FINANCIAL PLANNING[1]

by Timothy C. Nicholson

Individual Financial Planning

Current financial conditions have caused considerable concern to many business owners. In addition, significant changes in tax legislation have made long-term planning decisions that much more difficult. It is little wonder that the words "financial planning" are heard with increased frequency these days.

If you were to ask several different people to define financial planning, you would undoubtedly receive a variety of opinions. It is one of the more confusing subject matters because of its inherent complexity. What then is financial planning? Let me give you an overview.

Financial planning involves the coordination of four inter-related areas: 1) Accumulation Planning, 2) Estate Planning, 3) Business Continuity Planning, and 4) Fringe Benefit Planning. The type of strategy employed in any one of these areas will more than likely affect the others. As an example, how you plan the ultimate disposition of your business will certainly influence your overall estate plan. If we look at each of these disciplines in more detail, the validity of this coordinated strategy approach should become even more obvious.

Accumulation Planning combines investment and income tax planning to maximize investment return and reduce income tax liability. If done properly, accumulation planning should thoroughly examine risk tolerance, both tax and investment as well as proper asset allocation. The process should assist an individual in clearly identifying both short-term and long-term "living" objectives and provide a plan of action to accomplish them.

Estate Planning is a process which helps an individual determine personal objectives for the arrangement and disposition of assets and which lays out a plan to accomplish these objectives at the lowest possible cost. Thorough estate planning helps to conserve estate assets for the benefit of family members by reducing overall estate settlement costs. The fair market value of a closely-held business interest is often the principal estate asset and this value can shrink dramatically unless the proper planning has been done. In addition, estate planning should help provide the framework for adequate family financial management assistance along with the avoidance of probate and resultant publicity.

Business Continuity Planning deals with the most critical issue that each business owner must face: whether to keep the business within the family or sell to a non-family member. What makes this decision more complicated is the fact that it must be addressed separately for each of the major contingencies of death, disability and retirement. Business Continuity Planning helps establish the value of a business interest for the Federal Estate Tax purposes and provides for the mechanism to transfer it in the most appropriate manner. As previously mentioned, the strategies developed within the business continuity area have a definite impact on the estate planning area.

Fringe Benefit Planning involves a comprehensive study of the use of a business to attain benefits that would otherwise be purchased individually at a higher cost. It also assists a business owner in reducing personal income tax liability and providing for future income needs. A thorough fringe benefit analysis will focus on a review of health and disability insurance coverage as well as various qualified and non-qualified deferred compensation arrangements. As an added enhancement, good fringe benefit planning can be an invaluable asset in recruiting and retaining quality employees.

In summary, personal financial planning formulates a strategy to meet long-term and short-term objectives in all or some of the four mention-

1. Presented at the annual conference of the International Society of Arboriculture in Indianapolis, Indiana in August 1983.

ed areas above. It is a coordinated strategy involving the client and financial planner, as well as other relevant advisors such as an attorney or CPA. A well-developed comprehensive financial plan can make a significant difference in providing for a sound financial future.

Accumulation Planning: An Overview

"Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands; taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

—Judge Learned Hand

The accumulation of assets is a function of two processes — investment return and tax cost. More simply, the first is "how much do you make" and the second is "how much do you get to keep."

Investment opportunities come in a myriad of forms: stocks, bonds, commodities, precious metals, etc. All of these investments have their risks, and even occasionally their rewards! Each investment can be categorized by looking at its five attributes: tax advantages, cash flow, appreciation potential, liquidity, and safety of principal.

The "perfect" investment has been described as being entirely tax deductible, having consistently high cash flows and appreciation potential, being easy to liquidate, and involving no "down side" risk. Like every other syndication involving thoroughbred unicorns, the perfect investment is just a myth.

