

# **Wealth Management**

**A Treatise & Guide for Wealth Managers  
and Wealth Management Executives**

**Fundamentals of Wealth Management for  
The Wealthy, Financial Analysts, Portfolio  
Managers, Asset Managers, Wealth & Trust  
Management Professionals**

**Prof. George S. Mentz, JD, MBA, CWM, CPM, CAM, RFS,  
MFP, CTEP, FAD, CFC - Attorney at Law**

*CWM CHARTERED WEALTH MANAGER™*

*CWM™ Chartered Wealth Manager - AAFM Reference Guide*

**Formal Reference Guide for Executive Notes for  
Wealth Management Board Certification from the  
American Academy of Financial Management**

*CERTIFIED CHARTERED WEALTH MANAGER PROGRAM*

**The AAFM American Academy of Financial Management Handbook and  
WebContent © are Federally Copyrighted Content and Original Writings. All  
Rights Reserved 1996-2009**



*CWM CHARTERED WEALTH MANAGER™*

*CWM™ Chartered Wealth Manager - AAFM Reference Guide*

**Formal Reference Guide for Executive Notes for  
Wealth Management Board Certification from the  
American Academy of Financial Management**

AAFM Board Certified Wealth Manager



American Academy of Financial Management AAFM All Rights Reserved 2009

CWM Chartered Wealth Manager has been a registered mark in the States of  
LA CA NY for over 5 Years..

|   |    |
|---|----|
| Guide to Financial Statements.....                                      | 6  |
| The Basics .....  | 6  |
| “Show me the money!” .....  | 6  |
| Balance Sheets .....  | 7  |
| Income Statements .....   | 9  |
| Earnings Per Share or EPS .....   | 11 |
| Cash Flow Statements .....  | 11 |
| Operating Activities.....   | 12 |
| Investing Activities .....  | 12 |
| Financing Activities .....  | 12 |
| Read the Footnotes.....   | 12 |
| Read the MD&A .....   | 13 |
| Financial Statement Ratios and Calculations .....                       | 14 |
| Saving and Investing.....   | 16 |
| Define Your Goals .....   | 16 |
| Making a Financial Plan – Wealth Management and Financial Planning..... | 17 |
| Figuring Out Your Finances.....   | 17 |
| Your Net Worth Statement.....   | 18 |
| KNOW YOUR INCOME AND EXPENSES .....                                     | 19 |
| Small Savings Add Up to Big Money .....                                 | 20 |
| Pay Off Credit Card or Other High Interest Debt .....                   | 21 |
| Risk Tolerance.....   | 22 |
| Savings .....   | 22 |
| Investing.....  | 23 |
| Diversification .....   | 24 |
| Risk Tolerance .....  | 24 |
| Investment Products .....   | 25 |
| Stocks and Bonds .....  | 26 |
| Mutual Funds .....  | 27 |
| What is a mutual fund? .....  | 27 |
| Mutual Funds Without Active Management .....                            | 28 |
| Watch "Turnover" to Avoid Paying Excess Taxes.....                      | 29 |
| Selecting a Financial Professional .....                                | 29 |
| What If I Have a Problem? .....   | 31 |
| Other Investment and Insurance Products – Insurance and Annuities ..... | 32 |
| The Insurance Industry.....   | 32 |
| Estate Planning .....   | 35 |
| How Estates Are Taxed.....  | 37 |
| Trust Funds and Minimizing Estate Taxation .....                        | 38 |
| Basics of Life Insurance Policies and Types of Insurance.....           | 40 |
| Life Insurance.....   | 40 |
| What Is a Variable Annuity? .....                                       | 55 |
| How Variable Annuities Work.....  | 57 |

|   |           |
|---|-----------|
| The Death Benefit and Other Features .....  | 59        |
| Caution! .....  | 60        |
| Variable Annuity Charges.....   | 60        |
| Tax-Free “1035” Exchanges.....  | 63        |
| Bonus Credits.....  | 64        |
| Caution! .....  | 65        |
| Ask Questions Before You Invest.....  | 66        |
| US Treasury Investments Basics .....  | 68        |
| Online Investing .....  | 75        |
| <i>What You Need to Know About Trading In Fast-Moving Markets.....</i>                                | <i>75</i> |
| Online trading is quick and easy, online investing takes time .....                                   | 76        |
| Set your price limits on fast-moving stocks: market orders vs. limit orders                           | 76        |
| Online trading is not always instantaneous.....   | 77        |
| Know your options for placing a trade if you are unable to access your<br>account online .....        | 77        |
| If you place an order, don't assume it didn't go through.....   | 77        |
| If you cancel an order, make sure the cancellation worked before placing<br>another trade .....       | 78        |
| If you purchase a security in a cash account, you must pay for it before you<br>can sell it.....      | 78        |
| If you trade on margin, your broker can sell your securities without giving<br>you a margin call..... | 78        |
| No regulations require a trade to be executed within a certain time .....                             | 79        |
| More Information.....   | 79        |
| What To Do If You Have a Complaint.....   | 79        |
| Stocks and Financial Research .....   | 80        |
| Getting Info About Companies.....   | 80        |
| Corporate Reports.....  | 80        |
| Other Types of Information.....   | 81        |
| Mutual Funds .....  | 82        |
| Key Points to Remember .....  | 83        |
| How Mutual Funds Work.....  | 83        |
| What They Are .....   | 83        |
| Advantages and Disadvantages.....   | 86        |
| Different Types of Funds .....  | 87        |
| How to Buy and Sell Shares.....   | 90        |
| How Funds Can Earn Money for You.....   | 91        |
| Factors to Consider .....   | 92        |
| Degrees of Risk.....  | 92        |
| Fees and Expenses.....  | 93        |
| Classes of Funds .....  | 97        |
| Tax Consequences .....  | 98        |
| Avoiding Common Pitfalls .....  | 99        |
| Sources of Information - Prospectus .....   | 99        |

|   |     |
|---|-----|
| Past Performance.....   | 103 |
| Looking Beyond a Fund's Name .....  | 104 |
| Bank Products versus Mutual Funds.....  | 104 |
| If You Have Problems .....  | 105 |
| Glossary of Key Mutual Fund Terms .....                                       | 105 |
| Retirement Planning .....   | 111 |
| 10 Tips for Retirement .....  | 114 |
| Home Mortgages and Loans for your Home .....                                  | 117 |
| How the USA Economy Works .....   | 130 |
| The USA Stock Markets and Financial Markets.....                              | 148 |
| The Stock Exchanges .....   | 150 |
| Financial Glossary .....  | 164 |
| Appendix B - Expanded 100+ Page Wealth Management and Trust Glossary<br>..... | 171 |
| Wealth Management Definition and Trends.....                                  | 254 |
| Taxation in the United States – History & Updates .....                       | 256 |
| Educational Planning and College Planning .....                               | 275 |
| Types of Retirement Plans.....  | 310 |
| IRA Individual Retirement Accounts .....                                      | 310 |
| ROTH IRA Plans.....   | 315 |
| SARSEP .....  | 328 |
| What is a SEP?.....   | 333 |
| Simple IRA and Distributions .....  | 336 |
| Sources and References .....  | 345 |
| Economic Terms and Glossary.....  | 347 |

## **Guide to Financial Statements**

### **The Basics**

If you can read a nutrition label or a baseball box score, you can learn to read basic financial statements. If you can follow a recipe or apply for a loan, you can learn basic accounting. The basics aren't difficult and they aren't rocket science.

