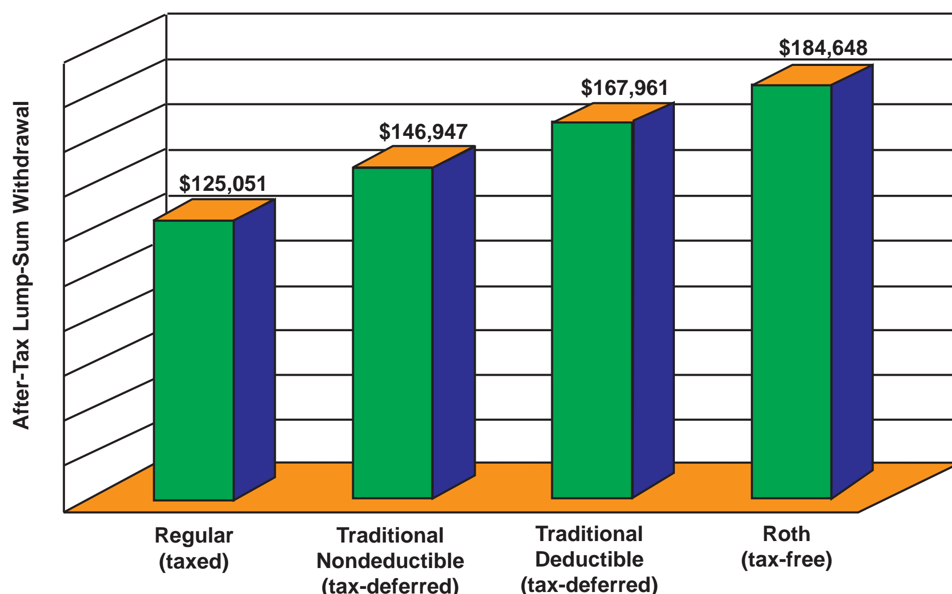
- the rate of return earned over the accumulation period;
- the rate of return earned during the dis-

tribution period;

- the number of years of accumulation before distributions begin;
- the period of time after retirement that distributions occur;
- the assumed marginal income tax rate during accumulation; and
- the assumed marginal income tax rate during the distribution period.

With these features guiding the IRA decision rules, the questions that remain are whether the Roth is for you and whether you should convert to a Roth. The determination of optimal IRA selection begins with a simple modeling of key variables. Oversimplified models have been widely disseminated in the popular financial press and are readily accessible from IRA providers or their Web sites.[9] More sophisticated computer software models which incorporate complex math algorithms for advanced financial planning simulations have also been developed.[10]

Figure 1. Tax-Free Beats Tax-Deferred



Assumptions: 28 percent tax bracket; $2,000 annual contributions for 25 years; nine percent average annual return

IRA Conversion Rules

Taxpayers with existing IRAs may be eligible to convert their accounts into Roth IRAs. An income ceiling of $100,000 applies to both single and joint filers. Married couples who file separate tax returns are not eligible. The $100,000 AGI limit does not include the converted IRA amounts. Any minimum distribution requirements after age 70½ that are being taken will, however, be counted as taxable income and will impact AGI.

Beginning in 2004, minimum distributions from IRAs and qualified retirement plans will not be included in AGI for the purpose of determining Roth income qualifications (1998 IRS Restructuring Bill). Conversions from a regular or nondeductible IRA will have different tax implications depending on the circumstances. To the extent that a withdrawal comes from funds that have not been taxed, the conversion triggers a taxable event (at the taxpayer's marginal rate). No early penalty is imposed on a conversion; however, if any money withdrawn is used to pay income taxes owed on the withdrawal, the premature distribution will be subject to a penalty. When converting, it is important to keep in mind that the additional conversion income and resultant increase in AGI could impact eligibility for tax credits, deductions, and exemptions.

In the case of a regular to Roth conversion, one of the following methods must be used: (1) rollover within 60 days after distribution, (2) trustee-to-trustee transfer, or (3) change from a regular to a Roth IRA with the same trustee.[11]

The controversial issue of conversion reversal has been clarified by the IRS. A reversal from a Roth back to a regular IRA, or a re-characterization, may be made by the tax return date without negative tax consequences. A trustee-to-trustee reversal should be made where the AGI eligibility is violated. A re-conversion is also permitted where the market value of the new Roth drops relative to the old converted regular IRA. Instead of paying higher taxes, the taxpayer in effect reclaims the new lower basis by reverting to a regular IRA. The re-conversion is complete when the taxpayer subsequently converts to a Roth IRA. Such strategic tax moves are now restricted to one re-conversion per year (IRS Notice 98-50).

The Roth Conversion Decision

For taxpayers who are eligible to convert their regular IRA, a rollover to a Roth exchanges a near-term tax liability for long-term tax freedom on the entire investment. The IRA rollover decision is complicated by the almost infinite number of scenarios that can be generated. Any attempt to simplify this decision must be made with an awareness of both popular myths and inherent risks. The ultimate merit of a conversion involves judgment on a set of variables that are neither precise nor certain. In addition to the factors of rate of return, timing of accumulation and withdrawals, and present and future tax rates, a real-world analysis incorporates the use of estate-planning considerations and the use of outside assets to pay the front-end tax.

In a recent article, the authors conducted a scenario analysis of comparative results under different assumptions. Ignoring other Roth advantages, where the tax paid at conversion comes from the converted IRA, a positive economic benefit depends on a lower expected marginal tax rate at the time of withdrawal. Mathematically, a break-even situation exists where the tax-rate remains the same.[12] If funds are available outside the IRA, the conversion amount stays constant, which constitutes a "ramp up" of the IRA, and the result will be positive even after the lost opportunity return on the extra funds invested is subtracted. The amount of the gain will accelerate as the yield increases. An even greater projected economic benefit occurs where the owner leaves the Roth untapped beyond age 70½. Perhaps surprisingly, this scenario shows that even where marginal rates fall at retirement, the conversion is advisable. This analysis uses a 30-year time period. As the growth period is shortened, the net advantage to the Roth begins to disappear. A basic tradeoff exists between tax rates and time left to grow.[13]

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Table 1. 1999 IRA Comparison

	Regular (§408)	Nondeductible (§408)	Roth (§408A)	Education (§530)
Qualification to Contribute	Must have earned income Must not be 70½ by end of year	Individual (or spouse) must have earned income, must not be 70½ by end of year.	Individual (or spouse) must have earned income, must not be 70½ by end of year.	Beneficiary must be under 18.
AGI Limitation	Phased out for active participant in employer retirement plan [i]; otherwise not [ii]	No limitation	Phased out, regardless of coverage by employer retirement plan [iii]	Contributor subject to phaseout rules
Contribution Limit	Lesser of $2,000 (for any combination of IRAs except education) or taxable compensation			$500 per year per beneficiary (not counted against limits for other IRAs)
Deduction	Fully deductible if individual not active participant in employer-maintained retirement plan; phased out for active participant	Not deductible	Not deductible, but contributions may be withdrawn any time tax- and penalty-free.	Not deductible
Taxation of Distributions	All distributions taxable	Earnings taxable; cost basis tax-free	Qualified distributions not taxable; earnings taxable for certain non-qualified distributions [iv]	Qualified distributions not taxable (including earnings)
Allowable Distributions (not subject to 10 percent penalty)	Participant over 59½ Death or disability of participant Series of substantially equal payments over life of participant (or joint lives of participant and beneficiary) Qualified medical expenses over 7.5 percent of AGI Health insurance premiums for certain unemployed individuals Qualified college expenses [v] Qualified first-time home purchase [§72(t)] [vi]		Qualified distributions not allowed for first five years of plan Entire distribution not taxable for: Participant over 59½ Death or disability of participant Earnings taxable (without penalty) for: Qualified college expenses Qualified medical expenses over 7.5 percent of AGI Substantially equal payments over life of participant Health insurance premiums for certain unemployed individuals	Qualified college expenses Qualified first-time home purchase
Penalties	10 percent penalty applied to all distributions not qualified under a §72(t) exception 6 percent penalty on excess contributions			
Required Distributions	Must begin by April 1 following year participant turns 70½		Required only after death of participant	Must be complete before beneficiary turns 30
Rollover and Conversion	May roll into another IRA; may roll into Roth IRA penalty-free if AGI < $100,000 [vii]	May roll into another nondeductible IRA; may roll into Roth IRA	May roll into another Roth IRA tax-free if AGI < $100,000	May roll into another education IRA tax-free (for same beneficiary or another in same family)

