



# THE PLANNER

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All of us at Net Worth Strategies, Inc. are deeply saddened by the September 11<sup>th</sup> tragedies. Our thoughts and prayers extend to all the friends, families, and colleagues of victims as well as the heroes from fire, police, and medical services.

In the August newsletter, *The Planner* promised to take an inside look at retirement distribution planning this issue. Net Worth Strategies has sponsored an independent study called, "Retirement Plan Distributions: The Simplification Myth." The 26-page study, authored by seven of the nation's most respected retirement distribution experts, concludes that the need for retirement distribution planning is increasing despite the new proposed IRS regulations. Each expert covers a different angle to how financial advisors can prepare clients and their heirs to maximize tax-deferred wealth under the new IRS proposed regulations for minimum required distributions, including stretch IRAs, Roth conversions and Section 72(t) distributions. The study's introduction appears below with the full report downloadable from our web site.

This month *The Planner* features the second part of an article on protective option strategies (POS) by Dr. Donald Moine. In addition to our regular StockOpter tip of the month, this issue marks the start of user tips for MRD-Determinator 2.0, our new retirement distribution planning software tool. And as always, check out the new happenings at Net Worth Strategies, including a new Section 72(t) distribution planning software and an advanced employee stock options planning course.

Be sure to get colleagues in *The Planner* loop. New subscribers can get their own complimentary subscription by signing up at [www.NetWorthStrategies.com](http://www.NetWorthStrategies.com).

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**Planning Article of the Month:** Introduction by Guerdon Ely, CFP, MBA

## Retirement Plan Distributions: The Simplification Myth

Press reports stating that distribution planning is easy are dangerous. Clients and their advisors might actually believe it! Why is retirement distribution planning so important? The short answer is that the impact of a mistake could be disastrous. There is an enormous pool of assets residing in retirement accounts, and the road to successful distribution planning is littered with traps to snare the uninformed.

By the end of 2000 there were \$11.5 trillion dollars in retirement accounts, almost triple the value at the start of the decade.\* IRAs are the fastest growing component of the retirement market because of an increase in rollovers from defined contribution plans. For many families, IRAs will be their primary

source of wealth and retirement income. This is a huge shift in responsibility from the employer to the employee. The employee is not only responsible for investment decisions but also distribution and estate transfer decisions. Many employees are ill equipped to handle these responsibilities. Furthermore, the laws and regulations governing retirement plans are anything but simple.

There are pension laws, but individual plan rules may be more restrictive. There are IRA distribution rules, but there are also account document rules. There are complicated issues with divorce, special needs individuals, charities, and trusts.

\* Fundamentals, Vol. 10/No.2, June 2001, Investment Company Institute

(See *Retirement Plans* on page 4)

### ***StockOpter Tip of the Month:*** Inputting current year-to-date returns into StockOpter 2.5's Price Indexer feature.

StockOpter 2.5's new Price Indexer feature aids decision-making power. It allows projection of portfolio values over 15 years using the stock price performance of a list of major US corporations.

This analysis enables you to show your client how the values in their portfolio would fare if the underlying stock behaved like the stock of the selected company, i.e., Xerox or PepsiCo.

The Price Indexer contains data on annual stock price performance through the year 2000. In addition, you can add a year-to-date return for the current year which may give a more compelling demonstration of diversification.

1. Click the Price Indices tab to view Price Indexer data.
2. Select the desired company then scroll to the far right until a company's year-to-date return numbers end.
3. Type the current year-to-date return in the cell corresponding to the company.

**Note:** You'll need to have the year-to-date return of the stock on hand to do the next step.

**Note:** Type the percentage as a decimal, i.e., 0.21, not 21%.

That's it! You now have updated a company's stock price performance with 2001's year-to-date return.