This brochure is designed to help you gain a basic understanding of how to read financial statements. Just as a CPR class teaches you how to perform the basics of cardiac pulmonary resuscitation, this brochure will explain how to read the basic parts of a financial statement. It will not train you to be an accountant (just as a CPR course will not make you a cardiac doctor), but it should give you the confidence to be able to look at a set of financial statements and make sense of them.

Let's begin by looking at what financial statements do.

### **“Show me the money!”**

We all remember Cuba Gooding's immortal line from the movie *Jerry Maguire*, “Show me the money!” Well, that's what financial statements do. They show you the money. They show you where a company's money came from, where it went, and where it is now.

There are four main financial statements. They are: (1) balance sheets; (2) income statements; (3) cash flow statements; and (4) statements of shareholders' equity. Balance sheets show what a company owns and what it owes at a fixed point in time. Income statements show how much money a company made and spent over a period of time. Cash flow statements show the exchange of money between a company and the outside world also over a period of time. The fourth financial statement, called a “statement of shareholders' equity,” shows changes in the interests of the company's shareholders over time.

## Balance Sheets

A balance sheet provides detailed information about a company's assets, liabilities and shareholders' equity.

Assets are things that a company owns that have value. This typically means they can either be sold or used by the company to make products or provide services that can be sold. Assets include physical property, such as plants, trucks, equipment and inventory. It also includes things that can't be touched but nevertheless exist and have value, such as trademarks and patents. And cash itself is an asset. So are investments a company makes.

Liabilities are amounts of money that a company owes to others. This can include all kinds of obligations, like money borrowed from a bank to launch a new product, rent for use of a building, money owed to suppliers for materials, payroll a company owes to its employees, environmental cleanup costs, or taxes owed to the government. Liabilities also include obligations to provide goods or services to customers in the future.

Shareholders' equity is sometimes called capital or net worth. It's the money that would be left if a company sold all of its assets and paid off all of its liabilities. This leftover money belongs to the shareholders, or the owners, of the company.

The following formula summarizes what a balance sheet shows:

$$\text{ASSETS} = \text{LIABILITIES} + \text{SHAREHOLDERS' EQUITY}$$

A company's assets have to equal, or "balance," the sum of its liabilities and shareholders' equity.

A company's balance sheet is set up like the basic accounting equation shown above. On the left side of the balance sheet, companies list their assets. On the right side, they list their liabilities and shareholders' equity. Sometimes balance sheets show assets at the top, followed by liabilities, with shareholders' equity at the bottom.

Assets are generally listed based on how quickly they will be converted into cash. Current assets are things a company expects to convert to cash within one year. A good example is inventory. Most companies expect to sell their inventory for cash within one year. Noncurrent assets are things a company does not expect to convert to cash within one year or that would take longer than one year to sell. Noncurrent assets include fixed assets. Fixed assets are those assets used to operate the business but that are not available for sale, such as trucks, office furniture and other property.

Liabilities are generally listed based on their due dates. Liabilities are said to be either current or long-term. Current liabilities are obligations a company expects to pay off within the year. Long-term liabilities are obligations due more than one year away.

Shareholders' equity is the amount owners invested in the company's stock plus or minus the company's earnings or losses since inception. Sometimes companies distribute earnings, instead of retaining them. These distributions are called dividends.

A balance sheet shows a snapshot of a company's assets, liabilities and shareholders' equity at the end of the reporting period. It does not show the flows into and out of the accounts during the period.



## Income Statements

An income statement is a report that shows how much revenue a company earned over a specific time period (usually for a year or some portion of a year). An income statement also shows the costs and expenses associated with earning that revenue. The literal “bottom line” of the statement usually shows the company’s net earnings or losses. This tells you how much the company earned or lost over the period.

Income statements also report earnings per share (or “EPS”). This calculation tells you how much money shareholders would receive if the company decided to distribute all of the net earnings for the period. (Companies almost never distribute all of their earnings. Usually they reinvest them in the business.)

To understand how income statements are set up, think of them as a set of stairs. You start at the top with the total amount of sales made during the accounting period. Then you go down, one step at a time. At each step, you make a deduction for certain costs or other operating expenses associated with earning the revenue. At the bottom of the stairs, after deducting all of the expenses, you learn how much the company actually earned or lost during the accounting period. People often call this “the bottom line.”

At the top of the income statement is the total amount of money brought in from sales of products or services. This top line is often referred to as gross revenues or sales. It’s called “gross” because expenses have not been deducted from it yet. So the number is “gross” or unrefined.

The next line is money the company doesn’t expect to collect on certain sales. This could be due, for example, to sales discounts or merchandise returns.

When you subtract the returns and allowances from the gross revenues, you arrive at the company’s net revenues. It’s called “net” because, if you can imagine a net, these revenues are left in the net after the deductions for returns and allowances have come out.

Moving down the stairs from the net revenue line, there are several lines that represent various kinds of operating expenses. Although these lines can be reported in various orders, the next line after net revenues typically shows the costs of the sales. This number tells you the amount of money the company spent to produce the goods or services it sold during the accounting period.

The next line subtracts the costs of sales from the net revenues to arrive at a subtotal called “gross profit” or sometimes “gross margin.” It’s considered “gross” because there are certain expenses that haven’t been deducted from it yet.

The next section deals with operating expenses. These are expenses that go toward supporting a company’s operations for a given period – for example, salaries of administrative personnel and costs of researching new products. Marketing expenses are another example. Operating expenses are different from “costs of sales,” which were deducted above, because operating expenses cannot be linked directly to the production of the products or services being sold.

Depreciation is also deducted from gross profit. Depreciation takes into account the wear and tear on some assets, such as machinery, tools and furniture, which are used over the long term. Companies spread the cost of these assets over the periods they are used. This process of spreading these costs is called depreciation or amortization. The “charge” for using these assets during the period is a fraction of the original cost of the assets.

After all operating expenses are deducted from gross profit, you arrive at operating profit before interest and income tax expenses. This is often called “income from operations.” Next companies must account for interest income and interest expense. Interest income is the money companies make from keeping their cash in interest-bearing savings accounts, money market funds and the like. On the other hand, interest expense is the money companies paid in interest for money they borrow. Some income statements show interest income and interest expense separately.

Some income statements combine the two numbers. The interest income and expense are then added or subtracted from the operating profits to arrive at operating profit before income tax.

Finally, income tax is deducted and you arrive at the bottom line: net profit or net losses. (Net profit is also called net income or net earnings.) This tells you how much the company actually earned or lost during the accounting period. Did the company make a profit or did it lose money?

### **Earnings Per Share or EPS**

Most income statements include a calculation of earnings per share or EPS. This calculation tells you how much money shareholders would receive for each share of stock they own if the company distributed all of its net income for the period.

To calculate EPS, you take the total net income and divide it by the number of outstanding shares of the company.

### **Cash Flow Statements**

Cash flow statements report a company's inflows and outflows of cash. This is important because a company needs to have enough cash on hand to pay its expenses and purchase assets. While an income statement can tell you whether a company made a profit, a cash flow statement can tell you whether the company generated cash. A cash flow statement shows changes over time rather than absolute dollar amounts at a point in time. It uses and reorders the information from a company's balance sheet and income statement. The bottom line of the cash flow statement shows the net increase or decrease in cash for the period. Generally, cash flow statements are divided into three main parts. Each part reviews the cash flow from one of three types of activities: (1) operating activities; (2) investing activities; and (3) financing activities.