[i] MFJ: $51,000–$61,000; Single and head of household (HOH): $31,000–$41,000. Phaseout ranges for active participants in employer retirement plans increase annually.
[ii] Individual (including non-working spouse) not considered active participant in employer-sponsored retirement plan merely because spouse is. In 1999, deduction for spouse of non-active participant phased out when AGI between $150,000 and $160,000 and deduction for spouse of active participant phased out when AGI between $51,000 and $61,000.
[iii] MFJ: $150,000–$160,000; Single and HOH: $95,000–$110,000.
[iv] Nonqualified distributions treated as if made from contributions first. Taxation on earnings begins when distributions exceed contributions.
[v] Withdrawals for qualified expenses of post-secondary education (e.g., tuition, fees, books, supplies) not subject to 10 percent penalty.
[vi] Withdrawals for first-time home purchase (up to lifetime cap of $10,000) not subject to 10 percent penalty. Individual (and spouse) must not have owned a house for previous two years.
[vii] Rollovers subject to income tax. Rollover of regular IRA into Roth IRA must remain in the Roth IRA for five years; otherwise 10 percent penalty applies to withdrawal.

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Decision Guidelines

An iteration of the Roth rules under different possible conversion scenarios leads to the following observations and rules-of-thumb:

- If the IRA has significant nondeductible contributions, the tax-free shift to a Roth would always be advantageous.
- Younger workers in a lower tax bracket would be better off paying taxes now and leaving funds to grow untaxed. As income grows, so does the marginal tax rate.
- Younger taxpayers derive greater potential benefit given the long horizon. The more years until retirement, the better.
- The best result will occur where income tax liabilities from conversion are paid out of outside assets. Conversion may be a bad move where taxes are paid out of the rollover, especially if there is a penalty for early distribution.
- Borrowing to pay taxes may be an option, but only if the payback period is reasonably short and the individual is capable of extra savings.
- The higher the expected return on the IRA investments, the greater the benefit from a conversion.
- The more it is anticipated that one's tax bracket will fall before the money is withdrawn, the less advantageous it is to convert.
- The popular notion that tax brackets are lower for most taxpayers at retirement often proves untrue.
- While the tax rate may change, a conversion locks in today's tax rate, thus eliminating uncertainty about future rates.
- The post age 70½ deferral, beyond the normal minimum distribution requirements that can be shared with a spouse, may be extremely valuable. The Roth is not only for the young; it can be a great benefit for the elderly.
- The ability under the Roth to pass wealth on to heirs without future income tax liability offers a unique family financial planning opportunity.
- Most scenarios use long accumulation periods of 20 or more years. As these time frames are shortened where the sole focus is on funds accumulated, the Roth advantage diminishes. If you are at least ten years away from retirement, the Roth almost always makes sense.
- One risk-reduction planning strategy would be to maintain funds needed for the next five years as a regular IRA and to convert the balance to a Roth account. This would be especially effective if conversion moves you to a higher tax bracket.
- Within 15 years of retirement, a partial conversion will generally lead to an optimal cash flow.

Web Sites

Brentwood Software Inc. Roth IRA Web site http://www.rothira.com
Fairmark http://www.fairmark.com/rothira/
FinanCenter http://www.calcbuilder.com
FundSpot http://www.fundspot.com/education
IRA Tax Forms: http://www.irs.ustrea.gov

Web-Based Calculators

Fidelity: IRA Evaluator
Marshall Funds: IRA Comparison Calculator and IRA Rollover Calculator
New England Funds: Comparison Calculator and Conversion Calculator
Prudential Insurance: Roth IRA Calculator and IRA Conversion Calculator
State Farm Insurance: Traditional vs. Roth IRA Calculator and Roth Conversion Calculator
Strong Funds: Roth IRA Calculators
T. Rowe Price: IRA Interactive Worksheet
Vanguard: Roth IRA Conversion Worksheet
Waterhouse Securities: Roth vs. Traditional Calculator

Conclusion

An awareness of the specific rules and practical considerations in IRA selection is critical to long-term retirement planning. The IRA market exceeds $2 trillion and is expected to grow dramatically in the future. IRA rollovers from 401(k)s and other pension plans will be substantial. Further, concern for inadequate retirement funding will most likely lead to future adjustments in the rules that will encourage a broadening of IRA ownership. The traditional IRA provides a front-end tax savings and compound growth of invested funds to those who meet the eligibility rules. Alternatively, a Roth IRA gives no tax break initially but offers a unique feature, tax-free accumulation. Earnings growth is untaxed and withdrawals are tax-free provided minimum holding requirements and one of the qualifying withdrawal rules are met. Where IRA conversion to a Roth is both permissible and meets the tests of practicality, the projected extra benefits can be sizeable. The Roth IRA offers a more flexible design, particularly in estate planning. Careful attention to the key decision parameters increases the probability of long-term success in IRA selection. ■

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What Everyone Should Know about Long-Term Care

by Anealia Sasser, John T. Lee, and Kenneth Hollman

Are you and your family members prepared to cope with issues surrounding an unexpected accident or prolonged illness requiring long-term care?

An unprotected retired couple stands a 75 percent chance of substantial financial loss due to long-term care (LTC).[1] Forty-three percent of seniors (65 and older) will require nursing-home care at costs that now exceed $50,000 per year. Two-thirds of those under such care will lose all of their assets within one year, and 90 percent will be bankrupt within two.[2] Further, LTC is not limited to the elderly since 40 percent of Americans needing long-term care are working adults between the ages of 18 and 64.[3]

Looking ahead, U.S. government statistics indicate that half of the 36 million retirement-age baby boomers will need some type of extended care. This care will require continuous medical assistance provided for months or years by a special assisted-living facility or home-care medical technicians.[4] Health-care advances have reduced the likelihood of sudden death while increasing longevity and the chance for physical or mental impairment. In the event LTC becomes necessary, the costs can be insurmountable.[5] The onset of LTC difficulties can be very rapid, and lifetime savings can dwindle quickly. The November '99 issue of *SmartMoney* states that older Americans, in the span of a decade, will spend $52 billion from their own retirement savings to pay for nursing-home care. This represents 58 percent more than today's figure. The cost of long-term care has been rising faster than inflation and is projected to grow by five percent a year during the next decade.[6]

Is the outlook all bad? According to statistics from United Seniors Health Cooperative, the majority of people at least 65 years of age will never enter a nursing home. Seventy-five percent of those 65 or older who do enter a nursing home will need to stay less than three months.[7] Only 25 percent of patients who enter a nursing home are there for more than a year, and less than 10 percent of patients actually stay in a nursing home five years or more.[8]

The purpose of this article is to provide practical information to use in evaluating your long-term care needs and the alternatives that best address those needs. Also considered are the key decision factors in evaluating LTC insurance as an option. First, we will consider the most common health care programs available.

