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Financial
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A Financial Planning Update

From the Desk of:

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MDRT®

Subtract Inflation and It All Adds Up!

Some of us may remember the "good old days," when gasoline prices were as low as 25¢ per gallon. Others may recall when a can of soda cost 15¢. But prices tend to rise over time—sometimes steadily and sometimes abruptly. In the years ahead, **inflation** will most likely decrease the purchasing power of your money, which means that during retirement, your dollars will buy less than they do today.

It is easy to misinterpret inflation as the rise in price of *individual* goods and services. However, inflation is the increase in the average price level of *all* goods and services. For example, the price you pay for oranges may rise during the winter due to unseasonably cold temperatures in Florida. On the other hand, the average price of other items in your local supermarket, like peanut butter and paper towels, may remain relatively level. So, the increase in the price of oranges is not a result of inflation but, rather, a function of **supply** and **demand**.

What Causes Inflation?

Inflation can result when either: 1) the total of all goods and services demanded exceeds production, or 2) the amount of all goods and services supplied by producers decreases.

Note how, as inflation is defined here, the supply and demand for oranges alone would have no effect on inflation. However, changes in supply and demand on a broader scale can result in inflation.

Consider the following economic scenario: suppose business is booming, unemployment is low, and the average worker's wages are increasing. As a result, consumers have more disposable income available and may therefore be able to purchase more goods and services. Average prices tend to rise under these circumstances due to the increase in *demand* for all goods and services.

In another scenario, suppose the economy is suffering. As unemployment rises and wages remain stagnant, consumers may be unable to purchase additional goods and services. Production may then slow down, with prices going up to minimize the losses. In this cycle, average prices tend to rise due to a decrease in the *supply* of all goods and services.

It is important to keep in mind that individual consumers are not the only participants in the market that can affect the economy. Businesses, government agencies, and foreign markets also spend billions of dollars on U.S. goods and services. Their spending, or lack thereof,

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The Importance of Domicile for Your Estate Plan

Increased mobility in today's society has changed the way we live, work, and play. Compared to previous generations, it is now quite common for work and recreational activities to cross state lines, resulting in ownership of property and formal relationships in more than one state.

When you consider the terms **domicile, statutory residence**, and **residence**, they may seem similar at first, but it is important to understand how they are different. Your *domicile* is the state where you maintain your permanent residence and intend to return to for prolonged periods. An individual can have only one legal domicile at a time. A *statutory residence* is the place where you live and work; you are subject to the income tax for that state. If you are a statutory resident of one state, while claiming a domicile in another, your domicile state may also require you to file a tax return. Your *residence* is any place (or places) where you live; the term "residence" bears little or no legal significance.

Estate Planning

Where your will is **probated** is determined by your domicile. If your domicile is unclear at your death, several states may be able to claim you as a domiciliary and tax your estate accordingly. Keep in mind that estate tax laws vary by state, and state laws may differ from Federal laws. In some states, your spouse may be taxed on a portion of his or her inheritance that, in another state, would pass to him or her free of state estate tax. Some states exempt smaller estates and certain property from the probate process. Other considerations may also apply.

In addition, your choice of domicile can affect your overall financial plan, especially regarding property ownership. Not all states define property ownership in the same way. Some allow married couples to own property and income separately. In other states, known as community property states, married couples share ownership of all assets acquired *during* the marriage, but each spouse may own previously acquired property separately.

Further, your choice of domicile can affect your state income tax. Your income may be taxed in your state of domicile, the state where you earn income, or both. If you change your domicile during the tax year and both your present and former domiciles tax income, you may have to file partial-year tax returns in both states.

Establishing or Changing Domicile

You can take certain steps to establish your state of domicile. In general, your domicile is not determined by the length of time you spend in a state. You may establish a domicile when you first occupy a property, or you may spend decades in a place and never call it your domicile. If you marry a person domiciled in another state, you may be able to claim your spouse's domicile as your own, even if you never visited that state.

If you have moved, your "true" domicile may hinge on the *number* and *significance* of the contacts you have in your former and present state. Here are other significant factors for you to consider:

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The Importance of Domicile In Your Estate Plan

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Retention of "historical" home. If you have moved, have you sold your long-time residence in a former state?

Business relationships. In which state are your significant business contacts located?

Location of property. Where is most of your significant real and tangible personal property located?

Social connections. Where do you maintain civic, religious, or family connections?

Time spent. Where do you spend the majority of your time?

While you may feel your *intent* is clear, it is most likely that your *actions* will determine the evidence of your intentions. Consequently, simple acts such as registering to vote in a new locale, changing your automobile registrations and driver's license, resigning from organizations in your former state, and joining organizations in a new state may also be viewed as evidence of intent to change your domicile.

Because your choice of domicile can affect your overall estate planning, be sure to consult your professional legal and tax advisors for specific guidance on your unique circumstances. $

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can equally influence increases or decreases in supply and demand that, in turn, can result in inflation.