## **Operating Activities**

The first part of a cash flow statement analyzes a company's cash flow from net income or losses. For most companies, this section of the cash flow statement reconciles the net income (as shown on the income statement) to the actual cash the company received from or used in its operating activities. To do this, it deducts from net income any non-cash items (such as depreciation expenses) and any cash that was used or provided by other operating assets and liabilities.

## **Investing Activities**

The second part of a cash flow statement shows the cash flow from all investing activities, which generally include purchases or sales of long-term assets, such as property, plant and equipment, as well as investment securities. If a company buys a piece of machinery, the cash flow statement would reflect this activity as a cash outflow from investing activities because it used cash. If the company decided to sell off some investments from an investment portfolio, the proceeds from the sales would show up as a cash inflow from investing activities because it provided cash.

## **Financing Activities**

The third part of a cash flow statement shows the cash flow from all financing activities. Typical sources of cash flow include cash raised by selling stocks and bonds or borrowing from banks. Likewise, paying back a bank loan would show up as a use of cash flow.

## **Read the Footnotes**

The footnotes to financial statements are packed with information. Footnotes can also contain critical issues of Intellectual Property, Tax, or Political Legal Conflicts and Regulatory Issues. Here are some of the highlights:

- Significant accounting policies and practices – Companies are required to disclose the accounting policies that are most important to the portrayal of the company’s financial condition and results. These often require management’s most difficult, subjective or complex judgments.
- Income taxes – The footnotes provide detailed information about the company’s current and deferred income taxes. The information is broken down by level – federal, state, local and/or foreign, and the main items that affect the company’s effective tax rate are described.
- Pension plans and other retirement programs – The footnotes discuss the company’s pension plans and other retirement or post-employment benefit programs. The notes contain specific information about the assets and costs of these programs, and indicate whether and by how much the plans are over- or under-funded.
- Stock options – The notes also contain information about stock options granted to officers and employees, including the method of accounting for stock-based compensation and the effect of the method on reported results.

## Read the MD&A

You can find a narrative explanation of a company’s financial performance in a section of the quarterly or annual report entitled, “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” MD&A is *management’s* opportunity to provide investors with its view of the financial performance and condition of the company. It’s management’s opportunity to tell investors what the financial statements show and do not show, as well as important trends and risks that have shaped the past or are reasonably likely to shape the company’s future.

The SEC's rules governing MD&A require disclosure about trends, events or uncertainties known to management that would have a material impact on reported financial information. The purpose of MD&A is to provide investors with information that the company's management believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations. It is intended to help investors to see the company through the eyes of management. It is also intended to provide context for the financial statements and information about the company's earnings and cash flows.

### Financial Statement Ratios and Calculations

You've probably heard people banter around phrases like "P/E ratio," "current ratio" and "operating margin." But what do these terms mean and why don't they show up on financial statements? Listed below are just some of the many ratios that investors calculate from information on financial statements and then use to evaluate a company. As a general rule, desirable ratios vary by industry.

- *Debt-to-equity ratio* compares a company's total debt to shareholders' equity. Both of these numbers can be found on a company's balance sheet. To calculate debt-to-equity ratio, you divide a company's total liabilities by its shareholder equity, or

$$\text{Debt-to-Equity Ratio} = \text{Total Liabilities} / \text{Shareholders' Equity}$$

If a company has a debt-to-equity ratio of 2 to 1, it means that the company has two dollars of debt to every one dollar shareholders invest in the company. In other words, the company is taking on debt at twice the rate that its owners are investing in the company.

- *Inventory turnover ratio* compares a company's cost of sales on its income statement with its average inventory balance for the period. To calculate the average inventory balance for the period, look at the inventory numbers listed on the balance sheet. Take the balance listed for the period of the report and add it to the balance listed for the previous comparable period, and then divide by two. (Remember that balance sheets are snapshots in time. So the inventory balance for the previous period is the beginning balance for the current period, and the inventory balance for the current period is the ending balance.) To calculate the inventory turnover ratio, you divide a company's cost of sales (just below the net revenues on the income statement) by the average inventory for the period, or

$$\text{Inventory Turnover Ratio} = \text{Cost of Sales} / \text{Average Inventory for the Period}$$

If a company has an inventory turnover ratio of 2 to 1, it means that the company's inventory turned over twice in the reporting period.

- *Operating margin* compares a company's operating income to net revenues. Both of these numbers can be found on a company's income statement. To calculate operating margin, you divide a company's income from operations (before interest and income tax expenses) by its net revenues, or

$$\text{Operating Margin} = \text{Income from Operations} / \text{Net Revenues}$$

Operating margin is usually expressed as a percentage. It shows, for each dollar of sales, what percentage was profit.

- *P/E ratio* compares a company's common stock price with its earnings per share. To calculate a company's P/E ratio, you divide a company's stock price by its earnings per share, or

$$\text{P/E Ratio} = \text{Price per share} / \text{Earnings per share}$$

If a company's stock is selling at \$20 per share and the company is earning \$2 per share, then the company's P/E Ratio is 10 to 1. The company's stock is selling at 10 times its earnings.

- *Working capital* is the money leftover if a company paid its current liabilities (that is, its debts due within one-year of the date of the balance sheet) from its current assets.

Working Capital = Current Assets – Current Liabilities

## **Saving and Investing**

### **Define Your Goals**

To end up where you want to be, you'll need a roadmap, a financial plan. To get started on your plan, you'll need to ask yourself what are the things you want to save and invest for. Here are some possibilities:

- A home
- A car
- An education
- A comfortable retirement
- Your children
- Medical or other emergencies
- Periods of unemployment
- Caring for parents



Make your own list and then think about which goals are the most important to you. List your most important goals first.

| What do you want to save or invest for? | By when? |
|---|----------|
| 1. _____                                | _____    |
| 2. _____                                | _____    |
| 3. _____                                | _____    |
| 4. _____                                | _____    |
| 5. _____                                | _____    |

Decide how many years you have to meet each specific goal, because when you save or invest you'll need to find a savings or investment option that fits your time frame for meeting each goal.

## **Making a Financial Plan – Wealth Management and Financial Planning**

### **Figuring Out Your Finances**

Sit down and take an honest look at your entire financial situation. You can never take a journey without knowing where you're starting from, and a journey to financial security is no different.

You'll need to figure out on paper your current situation— what you own and what you owe. You'll be creating a "net worth statement." On one side of the page, list what you own. These are your "assets." And on the other side list what you owe other people, your "liabilities" or debts.

## Your Net Worth Statement

| <b>Assets</b>      | <b>Current<br/>Value</b> | <b>Liabilities</b> | <b>Amount</b> |
|--------------------|--------------------------|--------------------|---------------|
| cash               | _____                    | mortgage balance   | _____         |
| checking account   | _____                    | credit cards       | _____         |
| savings            | _____                    | bank loans         | _____         |
| cash value of life | _____                    | car loans          | _____         |
| insurance          | _____                    | personal loans     | _____         |
| retirement         | _____                    | real estate        | _____         |
| accounts           | _____                    |                    |               |
| real estate        | _____                    |                    | _____         |
| home               | _____                    |                    | _____         |
| other              | _____                    |                    | _____         |
| investments        | _____                    |                    | _____         |
| personal property  | _____                    |                    | _____         |
| total              | _____                    | total              | _____         |

Subtract your liabilities from your assets. If your assets are larger than your liabilities, you have a “positive” net worth. If your liabilities are greater than your assets, you have a “negative” net worth. You’ll want to update your “net worth statement” every year to keep track of how you are doing. Don’t be discouraged if you have a negative net worth. If you follow a plan to get into a positive position, you’re doing the right thing.