Forty-three percent of seniors will require nursing-home care at costs that now exceed $50,000 per year. Ninety percent of those will be bankrupt within two years.

Health Insurance

Group Health Insurance was designed to pay for doctors, surgery, and short hospital stays. Even comprehensive major medical does not cover most costs associated with the long-term care of an individual. Further, with increasing demands being placed on hospitals and doctors due to managed care, the average health insurance policy no longer tolerates lengthy hospital stays.[9]

Family Care

Taking care of loved ones in the event of prolonged illness has been the preferred option for many. Today family members often live independently, divorce more frequently, and move more often. Many people cannot easily afford to care for a loved one for an extended period of time.[10] Single individuals may be especially vulnerable to long-term care issues. Statistics show that wives outlive their husbands by seven years, so this could easily be the case for widows as well.[11]

Social Security

Social Security provides benefits for retired workers and for workers and their families who experience a loss of income due to disability or death of a family wage earner.[12] There are five types of benefits available through Social Security (SS): disability, retirement, family benefits, survivors, and Medicare. SS credits are earned by working and by paying SS taxes. These credits are used to determine the amount of benefits. Full retirement benefits are payable at age 65 (with reduced benefits available as early as 62) to anyone with enough SS credits. Family benefits and survivors' benefits are payable to other members of the family in the event of the wage-earner's retirement, disability, or death.[13]

Social Security supplies only enough funds to pay supplemental living expenses, and there are no provisions for long-term or custodial care except for those outlined under disability as defined by Social Security. Further, it is unlikely that Social Security programs will be altered to address long-term care needs in the future. Social

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Table 1. Comparison of Insurance Companies

Company	Benefit Period	Daily Benefit	Waiting Period	Annual Premium At Age 60	65	70
American Travelers	3 years	$100	100 days	$910	$1,530	$2,120
Bankers Life	3 years	$100	90 days	$1,080	$1,500	$2,160
CAN	3 years	$100	90 days	$856	$1,168	$1,696
GE Capital Assurance	3 years	$100	100 days	$1,090	$1,480	$2,120
John Hancock	4 years	$100	100 days	$1,320	$1,740	$2,590
UNUM	3 years	$100	90 days	$1,875	$2,495	$3,207

Source: Kiplinger Update, http://www.1tcfs.com/kip_update.html, Buyer's Advocate Update, October, 1998

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Security is presently paying out less in benefits than it is receiving in taxes, with the excess funds being credited to SS trust funds. However, benefit payments are projected to exceed revenues in 2015, and the trust funds will be depleted in 2037.[14]

Supplemental Security Income

Supplemental Security Income (SSI) monthly payments are available to individuals of low income with limited assets. To qualify for SSI benefits, an individual must be either disabled or at least 65 years old. The benefit amount varies from state to state. SSI benefits are funded from general tax revenues, and the amount of eligibility is not based on past earnings. The federal government pays a portion of the benefit, and some states add to this amount. However, the state of Tennessee does not contribute to the funding of SSI benefits.

Medicare

Medicare consists of hospital insurance, partially funded by Social Security revenues of those still working, and medical insurance, paid from general revenues and monthly premiums of those enrolled. Medicare Supplement Insurance helps pay for medical supplies, outpatient visits, hospitals, and doctors. Those who qualify are generally over 65 years old and getting Social Security benefits.[15]

Medicare was never intended to handle long term or custodial care. Medicare only approves patient benefits for up to 100 days in a nursing home with "skilled care." The majority of nursing homes do not meet this "skilled care" requirement, which means that only 25 days of Medicare benefits are available. Further, the nursing home stay must occur within 30 days of hospitalization, and the extended stay must be for the same medical condition. Medicaid was not designed to handle the predicted burgeoning cost resulting from extended longevity and the large retirement-age population created by baby-boomers.

In an effort to protect assets and bypass the "impoverished" rule, some individuals have chosen to transfer assets to another party. This practice, "Medicaid Planning," is generally frowned upon, and Congress has taken action to limit it.

Medicaid

Medicaid covers long-term and custodial care but is available only to "impoverished persons." Private financial assets must be exhausted in order to qualify as "impoverished" for Medicaid benefits. In this case, all assets are at risk, including life-time acquisitions such as real estate, pensions, stocks, bonds, and trusts.

In an effort to protect assets and bypass the "impoverished " rule, some individuals have chosen to transfer assets to another party. This practice, known as "Medicaid Planning," is generally frowned upon, and Congress has taken action to limit it.[16] Prior to health care reforms such as OBRA, the Omnibus Budget and Reconciliation Act, Medicaid looked back no more than 30 months to see if assets had been transferred to another party. If transfer had occurred, the applicant for Medicaid was ineligible for Medicaid benefits for up to 30 months. OBRA eliminated the cap of 30 months on this look-back period, resulting in additional loss of benefits in some cases of asset transfer. OBRA also allows states to place a lien on homes for the amount of unpaid Medicaid costs incurred for long-term care. This practice, known as "Estate Recovery," steps in after one's personal savings run out.[17] In some states, this program requires Medicaid reimbursement even after the death of a recipient.

Long-Term Care Decisions

There are viable alternatives for securing a carefree retirement and future well-being. One avenue to protect against the risk of extended care is LTC insurance coverage. In many cases, LTC insurance is affordable and gives the security of protection in the event of a catastrophic illness or an accident.

The National Association of Insurance Commissioners offers a quick self-test to help in deciding whether or not this product is suited to your needs. They suggest that individuals should not buy long-term care insurance if they can't afford the premiums, they have limited assets, they have difficulty paying for basic needs such as food and utilities, or Social Security or SSI is their sole source of income. LTC insurance should be considered if significant assets and income are present, protection of assets and income is important, or individuals prefer to pay for their own care or wish to be independent from others' support.[18]

Long-Term-Care Insurance

Insurance Carrier—Over 100 companies compete in the LTC insurance market. The objective is to choose the company that offers the best combination of affordable price and features needed. Since LTC policies are expensive, some tradeoffs of cost and features may be necessary. Another vital consideration is the financial stability of the provider as reflected in the report card of the ratings services. Ratings of A or better are recommended. Among the rating services available are A. M. Best and Moody's.[19]

Table 1 lists several companies that Standard and Poor's rates "secure" for claims-paying ability. The daily benefit refers to nursing-home or home-health-care benefits. These companies' policies include a five percent compound inflation adjustment, and every company except GE Capital Assurance (formerly AMEX) offers a spousal discount.[20]

Costs—Premium rates are usually determined by the age of the applicant at the time of enrollment. Listed in Table 2 are sample premium ranges for LTC insurance coverage for different ages and at different levels of coverage. Planning for extended care should occur long before it is actually needed since age and physical condition are the key factors in an insurance carrier's approval and pricing decisions. Depending on income available and premium costs, one planning approach would be to hedge risk by some combination of insurance coverage and self-insurance.[21]

Benefits—Some companies pay a specific amount per day or month for nursing-home care. Others pay a percentage of the costs or pay the actual charges while allowing for carryover of any daily benefit amounts. The benefit amount should be specified and conform to the average costs in your area. Presently, nationwide average costs are $129 per day.[22]

Inflation Costs Included—Increased cost limits resulting from a policy's automatic increase in benefits are calculated in different ways. One of the more advantageous methods of calculation is for all cost items to be included initially in the cost of premiums. Be wary of a policy where the premium is scheduled to increase annually.

Prior Hospitalization—Premium costs are generally less for policies requiring prior hospitalization. However, in many cases, conditions that result in extended care do not require hospitalization.