Inflation and Economic Policy Decisions

To a certain extent, *some* inflation may be a sign of a healthy economy. In fact, one of the economic policy goals of the U.S. government is to maintain an inflation rate ranging from 0% to 3% per year. Too much inflation or no inflation at all can be a sign of troubling economic times. So one of the greatest challenges facing policymakers is making decisions that lead to the optimum level of inflation.

Two Federal economic policies are used in an attempt to control the economy. **Fiscal policy**, which falls under the auspices of Congress, uses taxation and spending to reach full employment, stabilize prices, and boost economic growth. In contrast, **monetary policy**, which is controlled by the Federal Reserve Bank (the Fed), manipulates the money supply and short-term interest rates in an attempt to spur growth or control inflation.

Congress, and especially the Fed, looks at the **Consumer Price Index (CPI)** when making policy decisions. The CPI is considered by many to be one of the best measurements of inflation. The CPI gauges the average change in prices paid by urban consumers for a fixed market basket of goods and services over a period of time. The CPI represents all goods and services purchased by urban consumers. Each month, the CPI is calculated, and constant fluctuations in the CPI will ultimately result in Congress or the Fed taking appropriate measures to regain control of inflation. Note that the Fed has the ability to react quickly. However, Congress must pass legislation, which requires debate and time, before its fiscal decisions can be carried out.

On a Personal Level

In addition to creating higher costs for goods and services, inflation creates depreciation in currency values. So, as prices increase, the purchasing power of your income—dollar for dollar—decreases. During sound economic times, price increases will usually be accompanied by wage increases that are equal to, or greater than, inflation. However, during economic downturns, when wages remain level, the cost of living increases as your purchasing power diminishes.

Regardless of what state the economy is in, one of your greatest long-term financial challenges may be planning for your retirement savings to outpace inflation. Therefore, it is always important to consider inflation, not only as you save, but also as you make purchasing decisions. $

Build Your Financial Foundation with Regular Reviews

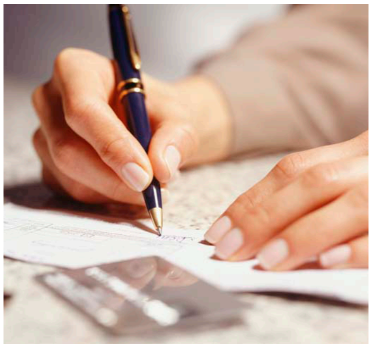
Successful money management requires ongoing discipline. Each year, you should pull all your records together and take a close look at your *entire* financial picture. Here are six steps that can help you put your financial affairs in order:

1. Analyze your cash flow. In your budget, does your income equal or exceed the amount you put into savings and fixed or variable expenses? If it exceeds the amount, by how much? The amount of income that exceeds what you saved or spent is called **positive cash flow**. If your expenses exceed your income, you have **negative cash flow**. If your cash flow is negative, it may be time to reorganize and minimize any unnecessary expenses in your budget.

2. Provide money for special goals. For every financial goal you establish, you need to address the projected cost, the amount of time until your goal is to be realized (time horizon), and your funding method (e.g., a scheduled savings plan, liquidating some assets, or taking a loan).

You should plan your goals on three tiers. On the first tier, you have an emergency fund of at least three months of income. On the second tier, you may have a special goal and may, for example, establish a savings plan for your children's weddings or educational expenses. Finally, on the third tier are more flexible goals such as purchasing an automobile, renovating your house, and planning a vacation.

3. Enrich your retirement. Are you going to have enough money when you retire? Pensions and Social Security may not provide enough income to maintain your current lifestyle during your retirement years. Therefore, review your retirement needs and plan a disciplined savings program for your retirement.



4. Minimize income taxes. Many taxpayers reduce their taxes by taking advantage of tax deductions. Most are familiar with common deductions (e.g., mortgage interest, contributions to retirement plans, and donations to charities). In addition to tax deductions, however, there may be other ways of reducing your income tax bite. For example, under appropriate circumstances, losses or expenses from previous years may be carried over to the next tax year.

5. Beat inflation. Let's say the inflation rate is currently 2%. In order to maintain your buying power—just to break even—you need a 2% annual wage increase. A decline in your buying power will certainly lower your standard of living and affect your lifestyle. In the end, you'll have less money if inflation starts to beat you. Consequently, you need to put your money to work to beat inflation.

6. Manage unexpected risks. You are probably well aware that life sometimes throws us unexpected "curve balls"—that is, unforeseen risks. Suddenly and unexpectedly, your potential risk may become a financial loss (e.g., you become disabled without income or an untimely death causes financial hardship for your family). As a result, many have made insurance the cornerstone of their overall finances because it offers protection that can help cover unforeseen potential liabilities and risks.

These six steps will help you focus on the important issues that affect your finances. If you faithfully keep track of your progress in these important areas, you may be able to both afford your future and finance your dreams. $