What does exist are investments that *individually* favor some of the above five attributes. However, the starting point of a successful investment strategy is to focus on *your objectives.* Then comes the selection of specific investments that will achieve your objectives. In choosing these investments, keep three thoughts in mind:

- Your selection of investments should be consistent with your ability to withstand risk.
- Risk and reward are usually two sides of the same coin. Safe investments tend to have more modest returns; investments with potentially greater returns also involve greater risk of loss.
- Your investment plan (and consequently your investments) should be flexible to adjust to your changing needs and market conditions.

Once the cart is now (correctly) behind the horse, the next question is: how do you keep Uncle Sam from eating up all the profits?

Despite what the IRS wants you to believe, *you do have control over how much federal income tax you pay!*

There are four general methods of legally reducing your income tax bill — deferral, conversion, diversion and deduction. Deferral means putting off the payment from one year to subsequent year(s). The advantage of deferring taxes is that, in effect, the IRS is making an interest-free loan to you. Obviously, the longer the deferral, the better the accumulation due to the compounding of investment return. One example of deferring taxes is the sale of a principal residence. If you sell your home at a gain but use the proceeds to buy another home costing more, you generally will not have to pay tax on the gain until you sell that new home.

Conversion means reducing the tax rate on the income you receive to a lower rate. For example, it is better to have investment income taxed at capital gains rates (maximum 20%) or not taxed at all rather than at ordinary income rates (maximum 50%).

Diversion means shifting income from a higher tax bracket to a lower bracket while still using that income to satisfy your personal objectives. For example, it is typically more tax efficient to fund education expenses by giving or lending funds to a child who is in a lower bracket. The child will pay less tax on investment income instead of running the dollars through your high bracket.

Deduction means increasing the use of tax deductible expenses, both cash and non-cash, to offset income that would otherwise be taxable.

Unfortunately, "tax planning" for most people involves the year-end scramble for deductions, which often increases the likelihood of an IRS audit (or as they call it, "an examination"). From my experience, greater tax savings are often realized by utilizing the other three techniques (i.e., defer, convert and divert) before going on a "deduction safari."

A final note. Tax planning techniques tend to be reminiscent of Newton's Law of Physics. "For every action, there is an equal and opposite reaction." It is always wise to check with your financial planner, attorney or accountant before embarking on a new course. You don't want to be the taxpayer who echoes Pyrrhus' famous line, "Another victory such as this one and all is lost!"

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ABSTRACTS

HOEKSEMA, ROGER and DAVID KENYON. 1983. **Trees in town.** Michigan Natural Resources Magazine 52(2): 54-59.

Our urban forest consists of a dynamic community of trees and plants which provide benefits to all the people of our state. What is an urban forest? It is simply the trees, shrubs, ornamental plantings, and other vegetation found or placed in your city, town, or community. The total number of trees in any urban forest may be less than those of woodland or woodlot forests, but the value per tree is much greater. Your urban forest includes trees in parks, along streets, in yards, in front of businesses and stores. Can you imagine what your community would like like without the green growing citizens? There's a great concern expressed for or against city trees. Fortunately, the record shows that trees benefit people in many ways, with shade and beauty high on the list of values. No forest offers more benefits to you than the forest just outside your door. The best time to manage that forest properly was 30 years ago—the next best time is now.

LEDERER, R.F. 1983. **Plants: an answer to urban blight.** ALI 10(1): 6-10.

Urban foresters are at the front line in the effort to promote forest and related vegetation management in and around the nation's communities. That's where they have been ever since the Urban Forestry Assistance Program was funded in 1978. And they face enormous challenges. Most urban forestry programs are underfunded because they have to compete for a share of tight city budgets. Because of the funding situation, a study conducted for the USDA Forest Service by the Syracuse Research Corporation showed most urban forestry programs have to be primarily occupied with day-to-day operational activities—chiefly tree planting and tree removal. That deserves a very high priority. Trees and other plants in the environment can be "preventative medicine" to reduce stress, boredom, and some other problems of daily life. But they are also being used successfully in the treatment process to overcome specific emotional conditions and help improve the life quality of an individual with problems.