Table 2. Comparison of Premiums and Coverage for Different Ages

Age at Entry	Average Premium Costs for *Minimal Coverage	Average Premium Costs for **Generous Coverage
40	$55/year	$1,300/year
45	$75/year	$1,400/year
50	$80/year	$1,500/year
55	$105/year	$1,700/year
60	$150/year	$2,000/year
65	$220/year	$3,400/year
70	$355/year	$5,000/year
80	$605/year	$7,900/year
85	$1,065/year	$11,900/year

Source: Long-Term Care Insurance Buyer's Advocate Rate Comparison Quote Service
Notes: Numbers in the chart are hypothetical and do not reflect any one company. *Minimal coverage refers to facility cost only, at the rate of $50 per day, a two-year benefit period, and a 90-day elimination (waiting) period. No adjustments are made for inflation. **Generous Coverage includes 100 percent of integrated home care at the rate of $140 per day and offers a lifetime benefit period and 90-day elimination period. A five percent adjustment is made for inflation.

Premium Waivers—Determine the specified times that policy premiums may be waived. Premium waivers vary with carriers from the first day of benefits to 90 days after the start of benefits.

Planning for extended care should occur long before it is actually needed since age and physical condition are the key factors in an insurance carrier's approval and pricing decisions.

Guaranteed Renewable—The policy chosen should be one that will not be canceled as long as the premiums are paid as agreed. The insurance company should not be able to retract this stipulation even if it discontinues offering LTC insurance.

Elimination (Waiting) Period—Know the length of time required prior to eligibility for benefits. "Skilled care" is sometimes covered by regular health care for those under 65, and Medicare approves up to 100 days. A particular policy must be evaluated to determine the kind of care (skilled, at home, nursing home) included in this waiting period.

Pre-Existing Conditions—Some companies' policies require a waiting period for pre-existing conditions; others become effective from the initial date of coverage. If a pre-existing condition exists, it should be disclosed at the time of application. The company may cancel the policy if discrepancies are discovered at a later time.

Inflation Benefits Included—According to the General Accounting Office, policy benefits should indicate provisions for inflation at the rate of 5.8 percent compounded annually. Some policies allow for the insured to buy extra coverage at regular intervals. This method is called a "Future Purchase Option," and the amount of coverage offered is usually based on changes in the Consumer Price Index (CPI). Since the CPI is frequently less than the medical component of the CPI, this index has not kept pace with actual increases in long-term-care costs.[23] Premiums for LTC insurance increase with the age of the insured, and these "interval offers" are based on age at the time of the offer.[24]

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Other policies allow the purchase of a rider stating the benefits will increase by a specific dollar amount, simple or compounded, for a specific amount of time. The premiums may be higher initially, as compared with the "Future Purchase Option," yet prove financially beneficial in the long run. This automatic increase in benefits is even more advantageous if the dollar amount is compounded annually.

Benefit Maximums—Policies use "time frame maximum" in referring to lengths of time and "total dollar amount maximum" when referring to the amount of money paid in benefits. Companies offer time frames of one year up to an unlimited period of time. If maximums are expressed in dollars, this refers to the dollar amount per period (day, month, year). "Total dollar amount maximum" is calculated by multiplying the dollar amount per period by the number of periods.

Benefits are divided into two categories: nursing-home and home-health care. Research on nursing-home care indicates that stays are usually less than three years with 20 percent of patients over 65 needing longer than five years of nursing-home care.[25]

Assisted living, a group living arrangement for the physically and cognitively challenged with a wide range of individualized assistance available 24 hours a day, is an alternative to nursing-home care for those individuals who only need help with one or two of the activities of daily living (ADLs). Nursing homes are usually for those needing help with three or four ADLs. Assisted-living facilities may be available at a lower cost and allow spouses to stay together.

Provider Options—Determine the limitations on care delivery as outlined in the policy. Preferably the policy allows benefits for both skilled and unskilled care, home care, nursing-home care, assisted-living facilities, and adult day-care centers. The more options available, the more expensive the premiums.

Benefit types—The policy should allow for payments at all levels of care, whether in the home, assisted-living facility, nursing home, or adult day-care center. It should pay for skilled as well as unskilled care. The terms *intermediate* and *custodial* simply mean unskilled. Benefits should not be reduced because the care is considered unskilled.

Bed Reservation—This benefit allows the nursing home to hold a patient's bed in the event of necessary short-term absences from the facility.

Benefits of the Non-Tax-Qualified Plan—Access to this plan requires physician certification that care is medically necessary, inability to perform at least two out of seven ADLs, or existence of a cognitive impairment.

> BECOMING IMPOVERISHED (SPENDING DOWN ASSETS) OFFERS A "LAST RESORT" IN WHICH MEDICAID WILL PAY AFTER ONE'S OWN FUNDS ARE EXHAUSTED. HOWEVER, THE SERVICES AVAILABLE THROUGH MEDICAID AND QUALITY OF CARE OFFERED BY FACILITIES THAT ACCEPT MEDICAID MAY NOT BE SATISFACTORY.

Medical necessity and the inability to perform two of seven ADLs are determined by the patient's physician using the basic standards of medical practice. ADLs recognized by this plan include bathing, toileting, continence, eating, transferring, and ambulating (getting around without a wheelchair). There are no automatic requirements of re-certification of cognitive impairment or organic mental disease, such as Alzheimer's, other than those chosen by the insurer on an investigative basis.

Benefits of the Tax-Qualified Plan—With a tax-qualified plan you may be able to deduct the premiums. Even more important to some individuals is the fact that benefits from tax-qualified plans are guaranteed not to be considered taxable income.

Access to this plan's benefits requires a condition considered "chronically ill" *and* the following: (1) certification by a licensed health care practitioner stating the patient's inability to perform, without substantial assistance from another person, at least two out of six ADLs for at least 90 days, *or* (2) the requirement of substantial supervision for protection against threats to health and safety due to the patient's severe cognitive impairment. For someone to qualify for benefits, the insurance company's claims administrator must determine that these qualifications are met as outlined.[26]

Physician certification does not automatically establish eligibility as it does in the non-tax-qualified plan. Cognitive impairment under this tax-qualified plan must be considered severe, and it must be documented that substantial supervision is required during performance of ADLs. Six ADLs are recognized by the tax-qualified plan, while seven are recognized by the non-tax-qualified plan.

MEDICAID

Individuals with limited assets and income who qualify as impoverished persons according to Medicaid guidelines may find Medicaid an attractive alternative. If Medicaid is the final choice for your long-term-care needs, you may wish to prepare in advance for the following scenarios that may be encountered:[27]

- In order to receive Medicaid benefits, in most states, you must be in a nursing home.
- Sometimes private-pay facilities are exclusive due to non-acceptance of Medicaid patients.
- Generally the waiting list for Medicaid patients is very long.
- Compared to private-pay facilities, upgrades in facilities and services are cost-prohibitive at nursing homes that accept Medicaid patients because less funding is available through Medicaid.
- Enrollment is required where a bed becomes available, not necessarily in the location the family chooses.
- The Medicaid patient must enroll at a facility that accepts Medicaid. Some facilities do not participate in Medicaid.
- The Medicaid patient is very limited in choices (such as a private room) as compared to the private-pay patient.

BECOMING IMPOVERISHED

Some people prefer not to invest premiums in an LTC policy that has a high prob-

ability of never being used. Becoming impoverished (spending down assets) offers a "last resort" in which Medicaid will pay after one's own funds are exhausted. However, the services available through Medicaid and quality of care offered by facilities that accept Medicaid may not be satisfactory.