**KNOW YOUR INCOME AND EXPENSES**

The next step is to keep track of your income and your expenses for every month. Write down what you and others in your family earn, and then your monthly expenses. Include a category for savings and investing. What are you paying yourself every month? Many people get into the habit of saving and investing by following this advice: always pay yourself or your family first. Many people find it easier to pay themselves first if they allow their bank to automatically remove money from their paycheck and deposit it into a savings or investment account. Likely even better, for tax purposes, is to participate in an employer sponsored retirement plan such as a 401(k), 403(b), or 457(b). These plans will typically not only automatically deduct money from your paycheck, but will immediately reduce the taxes you are paying. Additionally, in many plans the employer matches some or all of your contribution. When your employer does that, it's offering "free money." Any time you have automatic deductions made from your paycheck or bank account, you'll increase the chances of being able to stick to your plan and to realize your goals.

*"But I Spend Everything I Make."*

If you are spending all your income, and never have money to save or invest, you'll need to look for ways to cut back on your expenses. When you watch where you spend your money, you will be surprised how small everyday expenses that you can do without add up over a year.

**Monthly Income and Expenses**

**Income:** \_\_\_\_\_

**Expenses:**

Savings \_\_\_\_\_

Investments \_\_\_\_\_

Housing:

rent or \_\_\_\_\_

mortgage \_\_\_\_\_

electricity \_\_\_\_\_

gas/oil \_\_\_\_\_

telephone \_\_\_\_\_

water/sewer \_\_\_\_\_

property tax \_\_\_\_\_

furniture \_\_\_\_\_

Food \_\_\_\_\_

Transportation \_\_\_\_\_

Loans \_\_\_\_\_

Insurance \_\_\_\_\_

Education \_\_\_\_\_

Recreation \_\_\_\_\_

Health care \_\_\_\_\_

Gifts \_\_\_\_\_

Other \_\_\_\_\_

**Total** \_\_\_\_\_

## **Small Savings Add Up to Big Money**

*How much does a cup of coffee cost you?*

*Would you believe \$465.83.5? Or more?*

If you buy a cup of coffee every day for \$1.00 (an awfully good price for a decent cup of coffee, nowadays), that adds up to \$365.00 a year. If you saved that \$365.00 for just one year, and put it into a savings account or investment that earns 5% a year, it would grow to \$465.83.5 by the end of 5 years, and by the end of 30 years, to \$1,577.50.

That's the power of "compounding." With compound interest, you earn interest on the money you save and on the interest that money earns. Over time, even a small amount saved can add up to big money.

If you are willing to watch what you spend and look for little ways to save on a regular schedule, you can make money grow. You just did it with one cup of coffee.

If a small cup of coffee can make such a huge difference, start looking at how you could make your money grow if you decided to spend less on other things and save those extra dollars.

If you buy on impulse, make a rule that you'll always wait 24 hours to buy anything. You may lose your desire to buy it after a day. And try emptying your pockets and wallet of spare change at the end of each day. You'll be surprised how quickly those nickels and dimes add up!

## **Pay Off Credit Card or Other High Interest Debt**

Speaking of things adding up, there is no investment strategy anywhere that pays off as well as, or with less risk than, merely paying off all high interest debt you may have. Many people have wallets filled with credit cards, some of which they've "maxed out" (meaning they've spent up to their credit limit). Credit cards can make it seem easy to buy expensive things when you don't have the cash in your pocket—or in the bank. But credit cards aren't free money.

Most credit cards charge high interest rates—as much as 18 percent or more—if you don't pay off your balance in full each month. If you owe money on your credit cards, the wisest thing you can do is pay off the balance in full as quickly as possible. Virtually no investment will give you the high returns you'll need to keep pace with an 18 percent interest charge. That's why you're better off eliminating all credit card debt before investing savings. Once you've paid off your credit cards, you can budget your money and begin to save and invest. Here are some tips for avoiding credit card debt:

- **Put Away the Plastic**

Don't use a credit card unless your debt is at a manageable level and you know you'll have the money to pay the bill when it arrives.

- **Know What You Owe**

It's easy to forget how much you've charged on your credit card. Every time you use a credit card, write down how much you have spent and figure out how much you'll have to pay that month. If you know you won't be able to pay your balance in full, try to figure out how much you can pay each month and how long it'll take to pay the balance in full.

- **Pay Off the Card with the Highest Rate**

If you've got unpaid balances on several credit cards, you should first pay down the card that charges the highest rate. Pay as much as you can toward that debt each month until your balance is once again zero, while still paying the minimum on your other cards.

The same advice goes for any other high interest debt (about 8% or above) which does not offer the tax advantages of, for example, a mortgage.

## **Risk Tolerance**

You are approaching the half-way point in your journey to saving and investing. This is a good point to make sure that you understand some key concepts:

### **Savings**

Your "savings" are usually put into the safest places or products that allow you access to your money at any time. Examples include savings accounts, checking accounts, and certificates of deposit. At some banks and savings and loan associations your deposits may be insured by the [Federal Deposit Insurance Corporation \(FDIC\)](#). But there's a tradeoff for security and ready availability. Your money is paid a low wage as it works for you.

Most smart investors put enough money in a savings product to cover an emergency, like sudden unemployment. Some make sure they have up to 6 months of their income in savings so that they know it will absolutely be there for them when they need it.

But how "safe" is a savings account if you leave all your money there for a long time, and the interest it earns doesn't keep up with inflation? Let's say you save a dollar when it can buy a loaf of bread. But years later when you withdraw that dollar plus the interest you earned, it might only be able to buy half a loaf. That is why many people put some of their money in savings, but look to investing so they can earn more over long periods of time, say three years or longer.

## Investing

When you "invest," you have a greater chance of losing your money than when you "save." Unlike FDIC-insured deposits, the money you invest in securities, [mutual funds](#), and other similar investments are not federally insured. You could lose your "principal," which is the amount you've invested. That's true even if you purchase your investments through a bank. But when you invest, you also have the opportunity to earn more money than when you save.

But what about risk? All investments involve taking on risk. It's important that you go into any investment in stocks, bonds or mutual funds with a full understanding that you could lose some or all of your money in any one investment. While over the long term the stock market has historically provided around 10% annual returns (closer to 6% or 7% "real" returns when you subtract for the effects of inflation), the long term does sometimes take a rather long, long time to play out. Those who invested all of their money in the stock market at its peak in 1929 (before the stock market crash) would wait over 20 years to see the stock market return to the same level. However, those that kept adding money to the market throughout that time would have done very well for themselves, as the lower cost of stocks in the 1930s made for some hefty gains for those who bought and held over the course of the next twenty years or more.

## Diversification

It is true that the greater the risk, the greater the potential rewards in investing, but taking on unnecessary risk is often avoidable.

Investors best protect themselves against risk by spreading their money among various investments, hoping that if one investment loses money, the other investments will more than make up for those losses. This strategy, called “diversification,” can be neatly summed up as, “Don’t put all your eggs in one basket.” Investors also protect themselves from the risk of investing all their money at the wrong time (think 1929) by following a consistent pattern of adding new money to their investments over long periods of time.