### **Building Your Practice Through Employee Stock Option Planning:**

## **Protecting Your Client's Net Worth from a Stock Options Meltdown –**

**Part 2 of 2** (Abridged, full-length on web site)

By Dr. Donald Moine

This is the final part of my two part series on how financial advisors and planners can benefit from understanding and using protective option strategies (POS) to

avoid or mitigate losses to their clients' employee stock options (ESOs) and company stock. In the previous edition of *The Planner*, I introduced and explained POS, the use of cashless collars, best and worst case scenarios, and how to educate your clients about cashless collars. If you missed the prior edition or care to refresh your memory, please visit "Planner's Resources" at [NetWorthStrategies.com](http://NetWorthStrategies.com)

I'll now examine any risks to educating your clients about cashless collars and the tax issues related to collars.

### **Will Clients Try the Do-It-Yourself Approach?**

A risk in teaching financial strategies to clients is that some will invariably try to do it themselves. Nowadays millions of Americans pick their own mutual funds, stocks and even insurance policies without assistance. Could the same thing happen if the 10 million holders of ESOs are shown how to use cashless collars? It is doubtful. By sharing your expertise in these areas, it is more likely that you will create clients for life.

Collars and other protective strategies are inherently more complex than mutual funds or stocks. It is helpful to have an understanding of issues such as volatility, trading ranges, effects of market capitalization, time decay of options, taxes and other market factors.

Your client will need your help in determining if he or she should sell \$70 or even \$95 calls. Your client needs expert advice on the price of puts to be purchased, and for what time period. Your client needs to understand the importance of volume and liquidity in the options to be traded. They will need your tax advice. If the stock rises in price and is called out at a 25% profit, your client will need to know where to invest that money.

If the underlying stock is in a strong up trend, you need to show your client how to customize the collar for maximum benefit. Likewise, if it is in a strong downtrend, your client needs to know what to do to totally protect his or her net worth. Finally, your clients will need to know if they should use collars to protect 10%, 50%, or more of their stock options and company stock. They desperately

need your help and financial expertise. If you don't help them, they could lose the majority of their net worth.

Given that most Americans have never even printed out an options chain, employees with stock options desperately need your guidance on the above matters. As you develop expertise in these areas, you will distinguish yourself from other financial planners who cannot help their clients protect their most valuable assets: their stock options and company stock. You will become indispensable and will receive many referrals to friends and co-workers of your clients. You are not just a mutual fund picker and you aren't just giving generic stock options advice. You are actually helping your clients insure and protect millions of dollars worth of their net worth using these powerful techniques, and you are doing it at almost no cost to them.

### **Tax Issues**

Prior to helping your clients use POS, it's important to understand that there are complex tax issues relating to collars. This is another reason that clients will keep coming back to you for your expertise. An issue to consider is the Internal Revenue Code Section 1259, which deals with the "constructive sale" of appreciated financial positions. The hedged position cannot eliminate the potential for loss or gain. If it does so, the IRS could rule that a constructive sale took place and taxes are owed. For example, if your IBM options vest at \$100 a share, you would not want to buy \$100 strike price puts and sell \$100 strike price calls. It is true that your client would be totally protected and have his gains locked in, but it would probably be considered a constructive sale. While this tax issue is complex and clear rulings have not yet been issued, it is generally accepted that selling calls 15% out of the money and buying puts 10% below the stock's current price will preserve the potential for gain and loss and will thus not trigger a constructive sale.

What if the stock appreciates and the call is exercised? In that case, we have taxes on ordinary income on the gain in the price of the call and the loss in the value of the puts purchased is a capital loss (limited to a \$3,000 deduction each year, with carry forward allowed). Many senior executives do not understand this and they will need

your help. If an executive had spent \$200K purchasing protective puts and the stock rises, would he or she be writing off the loss for the next 67 years? Not necessarily. Use your tax expertise. Many executives have capital gains from other sources (other stocks, apartment buildings, etc.). Sell some of those other assets. Take the gain. Eliminate some or all taxes by using these put losses.

This article deals for the most part on POS concerning stock owned through the exercised of nonqualified stock options (NQSOs). While POS can be beneficial for stock owned through the exercise of incentive stock options (ISOs), the tax consequences are far more complicated. If you're unsure of the taxation effects of collars, consider contacting a stock option tax expert, such as Net Worth Strategies, prior to developing a POS.