Pension Plan

One option is to cover costs of extended care through retirement assets, assuming one's pension benefits and assets are substantial. Such a strategy of depending on personal assets to insure against unpredictable costs does not substitute for the predictable protection that an LTC insurance policy provides.

Investments

You may prefer to self-insure by investing the funds that would otherwise be used as premiums. Under certain scenarios, it can be shown that investments can accumulate to fund the cost of long-term care. Some investments to consider in this case would be stocks, bonds, and mutual funds. Consideration should also be given to life insurance policies that offer cash benefits, reverse home mortgages, and sale of other assets of value.[28]

Conclusion

The issues of long-term care and the inherent risk to one's financial well-being are generally misunderstood. Prior to reading this article, perhaps you were under the impression that most extended care needs were covered under Medicaid, when in fact one's assets must be spent down to qualify and many of the better nursing homes do not accept Medicaid patients. An even bigger misconception is that long-term-care costs are covered by health insurance, Medicare, or veterans' benefits. These programs were designed to pay for doctors, surgery, and hospital stays, not long-term care.

Generally, financial planners recommend LTC insurance for individuals between the ages of 55 and 72, with a net worth between $150,000 and $1 million, excluding the house and car. Individuals with a low net worth cannot afford the premiums, while those with a high net worth may choose to self-insure through personal investment portfolios. In the unlikely event that assets are depleted, Medicaid offers some but not necessarily the most desirable protection. For those who prefer peace of mind with more options and protection of assets, LTC insurance should be considered. In some cases, the children of wealthy parents may choose to pay LTC insurance premiums in order to protect their future inheritance.

To plan for the contingency that you or a family member could be seriously affected by the high cost of extended care, you should be aware of the risks and be familiar with the rules and restrictions of various insurance vehicles and other programs that may provide a solution to this financial gamble.

GENERALLY, FINANCIAL PLANNERS RECOMMEND LTC INSURANCE FOR INDIVIDUALS BETWEEN THE AGES OF 55 AND 72, WITH A NET WORTH OF BETWEEN $150,000 AND $1 MILLION, EXCLUDING THE HOUSE AND CAR.

This summary information was compiled to help in this planning process. With further analysis of your personal circumstances, you should now be able to make a more informed decision about the best option for your LTC needs. ■

Anealia Sasser is an MTSU doctoral economics student. John T. Lee is the chair of MTSU's Department of Economics and Finance. Kenneth Hollman holds MTSU's Martin Chair of Insurance.

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Unraveling the Tangled Web of Financing a Child's

Postsecondary Education

Because the cost of financing higher education has increased twice as fast as the national inflation rate and average family income over the past decade and because of growth in number and sophistication of education savings options, middle income Tennessee taxpayers are struggling with how best to finance their children's higher education costs.

by Robert G. Colvard and James L. Bush, Jr.

Unfortunately, this decision is affected by the number of educational savings options and the varied tax consequences of each, as well as exclusivity vis-à-vis other options. The availability of Hope and Lifetime Learning credits further confounds the typical Tennessee taxpayer's decision-making process.

The purposes of this article are to:

- identify and characterize the salient elements of six educational savings options;
- compare the economic effect of each option to the most prominent of ten potential tax considerations;
- consider the most effective uses of the Hope and Lifetime Learning credit; and
- suggest practical and useful solutions to common taxpayer scenarios.

The following discussion will provide a brief historical background and characterize each saving option as well as the newly enacted Hope and Lifetime Learning credits, compare each savings option with the most germane tax consideration, and suggest practical solutions and strategies to real-world scenarios.

Legislative History

For decades the provisions controlling the tax status of education expenses were governed by Section 162 of the Internal Revenue Code, the basic philosophy of which was to control the deductibility of educational expenses. The standard established was that education costs must have been incurred primarily to maintain and improve an employee's skills or to meet the specific requirements of the taxpayer's employer for continued employment. If there was the possibility that the expenses in question qualified the taxpayer for a new trade or business, the expenses could be expected to be challenged by the IRS.

Over time there was some softening of the requirements. Daniel Posin mentions the following benefits in force (in addition to Section 162) when there was a broadening of the options available to taxpayers to deal with education costs:

- exclusion of up to $5,250 each year for expenses paid under an employer's qualified educational assistance program (graduate education expenses were not addressed by the legislation);
- interest on Series EE bonds issued after 1989 if the interest was used to pay higher education expenses;
- exclusion of proceeds from qualified scholarships used to pay certain educational expenses;
- a provision not to trigger income when certain conditions were met concerning forgiveness of student loans; and
- tax deferral of the earnings from state prepaid tuition programs (Posin).

The shift in policy from the narrow view espoused traditionally by the code as reflected by the requirements of Section 162 to the broad array of inducements in the current code is profound. One explanation for the shift may be that the growth rate in the basic costs to attain a college degree has far outstripped the rate of increase in prices in the general economy for many years.

Education Savings Options

Six recently enacted savings options (Qualified State Tuition Programs, education IRA, Roth IRA, nondeductible IRA, deductible IRA, and U.S. savings bonds) are the legally sanctioned advantaged vehicles used to accumulate financial resources with which to pay higher education costs. While the Hope and Lifetime Learning credits provide a valuable dollar-for-dollar reduction of tax liability, neither is a means of amassing financial resources. Since one source defines middle-income taxpayers as two parents (aged 35-40) with two to three children (aged 6-12) and a combined income of $50-60,000, and since since few parents in this circumstance would release control to the child of limited financial assets needed to fund higher education costs, the Uniform Gift to Minors Act will not be considered.

Qualified State Tuition Plans

Qualified State Tuition Plans (QSTPs) are controlled by IRS Code Section 529, rules contained in the Small Business Job Protection Act of 1996 and subsequently amended by the Taxpayer Relief Act of 1997. Generally, these plans fall into two broad categories: prepaid tuition programs, providing insulation from future inflation in tuition regardless of the rate of increase, and a trust which anticipates its member's payments will earn returns at rates greater than the growth in tuition payments (CSPN).

To qualify their programs, states must also mandate that:

- all contributions be in cash;
- the contributor or beneficiary be prohibited from directing the investment;
- beneficiary changes occur only between family members;
- refunds must impose more than a *de minimus* penalty except for stated conditions;
- there be a separate accounting for each designated beneficiary;
- there be no pledging of plan assets as security for loans;
- there be a prohibition against excess contributions above those needed for Qualified Higher Education Expenses (QHEE) (Internal Revenue Code Section 529).

Maximum dollar or tuition unit contributions per beneficiary and any adjusted gross income (AGI) limitations vary, imposed by state law. Contributions to QSTPs are not tax deductible, but fund or account assets grow tax free—the central tax and economic benefit of the plan (Henderco). Taxation of the beneficiary occurs

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when the earnings in the account are distributed and used for payment of education costs. No federal early withdrawal penalty or excise tax is applied to QSTPs.

To operationalize a QSTP, a purchaser enters into contract and funds a special account used to cover future higher education costs for a designated beneficiary. When distributed, these funds must be used to pay qualified costs (tuition, fees, books, supplies, room and board). When funds are used to defray QHEE, no taxation occurs until these expenditures exceed contributions. Moreover, the tax is levied on the beneficiary. Therefore, middle income taxpayers should benefit since their tax rate is expected to be higher than that of the beneficiary—generally their child or grandchild.

Earnings of QSTPs refunded to purchasers will be assessed a 10 percent penalty unless the refund is for QHEE, because of death or disability, or made on account of scholarships earned. Contributions to QSTPs are subject to gift tax but eligible for the $10,000 annual gift tax exclusion. The account is included in the estate of the beneficiary.