Once you’ve saved money for investing, consider carefully all your options and think about what diversification strategy makes sense for you. While the SEC cannot recommend any particular investment product, you should know that a vast array of investment products exists—including stocks and stock mutual funds, corporate and municipal bonds, bond mutual funds, certificates of deposit, money market funds, and U.S. Treasury securities. Diversification can’t *guarantee* that your investments won’t suffer if the market drops. But it can improve the chances that you won’t lose money, or that if you do, it won’t be as much as if you weren’t diversified.

## Risk Tolerance

What are the best saving and investing products for you? The answer depends on when you will need the money, your goals, and if you will be able to sleep at night if you purchase a risky investment where you could lose your principal. For instance, if you are saving for retirement, and you have 35 years before you retire, you may want to consider riskier investment products, knowing that if you stick to only the “savings” products or to less risky investment products, your money will grow too slowly—or given inflation or taxes, you may lose the purchasing power of your money. A frequent mistake people make is putting money they will not need for a very long time in investments that pay a low amount of interest.



On the other hand, if you are saving for a short-term goal, five years or less, you don't want to choose risky investments, because when it's time to sell, you may have to take a loss. Since investments often move up and down in value rapidly, you want to make sure that you can wait and sell at the best possible time.

## **Investment Products**

When you make an investment, you are giving your money to a company or an enterprise, hoping that it will be successful and pay you back with even more money.

Some investments make money, and some don't. You can potentially make money in an investment if:

- The company performs better than its competitors.
- Other investors recognize it's a good company, so that when it comes time to sell your investment, others want to buy it.
- The company makes profits, meaning they make enough money to pay you interest for your bond, or maybe dividends on your stock.

You can lose money if:

- The company's competitors are better than it is.
- Consumers don't want to buy the company's products or services.
- The company's officers fail at managing the business well, they spend too much money, and their expenses are larger than their profits.
- Other investors that you would need to sell to think the company's stock is too expensive given its performance and future outlook.
- The people running the company are dishonest. They use your money to buy homes, clothes, and vacations, instead of using your money on the business.

- They lie about any aspect of the business: claim past or future profits that do not exist, claim it has contracts to sell its products when it doesn't, or make up fake numbers on their finances to dupe investors.
- The brokers who sell the company's stock manipulate the price so that it doesn't reflect the true value of the company. After they pump up the price, these brokers dump the stock, the price falls, and investors lose their money.
- For whatever reason, you have to sell your investment when the market is down.

Here are some kinds of investments you may consider making:

## Stocks and Bonds

Many companies offer investors the opportunity to buy either stocks or bonds. The following example shows you how stocks and bonds differ.

Let's say you believe that a company that makes automobiles may be a good investment. Everyone you know is buying one of its cars, and your friends report that the company's cars rarely break down and run well for years. You either have an investment professional investigate the company and read as much as possible about it, or you do it yourself.

After your research, you're convinced it's a solid company that will sell many more cars in the years ahead. The automobile company offers both stocks and bonds. With the bonds, the company agrees to pay you back your initial investment in ten years, plus pay you interest twice a year at the rate of 8% a year.

If you buy the stock, you take on the risk of potentially losing a portion or all of your initial investment if the company does poorly or the stock market drops in value. But you also may see the stock increase in value beyond what you could earn from the bonds. If you buy the stock, you become an "owner" of the company.

You wrestle with the decision. If you buy the bonds, you will get your money back plus the 8% interest a year. And you think the company will be able to honor its promise to you on the bonds because it has been in business for many years and doesn't look like it could go bankrupt. The company has a long history of making cars and you know that its stock has gone up in price by an average of 9% a year, plus it has typically paid stockholders a dividend of 3% from its profits each year.

You take your time and make a careful decision. Only time will tell if you made the right choice. You'll keep a close eye on the company and keep the stock as long as the company keeps selling a quality car that consumers want to drive, and it can make an acceptable profit from its sales.

## **Mutual Funds**

Because it is sometimes hard for investors to become experts on various businesses—for example, what are the best steel, automobile, or telephone companies—investors often depend on professionals who are trained to investigate companies and recommend companies that are likely to succeed.

Since it takes work to pick the stocks or bonds of the companies that have the best chance to do well in the future, many investors choose to invest in mutual funds.

### **What is a mutual fund?**

A mutual fund is a pool of money run by a professional or group of professionals called the “investment adviser.” In a managed mutual fund, after investigating the prospects of many companies, the fund's investment adviser will pick the stocks or bonds of companies and put them into a fund. Investors can buy shares of the fund, and their shares rise or fall in value as the values of the stocks and bonds in the fund rise and fall.

Investors may typically pay a fee when they buy or sell their shares in the fund, and those fees in part pay the salaries and expenses of the professionals who manage the fund. Even small fees can and do add up and eat into a significant chunk of the returns a mutual fund is likely to produce, so you need to look carefully at how much a fund costs and think about how much it will cost you over the amount of time you plan to own its shares. If two funds are similar in every way except that one charges a higher fee than the other, you'll make more money by choosing the fund with the lower annual costs.

### **Mutual Funds Without Active Management**

One way that investors can obtain for themselves nearly the full returns of the market is to invest in an “index fund.” This is a mutual fund that does not attempt to pick and choose stocks of individual companies based upon the research of the mutual fund managers or to try to time the market's movements. An index fund seeks to equal the returns of a major stock index, such as the Standard & Poor 500, the Wilshire 5000, or the Russell 3000. Through computer programmed buying and selling, an index fund tracks the holdings of a chosen index, and so shows the same returns as an index minus, of course, the annual fees involved in running the fund. The fees for index mutual funds generally are much lower than the fees for managed mutual funds. Historical data shows that index funds have, primarily because of their lower fees, enjoyed higher returns than the average managed mutual fund. But, like any investment, index funds involve risk.

## **Watch "Turnover" to Avoid Paying Excess Taxes**

To maximize your mutual fund returns, or any investment returns, know the effect that taxes can have on what actually ends up in your pocket. Mutual funds that trade quickly in and out of stocks will have what is known as “high turnover.” While selling a stock that has moved up in price does lock in a profit for the fund, this is a profit for which taxes have to be paid. Turnover in a fund creates taxable capital gains, which are paid by the mutual fund shareholders.

The SEC requires all mutual funds to show both their before- and after-tax returns. The differences between what a fund is reportedly earning, and what a fund is earning after taxes are paid on the dividends and capital gains, can be quite striking. If you plan to hold mutual funds in a taxable account, be sure to check out these historical returns in the mutual fund prospectus to see what kind of taxes you might be likely to incur.

## **Selecting a Financial Professional**

Are you the type of person who will read as much as possible about potential investments and ask questions about them? If so, maybe you don't need investment advice. But if you're busy with your job, your children, or other responsibilities, or feel you don't know enough about investing on your own, then you may need professional investment advice. You should consider consulting with a Board Certified Wealth Manager, Certified Portfolio Manager or Master Financial Professional Planner.

Investment professionals offer a variety of services at a variety of prices. It pays to comparison shop.

You can get investment advice from most financial institutions that sell investments, including brokerages, banks, mutual funds, and insurance companies. You can also hire a broker, an investment adviser, an accountant, a financial planner, or other professional to help you make investment decisions.

Choosing someone to help you with your investments is one of the most important investment decisions you will ever make. While most investment professionals are honest and hardworking, you must watch out for those few unscrupulous individuals. They can make your life's savings disappear in an instant.

Securities regulators and law enforcement officials can and do catch these criminals. But putting them in jail doesn't always get your money back. Too often, the money is gone. The good news is you can avoid potential problems by protecting yourself.