### Conclusion of Real Life Example

How powerful are these strategies? The stock of the NYSE company used as an example in the first part of my article was approximately \$60 per share one year ago. Today, the stock of this industry leader is less than \$10 per share. The executives who utilized protective options strategies have retained almost all of their net worth. The employees who were given no guidance in how to use POS have lost all or almost all of the value of their hard earned stock options and have lost about 83% of the value of their company stock. Due to the stunning losses employees have suffered in their unprotected stock options and unprotected company stock, a record number of stock option lawsuits are now being filed. Many of these lawsuits could have been avoided if companies had given their employees basic instruction in how to protect the value of their stock options and company stock.

This is a tremendous marketing opportunity for you. Companies are scared to death to give any advice on stock options. In many cases, their executives and HR departments don't understand stock options. The HR director at one high-tech company told me, "I don't like options. They are too risky." As gently as I could, I explained to her that the risk was in not using protective options. Employees at her company had lost hundreds of millions of

dollars because no one was showing them how to use protective options. This spells a once in a decade opportunity for you. You can do seminars showing employees how to protect the value of their stock options and company stock. In doing so, you can quickly gain tens of millions of dollars in new assets under management, your clients will be able to protect their net worth at low cost to no cost (no matter what the stock market does), and the company will end up with happier, more loyal employees. Plus, the company won't have the public relations nightmare of having to re-price its stock options. They will have immense respect for you. This is truly a win-win-win situation for you, the employees and the company.

(See Meltdown on page 4)

## What's New at Net Worth Strategies:

**New Software Tool:** More and more people are retiring before age 59½. As most planners know, section 72(t) is a way for those who are under age 59½ to tap their IRAs without incurring a 10% penalty. October marks the month that MRD-Determinator customers can preview Pre-Determinator, a retirement distribution planning tool for 72(t) distributions. Current MRD-Determinator customers will be entitled to a free copy of the beta version of Pre-Determinator, as well as the final copy once it's released.

**New Course:** Supplemental Stock Option Planning with StockOpter. We have developed an intensive half-day session for advisors wishing to improve or refresh their employee stock option planning skills. The course will teach advisors advanced stock option strategies, including new diversification strategies, restricted stock plans (RSPs) and 83b elections, as well as a detailed overview of the new features available in StockOpter 2.5. For more information and a course schedule of the new course see: [www.NetWorthStrategies.com](http://www.NetWorthStrategies.com)

### MRD-Determinator Tip of the Month: Demonstrate how proper planning with a stretch IRA will increase the value of a portfolio.

Proper planning with a stretch IRA can increase the value of a portfolio by deferring retirement assets from taxes over a longer period of time, resulting in a higher after-tax return. You can use MRD-Determinator to help your clients decide whether a stretch IRA is a good alternative for them.

For example, your client, Mr. Boyle, has a \$1,000,000 IRA and his three children are named as beneficiaries. Mr. Boyle was born in 1911 and died in 2001. His three children were born in 1937, 1942, and 1949. The oldest child's age determines the payout period for the IRA after the participant's death. You want to determine whether there is any benefit to creating a stretch IRA for the two younger children by splitting the IRA into three separate IRA accounts.

To model the effect of creating accounts for each child do the following:

1. On the Determinator Input form, type the client's date of birth (1/15/1911), check **Yes** in the **Is the participant deceased** box, and enter his date of death as 5/5/2001.
2. On the **After Death** tab select **Non-Spouse** as the Beneficiary Type and enter the first child's birth date as 2/7/1937.
3. Click **Save Case** and save the case as **Child1**.
4. Change the date of birth to the second child's (10/13/1942) and save the case as **Child2**.
5. Do the same for the third child's birthday (3/22/1949) and save the case as **Child3**.
6. Click **Return to Case List**, click **Case Comparisons**, and then check the boxes next to Child1, Child2, and Child3. (If those names do not appear in the list, click **Refresh Case List**).
7. Enter 2001 for the Start Year and enter 333,333 for each **Account Value**.
8. Click **Run**. The **Current** worksheet displays the three separate accounts and their respective values.
9. Click the **Projected** tab. The account values display, with the accounts

(See MRD-Determinator Tip page 4)

## Retirement Plans

(Continued from front page)

There may also be community property vs. separate property issues. And let's not forget that the new tax law, with its phase-ins, phase-outs, and sunset provisions adds an additional dose of uncertainty!