Contributions to QSTPs permit middle income taxpayers to retain adult control of education assets until they are used for QHEE and can be used to cover both undergraduate and graduate costs. Contributions cannot be made to a QSTP and an education IRA in the same annual period.

Tennessee's Baccalaureate Education System Trust (BEST)

Tennessee's BEST program is representative of prepaid tuition programs that protect participants from future inflation in higher education costs. As of April 20, 2000, the BEST had entered into 6,138 contracts and sold nearly 780,000 units, while amassing over $20 million in assets.

QSTP program components vary by state. The following characterize some major "rules of the contract" of Tennessee's BEST program.

- Any resident of the state may open an account for the child (must have Social Security number).
- The BEST is portable; that is, the funds may be used to pay tuition at any qualifying university in the nation.
- BEST funds can be used to pay room and board as well as tuition and fees if billed through the institution.
- Presently, up to 1,500 units may be purchased per child.
- Tuition units purchased must be on account with BEST at least two years prior to their use.
- BEST funds cannot be accessed by creditors of the donor or child, and the funds may not be used for other than QHEE except for death or permanent disability.
- Transfers may be made to other family members (defined only by approval of the child and the purchaser).
- Tuition units may be used for graduate or undergraduate education costs.
- Contributions to BEST are not subject to state, county, or municipal taxes.
- BEST contributions are subject to federal gift taxes but eligible for the $10,000 per person exclusion.
- The BEST account is a part of the beneficiary's estate.
- When a dependent child uses prepaid tuition for college and the family meets household income requirements, one can claim the Hope scholarship or Lifetime Learning tax credit on a tax return.

Education IRA

Among the provisions contained in the TRA '97 are those which create education IRAs. IRC Section 530 permits an IRA to be specifically designated as an education IRA at the point the account is established. A nondeductible contribution of $500 may be made annually to an education IRA, and the account's earnings will enjoy tax-free growth. The account's designated beneficiary must be under the age of 18, and no deposits will be permitted once the beneficiary reaches the age of 18. Any number of IRA accounts may be opened on behalf of a given beneficiary. However, the $500 is an annual limit per beneficiary and not per education IRA account. Therefore, maximum contributions are limited to a total of $9,000 unless the contributor is willing to pay a six percent excise tax on excess contributions. This contribution limit may sorely hamper a taxpayer in amassing enough funds to provide for a child's education. While the education IRA does not possess flexibility as to the amount of funding, anyone whose AGI does not exceed phaseout range amounts ($95,000 single; $150,000 joint) may contribute to the account.

The enabling legislation treats distributions from designated educational IRAs as tax-free to the extent that the funds are used to pay QHEE—tuition, books, supplies, and equipment required to enroll in or attend an eligible educational institution. Room and board are QHEE for students enrolled at least half-time. Amounts paid for room and board on campus qualify if amounts paid do not exceed the rates established and published by the student's institution. For those who live off campus (but not at home), the law provides a $2,500 per year cap on tax-free distributions for room and board.

If students withdraw an amount greater than the amount of their QHEE, a portion of the amount withdrawn will be taxable to the beneficiary. Generally, the ratio of total contributions divided by the account balance prior to the withdrawal will establish the portion of the withdrawal that derives from accumulated earnings. The next step in the measurement of the taxable portion of the withdrawal is to divide the qualified educational expenses by the amount of the withdrawal (Publication 970).

A beneficiary can roll over educational IRA funds to another educational IRA if the new account's beneficiary is either the taxpayer or a member of the taxpayer's family. Rollovers are tax free if completed within 60 days of the withdrawal. A taxpayer can roll over only one account during any twelve-month period. Education IRA balances may be transferred free of taxable consequences to another member of the beneficiary's family (the beneficiary's children and their descendants, brothers and sisters and their children, parents and grandparents, spouses and stepchildren including their children, and stepparents).

An education IRA is a trust or custodial account created for the sole purpose of paying QHEE of the designated beneficiary. Among other requirements, the trust must be organized in the U.S. with an IRA-approved trustee and funded in cash before the beneficiary is 18. The student-beneficiary may waive tax-free treatment and elect to pay the tax, leaving his parents the right to claim the Hope or Lifetime Learning credit. Education IRA participants will incur a 10 percent penalty on withdrawals not used for QHEE.

Roth, Nondeductible, and Deductible (Traditional) IRAs

As compared to the ten selected tax considerations, each IRA vehicle has commonalties and differences. Each permits tax-free growth of investments and is lim-

ited to an annual contribution of $2,000 per year per person. Further, the total contribution is limited to $2,000 regardless of which type of accounts any investments are directed toward. Only deductible/traditional IRAs have a direct income tax benefit. Adult control of resources is maintained in each case.

AGI phaseout ranges are not applicable to contributions in nondeductible IRAs, while Roth ($150,000 joint returns) and deductible IRAs ($40,000 joint returns) establish different limits. All IRA accounts may now take penalty-free distributions for QHEE. One must include distributions as income, but only to the extent they exceed total contributions made to the account. For the Roth account, no minimum distributions must be taken at age 70½. Of course, a 50 percent excise tax is applied to the remaining cases if minimum distributions are not taken.

Savings Bonds

Internal Revenue Code Section 135, added by the Technical and Miscellaneous Revenue Act of 1988, permits the exclusion of interest earned on series EE U.S. savings bonds if the taxpayer uses the interest income to pay QHEE. Clearly the greatest potential of this provision is available to the taxpayer who has deferred recognition of interest until redemption. Taxpayers may use Form 8818 to document bond serial numbers, issue date (which must be after 1989), face value, and proceeds received when bonds are surrendered (Notice 90-7).

EE bonds would be a flexible vehicle for financing education expenses if not for requirements that the bond must have been issued in the name of the taxpayer or his spouse. The taxpayer is required to have been 24 or older when the bonds were issued; however, the purchaser may designate any beneficiary. The definition of QHEE is tuition and fees, not books or room and board. Taxpayers must reduce higher education expenses by scholarships, fellowships, veteran's benefits, or other tax-exempt educational benefits.

Further limiting the wide use of EE bonds, other than relatively low returns, are modified AGI phaseouts beginning at $40,000 for single taxpayers and $60,000 for those filing jointly. No maximum contributions apply, and no tax deduction is available for series EE bonds. No 50 percent excise taxes or 10 percent early withdrawal penalty apply to account distributions.

Both Hope and Lifetime Learning credits

- are based on the amount of qualified tuition and related expenses paid;
- will be phased out at some level of modified AGI;
- are non-refundable;
- are not available to married-filing-separately filers;
- require the eligible student's name and I.D. number on the tax form;
- are based on qualified tuition and related expenses required for enrollment, not including books, room and board, and equipment;
- require that the student be you, your spouse, or an eligible dependent;
- require the student to attend an eligible educational institution;
- cannot be used as both credit and deduction on the same tax form.

Hope Credit Only

- is available to a maximum of $1,500;
- is calculated as 100 percent of first $1,000 and 50 percent of second $1,000 paid for tuition and related expenses;
- is available for expenses paid during tax year 1998;
- can be claimed for only the first two taxable years of postsecondary education for each eligible student;
- requires the student to take at least one-half the normal, full-time work load in credit hours;
- requires the student to be free of felony conviction for possessing or distributing a controlled substance;
- will be reduced if modified AGI is above $40,000 for single or $80,000 for married taxpayer ($10,000 phaseout range).

Lifetime Learning Credit only

- is effective for expenses paid after June 30, 1998;
- is available for expenses paid during the 1998 tax year;
- is calculated as 20 percent of a maximum of $5,000, thus limited to $1,000 per year;
- is applied on a per family basis;
- applies to the same education cost as stated above;
- is applied to eligible student and institution as above;
- is not based on student's workload or limited to the first two years;
- is available for graduate level expenses;
- does not vary depending on the number of students.