Let's say you've already met with several investment professionals based on recommendations from friends and others you trust, and you've found someone who clearly understands your investment objectives. Before you hire this person, you still have more homework.

Make sure the investment professional and her firm are registered with the SEC and licensed to do business in your state. And find out from your state's securities regulator whether the investment professional or her firm have ever been disciplined, or whether they have any complaints against them. You should also find out as much as you can about any investments that your investment professional recommends. First, make sure the investments are registered. Keep in mind, however, the mere fact that a company has registered and files reports with the SEC doesn't guarantee that the company will be a good investment. Likewise, the fact that a company hasn't registered and doesn't file reports with the SEC doesn't mean the company is a fraud. Still, you may be asking for serious losses if, for instance, you invest in a small, thinly traded company that isn't widely known solely on the basis of what you may have read online. Be wary of promises of quick profits, offers to share "inside information," and pressure to invest before you have an opportunity to investigate.

Ask your investment professional for written materials and prospectuses, and read them before you invest. If you have questions, now is the time to ask.

- How will the investment make money?
- How is this investment consistent with my investment goals?
- What must happen for the investment to increase in value?
- What are the risks?
- Where can I get more information?

### **What If I Have a Problem?**

Finally, it's always a good idea to write down everything your investment professional tells you. Accurate notes will come in handy if ever there's a problem.

Some investments make money. Others lose money. That's natural, and that's why you need a diversified portfolio to minimize your risk. But if you lose money because you've been cheated, that's not natural, that's a problem.

Sometimes all it takes is a simple phone call to your investment professional to resolve a problem. Maybe there was an honest mistake that can be corrected. If talking to the investment professional doesn't resolve the problem, talk to the firm's manager, and write a letter to confirm your conversation. If that doesn't lead to a resolution, you may have to initiate private legal action. You may need to take action quickly because legal time limits for doing so vary. Your local bar association can provide referrals for attorneys who specialize in securities law.

## Other Investment and Insurance Products – Insurance and Annuities

### The Insurance Industry

The insurance industry provides protection against financial losses resulting from a variety of perils. By purchasing insurance policies, individuals and businesses can receive reimbursement for losses due to car accidents, theft of property, and fire and storm damage; medical expenses; and loss of income due to disability or death. The insurance industry consists mainly of *insurance carriers* (or *insurers*) and *insurance agencies and brokerages*. In general, insurance carriers are large companies that provide insurance and assume the risks covered by the policy. Insurance agencies and brokerages sell insurance policies for the carriers. While some of these establishments are directly affiliated with a particular insurer and sell only that carrier's policies, many are independent and are thus free to market the policies of a variety of insurance carriers. In addition to supporting these two primary components, the insurance industry includes establishments that provide other insurance-related services, such as claims adjustment or third-party administration of insurance and pension funds.

Insurance carriers assume the risk associated with annuities and insurance policies and assign premiums to be paid for the policies. In the policy, the carrier states the length and conditions of the agreement, exactly which losses it will provide compensation for, and how much will be awarded. The premium charged for the policy is based primarily on the amount to be awarded in case of loss, as well as the likelihood that the insurance carrier will actually have to pay. In order to be able to compensate policyholders for their losses, insurance companies invest the money they receive in premiums, building up a portfolio of financial assets and income-producing real estate which can then be used to pay off any future claims that may be brought. There are two basic types of insurance carriers: *direct* and *reinsurance*.



Direct carriers are responsible for the initial underwriting of insurance policies and annuities, while reinsurance carriers assume all or part of the risk associated with the existing insurance policies originally underwritten by other insurance carriers.

Direct insurance carriers offer a variety of insurance policies. *Life insurance* provides financial protection to beneficiaries—usually spouses and dependent children—upon the death of the insured. *Disability insurance* supplies a preset income to an insured person who is unable to work due to injury or illness, and *health insurance* pays the expenses resulting from accidents and illness. *An annuity* (a contract or a group of contracts that furnishes a periodic income at regular intervals for a specified period) provides a steady income during retirement for the remainder of one's life. *Property-casualty insurance* protects against loss or damage to property resulting from hazards such as fire, theft, and natural disasters. *Liability insurance* shields policyholders from financial responsibility for injuries to others or for damage to other people's property. Most policies, such as automobile and homeowner's insurance, combine both property-casualty and liability coverage. Companies that underwrite this kind of insurance are called property-casualty carriers.

Some insurance policies cover groups of people, ranging from a few to thousands of individuals. These policies usually are issued to employers for the benefit of their employees or to unions, professional associations, or other membership organizations for the benefit of their members. Among the most common policies of this nature are group life and health plans. Insurance carriers also underwrite a variety of specialized types of insurance, such as real-estate title insurance, employee surety and fidelity bonding, and medical malpractice insurance.

A relatively recent act of Congress allows insurance carriers and other financial institutions, such as banks and securities firms, to sell one another's products. As a result, more insurance carriers now sell financial products such as securities, mutual funds, and various retirement plans.

This approach is most common in life insurance companies that already sell annuities; however, property and casualty companies also are increasingly selling a wider range of financial products. In order to expand into one another's markets, insurance carriers, banks, and securities firms have engaged in numerous mergers, allowing the merging companies access to each other's client base and geographical markets.

Insurance carriers have discovered that the Internet can be a powerful tool for reaching potential and existing customers. Most carriers use the Internet simply to post company information, such as sales brochures and product information, financial statements, and a list of local agents. However, an increasing number of carriers are starting to expand their Web sites to enable customers to access online account and billing information, and a few carriers even allow claims to be submitted online. Some carriers also provide insurance quotes online based on the information submitted by customers on their Internet sites. In the future, carriers will allow customers to purchase policies through the Internet without ever speaking to a live agent. In addition to individual carrier-sponsored Internet sites, several "lead-generating" sites have emerged. These sites allow potential customers to input information about their insurance policy needs. For a fee, the sites forward customer information to a number of insurance companies, which review the information and, if they decide to take on the policy, contact the customer with an offer. This practice gives consumers the freedom to accept the best rate.

The insurance industry also includes a number of independent organizations that provide a wide array of insurance-related services to carriers and their clients. One such service is the processing of claims forms for medical practitioners. Other services include loss prevention and risk management. Also, insurance companies sometimes hire independent claims adjusters to investigate accidents and claims for property damage and to assign a dollar estimate to the claim.

Other organizations in the industry are formed by groups of insurance companies, to perform functions that would result in a duplication of effort if each company carried them out individually. For example, service organizations are supported by insurance companies to provide loss statistics, which the companies use to set their rates.

## **Estate Planning**

Planning your estate is to distribute your assets according to your wishes after your death. Successful estate planning transfers your assets to your beneficiaries quickly and usually with minimal tax consequences. The process of estate planning includes inventorying your assets and making a will and/or establishing a trust, often with an emphasis on minimizing taxes. This pamphlet provides only a general overview of estate planning. You should consult an attorney, or perhaps a CPA or tax advisor for additional guidance.

### **Do I Need to Worry?**

You may think estate planning is only for the wealthy. If your assets are worth \$1,000,000 or more, estate planning may benefit your heirs. That's because generally taxable estates worth in excess of the amounts in the chart below may be subject to federal estate taxes, with rates as high as 45% to 50% of the taxable estate.

Adding up the value of your assets can be an eye-opening experience. By the time you account for your home, investments, retirement savings and life insurance policies you own, you may find your estate in the taxable category.