Many published reports highlighted the fact that lifetime distributions have been simplified. That's true, but they ignore what is really important:

- Retirement distribution planning has never been about the participant; it's about the beneficiaries.
- The new rules have greatly expanded meaningful planning opportunities.

Appropriate beneficiary designations are the name of the game, and they always have been. Why? To ensure that the right people get the retirement assets and to maximize the economic benefit of those assets. However, more estate planning is done by accident when filling out beneficiary forms than is done by attorneys leading to surprising financial consequences.

Consider the following:  
*IRA owners can easily disinherit their grandchildren without even knowing it.*

Most IRA beneficiary forms do not allow the client to select whether assets should be distributed per capita or by right of representation. If the client named his three grown children as beneficiaries and one of the children predeceases the client, the IRA contract says the assets shall be distributed among the remaining two children and no assets will be distributed to any children of the deceased child.

To remedy accidentally disinheriting heirs, an IRA owner might name their estate as beneficiary. However, this apparent solution is a mistake when compared to the "stretch-out" option. A stretch-out strategy maximizes the transfer of tax-deferred wealth over future generations by naming beneficiaries properly. An illustration of the potential outcome of a properly executed stretch-out strategy appears on page 7 of the full report available at [www.NetWorthStrategies.com](http://www.NetWorthStrategies.com).

For more information on stretch-outs, read Ed Slott's essay beginning on page 9.

In conclusion, distribution planning still presents opportunities and challenges. The demand for advisors who are equipped to help clients make informed decisions will continue to the foreseeable future.

### ***MRD-Determinator Tip***

(Continued from page 3)

for Child2 and Child3 "stretched" over longer time periods than Child1's account - they are younger and therefore have longer distribution periods.

**10.** Click the **CompChart** tab to see the data in an easy-to-understand graphical format that you can print and share with your clients.

Next, quantify the value of the additional deferral in dollars:

1. On the **Case List** choose Child1.
  2. Click **Add/Edit Case**.
  3. On the **Input Form** click **Run Report**.
  4. On the **Projection** worksheet, click **New Projection** and enter 333,333 into the account value.
  5. Click **Run Report**.
  6. Click cell I1 and enter .2. This is the average income tax rate assumption.
  7. Click cell I2 and enter .03. This is the discount rate assumption for calculating Net Present Value.
  8. Click cell H6 and enter the following : =E6\*(1-\$I\$1).
  9. Copy the formula from cell H6 through cell H55. This will calculate the after-tax value of the required distributions.
  10. Click cell I6 and enter the Excel net present value formula as follows: =NPV(\$I\$2,H6:H55).
  11. Repeat process for Child2 and Child3. The formulas you created will be saved for future when you save the workbook when you exit Excel.
- The net present value for each child is as follows:
- Child1 (born in 1937) \$465,419
  - Child2 (born in 1942) \$524,923
  - Child3 (born in 1949) \$625,318

By creating separate IRAs, Child2 receives an additional benefit of \$59,504 and Child3 receives a benefit of \$159,899, for a total of \$219,403 total benefit.

Fortunately, with this information in hand, the beneficiaries can create separate accounts, even after the participant's death. And, by the way, you can use MRD-Determinator to keep a permanent record of each child's required distribution and actual distribution on a year-by-year basis. This can be important, especially if the IRA is transferred to different custodians over the years.

## Meltdown

(Continued from page 3)

Employees who are educated in how to use protective options strategies will be able to preserve and grow their financial fortunes and realize their dreams even during these challenging economic times. A broader use of protective option strategies could help preserve hundreds of billions of dollars of the net worth of employees and in doing so will strengthen our economy. In addition, many of these people you have helped will become your clients for life. © 2001 Dr. Donald Moine

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