Hope and Lifetime Learning Credits

These credits, available to taxpayers beginning with the 1998 tax year, reduce taxes payable dollar for dollar and differ significantly in their tax effect from deductible education costs (table at left).

Conclusions

It is time to recall our hypothetical middle-income taxpayer who intends to accumulate funds necessary for the education of two children. One child will begin college in seven years, and the other in eleven years. Let's assume we can begin funding in the year the oldest child becomes twelve and that the family budget will permit us to "squeeze out" $5,000 a year for the next several years.

How should the funds be allocated? The approximate cost of educating a child for one year is $6,000 in the Tennessee Higher Education Commission system. None of the IRA options appears useful, even considering high investment returns, because of annual contribution limitations. The AGI phaseout range is so low for deductible IRAs as to eliminate its use for this case. EE savings bonds fail to meet our needs on three counts: low rates of returns, limited covered education costs, and extreme conditions of original purchase.

BEST, on the other hand, has unlimited contributions up to 1,500 units per account, broadly defined QHEE, and the ability to "lock in" education costs at today's prices. The BEST program is the recommended savings vehicle in this case. Other savings options may be useful, depending on circumstances. BEST funds cannot be used for off-campus housing, but the education IRA funds may be used in amounts up to $2,500 per year. If QSTP units are exhausted, the family may be able to apply the Hope or Lifetime Learning credit.■

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Retirement Planning and Social Security

by Thomas F. Dernburg

Social Security benefits represent a vital element in the retirement income of the average citizen. Incorporating expected benefits into a retirement savings program is therefore essential. Unfortunately, the largely negative current public debate over Social Security has created unnecessary anxiety, pessimism, and uncertainty with respect to the system's long term viability. Especially unfortunate is the widespread belief among young workers that they cannot count on Social Security to provide income when they retire.

Recent events have demonstrated that the resources to maintain the retirement program are readily available in a dynamic economy that continues to grow, create jobs, and raise real wages. If there is a threat to Social Security, that threat arises from potentially destructive legislation. Among these threats are proposals to raise the retirement age, reduce the percentage of full benefits of early retirees, reduce the inflation correction of benefits, increase payroll taxes, and stunt economic growth through ill-advised policies.

A very positive recent legislative step has been the elimination of the disincentive to work among persons between the ages of 65 and 70 by eliminating reductions in benefits against labor income earned by working persons in this age group. Elderly persons who work contribute to the economy and Social Security by continuing to pay payroll taxes. Further steps along this line would surely be beneficial. One step in this direction would be to tax benefits as ordinary income, rather than at 80 percent as at present, thereby reducing the incentive to retire.

The economy has been riding a wave of prosperity that is now in its ninth year. Thanks to rapidly rising revenues, the federal budget has generated surpluses of $70 billion and $125 billion in calendar years 1998 and 1999, respectively. The President's Economic Report projects surpluses of $167 billion this year and $184 billion in 2001. There should, therefore, be plenty of money available to assist the programs that benefit retirees. It must be recognized, however, that prosperity tends to yield to periodic recessions. The Federal Reserve has increased interest rates several times during the last year to prevent overheating of the economy. Recent evidence indicates that these rate increases are exacting their toll by slowing economic expansion.

Budget surpluses last only as long as prosperity lasts. When the next recession arrives, today's surpluses will turn into deficits. A back-of-the-envelope calculation suggests that a one percent increase in the unemployment rate will automatically reduce the budget surplus by about $95 billion. About $75 billion of this will be due to lower tax receipts, and the other $20 billion will be due to increases in transfer outlays on unemployment compensation and food stamps. During the last recession, a deficit of $152.5 billion in 1989 ballooned to $297.5 billion in 1992.

A CRUNCH WILL OCCUR WHEN BENEFIT PAYMENTS TO RETIREES BEGIN TO OUTSTRIP PAYROLL TAX RECEIPTS IN AN ESTIMATED 15 YEARS.

There has been much talk about using current budget surpluses to assist Social Security and Medicare. However, specific plans for doing this remain vague. How it can be accomplished seems not to have been clearly thought out. This is true as well for "locked box" proposals that would prevent the Treasury from using Social Security surpluses to finance non Social Security expenditures. Federal payroll tax receipts have exceeded benefit payments by an average of $36.3 billion per year over the last ten years. The surplus ballooned to $66.6 billion in 1999. An infusion of funds to deal with the current obligations of Social Security is hardly necessary.

How can today's budget surplus help Social Security in the future? The administration's budget for fiscal year 2001 proposes to use the projected Social Security surpluses through 2010 to retire federal debt. The interest savings from debt retirement would be credited to the Social Security trust fund account. Starting in 2011 the trust fund would receive a credit of $100 billion. Annual credits would continue rising, reaching $211 billion in 2015. Subsequent infusions would continue at a rate of $211 billion annually. The administration estimates that these infusions would extend the life of the trust fund from 2034 to 2050.

It is important to understand the nature of the trust fund. It is not a bank account from which withdrawals can be made at any time; rather it is a bookkeeping creation. Payroll taxes are paid to the Treasury, and benefits are paid by the Treasury. When payroll contributions exceed benefit payments, the difference is credited to the trust fund while the Treasury keeps the money. Crediting Social Security's trust fund account can easily be accomplished without affecting the budget surplus or costing the Treasury as much as a dime in real money. Such crediting stretches the time at which the trust fund runs out. However, a crunch will occur, not when the trust fund is exhausted, but when benefit payments to retirees begin to outstrip payroll tax receipts. That is expected to happen in an estimated 15 years. At that time it will be necessary for the Treasury to subsidize Social Security from general revenues, just as Social Security has been subsidizing the Treasury, or it will be necessary to increase payroll taxes.

Payroll tax rates now exceed 15 percent of payrolls. Fully 60 percent of wage and salary earners pay more in payroll taxes to finance Social Security and Medicare than they pay in income taxes. Payroll taxes are taxes on labor income. Other sources of income—interest, dividends, capital gains, rents, and royalties—are not taxed at all in support of Social Security and Medicare. The 30 percent of national income that largely accrues to the affluent escapes social insurance taxation entirely. The adverse effects of this on the distribution of income are enormous.

Further increases in payroll taxes are surely ill-advised. Increases in the worker's share worsen the distribution of income. Increases in the employer's share raise labor costs, add to inflation, and reduce production and employment, even if matched by equivalent government spending increases. The deflationary spending effects of most tax increases can be neutralized if the tax increase is accompanied by an increase in government expenditures. However, in the case of payroll tax increases, there is more at work. An increase in the employer's payroll contribution amounts to an increase in variable labor costs. Economic theory teaches that profit-maximizing firms will respond by reducing production and employment. In the aggregate, this implies a reduction in GDP and personal income. However, because consumer spending tends to

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decline by less than the reduction in income, excess demand appears in markets for goods and services, and this pulls up the price level.

A rise in the price level, unaccompanied by expansion of the money supply, reduces the purchasing power (real value) of the money supply. This raises interest rates and reduces interest-sensitive spending. In addition, the real value of the private sector's net claims against the government—currency and government bonds—declines. The resulting loss of real financial wealth tends to reduce consumer spending. Thus, both the interest rate and the wealth effect reduce GDP and the level of employment.