Even if your estate is not likely to be subject to federal estate taxes, estate planning may be necessary to be sure your intentions for disposition of your assets are carried out.

| YEAR | EXCLUSION AMOUNT | HIGHEST ESTATE TAX RATE |
|------|------------------|-------------------------|
| 2002 | \$1,000,000      | 50%                     |
| 2003 | \$1,500,000      | 49%                     |
| 2004 | \$1,500,000      | 48%                     |
| 2005 | \$1,500,000      | 47%                     |
| 2006 | \$2,000,000      | 46%                     |
| 2007 | \$2,000,000      | 45%                     |
| 2008 | \$2,000,000      | 45%                     |
| 2009 | \$3,500,000      | 45%                     |

It is also important to note that estate taxes are scheduled to be repealed in 2010. However, if Congress does not affirmatively extend the repeal, in 2011 the estate tax law will revert to the provisions in effect in 2001 including a \$1,000,000 exclusion amount and a 55% highest estate tax rate.

### Taking Stock

The first step in estate planning is to inventory everything you own and assign a value to each asset. Here's a list to get you started. You may need to delete some categories or add others.

- Residence
- Other real estate
- Savings (bank accounts, CDs, money markets)
- Investments (stocks, bonds, mutual funds)
- 401(k), IRA, pension and other retirement accounts
- Life insurance policies and annuities
- Ownership interest in a business
- Motor vehicles (cars, boats, planes)
- Jewelry
- Collectibles & Other personal property

Once you've estimated the value of your estate, you're ready to do some planning. Keep in mind that estate planning is not a one-time job. There are a number of changes that may call for a review of your plan. Take a fresh look at your estate plan if:

- The value of your assets changes significantly.
- You marry, divorce or remarry.
- You have a child.
- You move to a different state.
- The executor of your will or the administrator of your trust dies or becomes incapacitated, or your relationship with that person changes significantly.
- One of your heirs dies or has a permanent change in health.
- The laws affecting your estate change.

## **How Estates Are Taxed**

Federal gift and estate tax law permits each taxpayer to transfer a certain amount of assets free from tax during his or her lifetime or at death. (In addition, as discussed in the next section, certain gifts valued at \$11,000 or less can be made that are not counted against this amount.) The amount of money that can be shielded from federal estate or gift taxes is determined by the federal applicable credit. The credit is used during your lifetime when you make certain taxable gifts, and the balance, if any, can be used by your estate after your death.

Keep in mind that while you can plan to minimize taxes, your estate may still have to pay some federal estate taxes. What's more, your estate may be subject to state estate or inheritance taxes, which are beyond the scope of this pamphlet. An estate planning professional can provide more information regarding state taxes.

## Trust Funds and Minimizing Estate Taxation

There are a number of estate planning methods that can be used to minimize federal taxes on your estate.

**Giving away assets during your lifetime.** Federal tax law generally allows each individual to give up to \$11,000\* per year to anyone without paying gift taxes, subject to certain restrictions. That means you can transfer some of your wealth to your children or others during your lifetime to reduce your taxable estate. For example, you could give \$11,000 a year to each of your children, and your spouse could do likewise (for a total of \$22,000 per year to each child). You may make \$11,000 annual gifts to as many people as you wish. You may also give your child or another person more than \$11,000 a year without having to pay federal gift taxes, but the excess amount will count against the amount shielded from tax by your applicable credit. For example, if you gave your favorite niece \$33,000 a year for the last three years, you would have reduced your applicable credit by \$66,000 (a \$22,000 excess gift each year).

*\* The annual gift tax exclusion will be adjusted for inflation, as measured by the Consumer Price Index (CPI) published by the Department of Labor. The increases will be in multiples of \$1,000. This exclusion applies only to a gift of a present interest in property. Therefore, gifts made in trust generally will not qualify for this exclusion.*

**The marital deduction shields property transferred to a spouse from taxes.** Federal tax law generally permits you to transfer assets to your spouse without incurring gift or estate taxes, regardless of the amount. This is not, however, without its drawbacks. Marital deductions may increase the total combined federal estate tax liability of the spouses upon the subsequent death of the surviving spouse. To avoid this problem, many couples choose to establish a bypass trust.

**Bypass trusts or credit shelter trusts can give a couple the advantages of the marital deduction while utilizing the unified credit to its fullest.** Let's say, for example, that a married couple has a federal taxable estate worth \$2 million (or \$1,000,000 each). Using the marital deduction, if one spouse dies in 2003 the full \$1,000,000 can be left to the other spouse without incurring taxes. However, when the second spouse dies in 2004 and passes his or her \$2 million estate on to their children, taxes will be levied on the excess over the amount of assets shielded by the applicable credit ( $\$2,000,000 - \$1,500,000 = \$500,000$  subject to estate tax). With a bypass or credit shelter trust, the first spouse to die can leave the amount shielded by the applicable credit to the trust. The trust can provide income to the surviving spouse for life, then upon the death of the surviving spouse the assets are distributed to beneficiaries, such as children. This permits the spouse who dies first to fully utilize his or her applicable credit. If the trust document is drawn properly, the assets in the trust are not included in the surviving spouse's estate. Thus, the surviving spouse's estate will be smaller and can also utilize the applicable credit. In the example above, the surviving spouse's estate would not have to pay federal estate taxes. Because both partners have made use of their applicable credit, the couple is able to pass on a substantial estate tax free to their beneficiaries.

**Charitable gifts are not taxed as long as the contribution is made to an organization that operates for religious, charitable or educational purposes.** Check to see if the organization you want to give money to is an eligible charity in the eyes of the Internal Revenue Service. You, or your estate may be entitled to a tax deduction for contributions to a qualifying charity. Consult your tax advisor.

**Life insurance trusts can be designed to keep the proceeds of a life insurance policy out of your estate and give your estate the liquidity it needs.** Generally, you can fund a life insurance trust either by transferring an existing life insurance policy or by having the trust purchase a new policy.\*

To avoid inclusion in your estate, such trusts must be irrevocable—meaning that you cannot dissolve the trust or change the terms of the trust if you change your mind later. With proper planning, the proceeds from life insurance held by the trust may pass to trust beneficiaries without income or estate taxes. This gives them cash which may be used to help pay estate taxes or other expenses, such as debts or funeral costs.

*\* Transferring an existing policy may have gift tax consequences. Consult your tax advisor.*

Estate planning is very complex and is subject to changing laws. This pamphlet by no means covers all estate planning methods. Be sure to seek professional advice from a qualified attorney, and perhaps a CPA or estate planner. The money you spend now to plan your estate can mean more money for your beneficiaries in the long run.

## Basics of Life Insurance Policies and Types of Insurance

### Life Insurance

#### How Much Life Insurance Do I Need?

There is no precise formula to tell you how much insurance coverage you need. Some consumer groups recommend five times your gross annual income. Under this formula, a family with an income of \$40,000 might need at least \$200,000 worth of life insurance protection ([face value](#) of the policy).

Some insurance industry organizations recommend a policy paying ten times your gross yearly income. With this formula, the family mentioned above would need \$400,000 worth of insurance.



Before buying life insurance, assemble your personal financial information and review your needs. You should consider:

- Immediate needs at the time of death, such as final illness expenses, burial costs, and estate taxes.
- Funds for a readjustment period, to finance a move or to provide time for remaining family members to find jobs or better-paying jobs.
- Ongoing financial needs such as monthly bills and expenses, outstanding debts, day-care costs, college tuition, support for elderly parents, and retirement.