The net result of the increase in payroll taxes is to produce the symptoms of stagflation. The price level rises while real output and employment decline. When there is a steady succession of payroll tax increases such as occurred during the 1980s, this builds a stagflation-generating mechanism into the economy. Such a perverse syndrome creates a dilemma for policy. Lower output and employment calls for stimulative policies to raise spending, but that adds to the rise in prices. Preventing inflation implies the need for restrictive policies, but that reduces spending and aggravates job and output losses. Another stagflation dilemma, such as those of the 1970s and late 1980s, is something dearly to be avoided. If there are to be tax increases, let them be almost anything other than further escalation of payroll taxes.

Giving real money to Social Security would necessitate a radical restructuring of the relationship between Social Security and the Treasury. To effect a genuine transfer of resources, it would be necessary to establish Social Security as an independent agency similar to the Federal Reserve System. Receipts of payroll contributions and payment of benefits would be transferred from the Treasury to Social Security. That part of the budget surplus which Congress decides to give to Social Security would also be transferred. The dilemma is that Social Security would have to find something to do with the money it does not need at present.

A major role of the Federal Reserve System is its function of acting as a bank for the Treasury and for its member banks. A Federal Reserve account could easily be created for Social Security. Payroll taxes paid by the private sector would be deposited by Social Security in its Fed account. The process must not stop there or the private sector will have lost the taxes it has paid, and since it receives nothing in return, its net worth will have been reduced.

A POSITIVE PROGRAM MAY BE SUGGESTED TO (1) ELIMINATE THE PRESENT SOCIAL SECURITY SURPLUS BY REDUCING PAYROLL TAXES, (2) REQUIRE LEGISLATION OBLIGING WORKERS TO INVEST THEIR TAX SAVINGS IN INDIVIDUAL RETIREMENT ACCOUNTS, AND (3) CREATE A NONPOLITICAL INVESTMENT AUTHORITY INTO WHICH THE FUNDS WOULD BE DEPOSITED.

At the same time, the nation's money supply (currency and checkable deposits in the private sector) will have been reduced by the amount of the tax. Thus deposits into the Social Security account would be sterilized and represent a purchasing-power drain. To avoid the deflationary effects, Social Security must find ways to use its Federal Reserve deposits productively in the private sector of the economy.

When a government agency has the problem of what to do with surplus money, it must decide where to invest it. If it is invested in the stock market, eyebrows will immediately be raised. To buy the stock of particular companies amounts to the provision of cheap credit to such companies, creating a windfall for the brokerage firms that are fortunate enough to get the business. Why favor one company or brokerage firm as opposed to others? How can political pressure to invest in favored industries or particular geographic locations be avoided? Merely depositing the funds in the banking system gives rise to the same problem. The Federal Reserve avoids these problems by limiting its portfolio to government securities, but if Social Security does that, it will just be giving the money back to the Treasury. It might earn a higher rate of return than at present, but that is the only substantial difference.

A positive program that would ease, but not eliminate, this dilemma and achieve other benefits as well may be suggested. The first step would be to eliminate the present Social Security surplus by reducing payroll taxes. That would convert the adverse economic effects of higher payroll taxes into a mirror image of beneficial effects. The second step would require legislation that obliges workers to invest their tax savings in individual retirement accounts rather than use the funds for consumption. This step would provide individuals with greater assurance of retirement income and raise private savings. The third step would be to create a nonpolitical investment authority into which the funds would be deposited. The authority would be required to invest the savings in conservative, nonspeculative earning assets in the private sector, thereby promoting economic growth. It must be made accountable to the investors, not to businesses seeking funds. During years of overall budget surplus, the authority might even be authorized to tap the trust fund account, and therefore the Treasury, for additional funds to be distributed to the retirement accounts and invested to support economic growth in the private sector.

Many of tomorrow's anticipated financial problems will have to be faced tomorrow. Individuals are able to save for retirement, but Social Security by itself cannot readily do so. Hopefully there will be budget surpluses that will help to finance retirement benefits when the need for this arises. The Treasury might have to pay its debts to Social Security from general revenues rather than being a perennial borrower, which would be entirely appropriate. It makes absolutely no economic sense to keep lowering income taxes while raising payroll taxes.

Cheer up! The odds are good that Social Security will be there when you need it. ■

Thomas F. Dernburg taught at Purdue University, Oberlin College, and the American University, held the Chair of Excellence in Free Enterprise at Austin Peay State University, and served on the staff of the President's Council of Economic Advisers as well as three U.S. Senate committees.

A Letter From the Dean

BY E. JAMES BURTON

Friends of the Jennings A. Jones College of Business and the Business and Economic Research Center:

Once again *Tennessee's Business* is focusing on a pressing and useful topic. One important consideration that may not receive as much attention as it deserves is the question of how to educate those who will provide these necessary and valuable professional financial planning services. Many disciplines claim the high ground.

I proudly hold two professional certifications—Certified Public Accountant (CPA) and Certified Fraud Examiner (CFE). Each provides a level of differentiation and distinction within the marketplace, and each provides potential clients some degree of confidence in the training, background, and experience of the holder.

The CPA designation has been around for a long time and, for many years, was considered adequate for most financial needs. CPAs supplied financial expertise to clients—personal and corporate. This included, but was not limited to, tax planning and advice. As an outgrowth of the tax planning, other sorts of financial counseling often arose.

Things have changed and are continuing to change. While the accounting profession rested comfortably on its long-established credential, others began to recognize the need for specialty training and advice. New credentials were created, and new professionals began to emerge. The marketplace was active, alive, and well.

Recently, the American Institute of Certified Public Accountants (AICPA) realized the potential loss of status for the CPA credential. The institute began what was called the Vision Project to look at the future of the profession. It was an overdue and most needed effort that is beginning to pay dividends.

New designations such as the Personal Financial Specialist (PFS) emerged. This designation is granted only to those who are already CPAs and want to demonstrate particular skills in this important area. With at least 250 hours of experience per year in personal financial planning, the CPA must apply for and pass a special examination and maintain a continuing education requirement.

WHAT DOES THIS PROLIFERATION OF DESIGNATIONS MEAN TO THE FUTURE OF ACCOUNTING AND FINANCE EDUCATION?

More recently, the AICPA has joined the professional accounting organizations of Canada, Australia, England and Wales, Ireland, New Zealand, Scotland, and South Africa to propose a new designation currently being called the "XYZ" as a placeholder title. A press release from the AICPA says, "The proposed designation would enable professionals from a wide range of disciplines to build on their ethical standards, traditional skills, and expertise, helping them to provide a broader range of globally relevant services to clients, customers, and employers."

What does this proliferation of designations mean to the future of accounting and finance education? We wish we really knew the answers. There are, perhaps, a few projections that do not require rash speculation.

- Specializations are likely to require additional levels of pre-certification study. Just as the requirements for the CPA exam now generally encompass 150 semester hours, many of the other specializations and credentials will likely require more pre-exam training.
- Continuing education will become more designation-specific. To maintain one's currency, annual or bi-annual education aimed specifically at the designation is highly probable. This means those with multiple certifications and designations will have more difficulty maintaining their credentials.
- The Internet will become a greater force in education and training, particularly continuing education. It will provide a "travel-less," cost-effective way to acquire at least some of the ongoing skills necessary to retain a credential.

We of the academy, especially the colleges of business, must prepare for these changes. As always, we need and want your input. We ask those of you in the trenches to give us your best advice. To paraphrase what someone either said or should have said, "The race is not always won by the swift nor the battle always by the strong, but if I were you, that's the way I would bet." We are betting on those of you already in the arena to give us advice on how to prepare the next wave of professionals.

Sincerely,

E. James Burton, Dean
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E. James Burton is dean of MTSU's Jennings A. Jones College of Business. Also at MTSU he has served as an accounting professor, Executive Director of the Jones Chairs of Excellence, and assistant dean of the Jennings A. Jones College of Business.