You also need to take into account any assets you have, such as cash; savings; Social Security and pension benefits; other insurance, including mortgage insurance; and, real estate. Some of these assets will be available for immediate use, some to finance a readjustment period, and others may help your family meet long-term, continuing needs.

## **What Kind of Life Insurance Should I Buy?**

Not all life insurance policies are the same. There are four basic types of life insurance: Term Life Insurance, Whole Life Insurance, Universal Life Insurance, and Variable Life Insurance.

### **Term Life Insurance**

Term Life Insurance policies provide a check to your [beneficiary](#) when you die. Term Life Insurance policies generally are cheaper and easier to understand than other kinds of life insurance policies. Term Life Insurance usually offers you the best value for your money by giving you the biggest death benefit for your premium dollar.

Term Life Insurance covers you for a term of one or more years. It pays a death benefit only if you die in that term.

You can renew most Term Life Insurance policies for one or more terms even if your health has changed, although you may be required to complete a medical questionnaire and might be refused insurance if your health is poor. But each time you renew the policy for a new term, premiums may be higher because you will be older.

If you are thinking of buying Term Life Insurance, make sure you can afford the premiums for as long as you want to keep the policy. You should ask the company to show you how you could expect premiums to increase over a 10-year or 20-year period.

To avoid yearly increases, you may want to look for 5, 10, 20, or even 30-year renewable Term Life Insurance policies where the premiums will stay the same for those periods. These long-term policies may "lock in" premiums for as long as you need a high level of insurance, e.g., until your mortgage is paid or your children graduate from college.

Most Term Life Insurance policies are convertible. You can exchange your Term Life Insurance policy for a Whole Life or other type of insurance policy without taking a medical exam or answering any health questions. You may decide to convert your Term Life Insurance policy if your health declines; it may be difficult for you to qualify for a new Term Life Insurance policy at affordable rates. Conversion is usually allowed until age 65.

### **Whole Life Insurance, Universal Life Insurance, and Variable Life Insurance**

All of these types of insurance differ from Term Life Insurance in one way: once you have paid your premiums for a number of years, the policy will have a cash value attached to it. But, if you withdraw all or part of the cash value, the amount of money you receive usually has substantial [surrender charges](#) already taken out of the amount you will get. The amount you may expect to receive when you terminate the policy is called the [cash surrender value](#). You may need to pay taxes on the cash surrender value when it is paid out to you.

If you buy a cash surrender value policy, be sure you will be able to keep up premium payments for at least fifteen to twenty years. If you cash the policy in before that time, the surrender charges and other expenses might leave you little actual cash surrender value remaining.

[Agent commissions](#) on cash surrender value policies are several times higher than those on Term Life Insurance policies. Keep this in mind if an agent continues to recommend a Whole Life Insurance policy when you ask about Term Life Insurance.

The insurance company will lend you money against the cash surrender value of your policy, or you may use your cash surrender value as collateral for a bank loan. If the loan is with the insurance company, you may have the option of paying the loan interest from any value that is left or future dividends that you earn. ***But, if there is not enough left in your account to support at least those payments, you are in danger of losing the policy altogether.*** Plus, if you die and the loan has not been repaid, the insurance company will deduct the amount owed plus interest from the money paid to your beneficiary.

In recent years, some consumers were encouraged to make a loan against the cash surrender value or to use dividends from insurance policies they already owned to buy a new or additional policy. Some consumers found they had taken too much in loans. They lost the first policy and then couldn't afford the second policy.

Even if you are in no danger of losing one or both policies, these kinds of transactions are not generally in your best interest.

## **Whole Life Insurance**

Whole Life Insurance may be called straight life, ordinary life, or permanent insurance. Whole Life Insurance covers you for as long as you live, as long as you pay the premiums. There is no need to renew Whole Life policies. In order to buy Whole Life Insurance you will usually have to fill out a health questionnaire, and you may need to have a medical exam. Depending on the medical information you provide, your premiums may be higher than the standard rate, or the insurance company may decide not to offer you a life insurance policy.

It is important to be very honest about any medical conditions which could affect your life insurance. Your beneficiaries might receive no benefit at all if you die within two years of buying the policy and you have not told the truth about a situation or medical condition which would have caused the company to deny you insurance if they had known the truth.

With a Whole Life Insurance policy, you generally pay the same amount in premiums for as long as you live. This premium is based on your age and your health at the time of purchase. In some cases, the premium you pay may change over time, but you would be shown this when you first buy the policy. Be sure you understand what your premium payments will be and that you can afford them over time.

In the early years of the policy, premiums for Whole Life Insurance may be much higher than you would pay for the same amount of Term Life Insurance. But remember, the premiums in most term policies will rise each time you renew.

Many Whole Life Insurance policies also earn dividends, usually on an annual basis. If you do not take the dividends out when they are earned, but instead leave them on account with the insurance company, the dividends will also earn interest.

If a company pays dividends, it may pay more or less in dividends than it had been paying when you bought the policy. The dividends a company will pay depend on many factors, including the performance of their own investments and the efficiency of their operations. The company's earnings and expenses can fluctuate just like the stock market. When you are choosing an insurance company that pays dividends, ask for a company's history of projected dividends versus paid dividends. Remember that dividends are not guaranteed and may differ from those shown in sales illustrations. Sometimes, dividends may be used to purchase [Paid-Up Additions](#) (PUA's) to your policy, an increase to the death benefit. Some companies will use the dividends on your policy to buy additional Term Life Insurance. But, you might have less insurance than you planned if the dividends go down and these additions did not supplement your benefits.

In recent years, many consumers were told that dividends their policies earned, and the interest on those dividends might, or would, become large enough to pay the premium payments. (This is sometimes called "**abbreviated payment**," or "**vanishing premium**.") But, often this didn't happen and those consumers were stuck paying for insurance they couldn't afford. Or, they lost their insurance plus all the money they had paid in.

If you decide to buy a policy which has an abbreviated payment or vanishing premium option, you should keep close track of your policy's earnings. Changes in interest rates, cost of insurance, policy expenses and loans can quickly eliminate your policy's ability to pay for itself. Even if you can stop paying premiums at some point, you might have to start paying again at some later point.

Unless the insurance company guarantees **in writing** that you will no longer have to pay premiums after a certain time, you should assume you will have to continue to pay.

## **Universal Life Insurance**

Universal Life Insurance, also referred to as Flexible Premium Universal Life, lets you vary your premium payments and when you will pay the premiums, with some limits on how flexible you can be. For example, you may be able to skip a premium payment; or, increase or decrease your premium payments as long as the total amount of premiums you are paying in over a period of time is enough to keep the policy in force. As you get older, however, the minimum premium payments may increase.

Cash surrender value for a Universal Life Insurance policy depends on the performance of the insurance company's investments. Make sure you understand whether any benefits or cash surrender values are guaranteed. Even if there is enough in your account to pay the premiums, continuing to pay premiums yourself means you build up more cash surrender value.

If you do not pay enough in premiums, you may reach the point where your insurance coverage will end. To prevent that, you may need to raise your premium payments or lower your death benefits. The insurance company must send you an annual report and will also notify you if you are in danger of losing your policy due to insufficient value.

When you buy Universal Life Insurance, you may be able to change the amount of the death benefit (also called the "face amount"), after you buy the insurance. But, to increase the death benefit, you may need to fill out another health history or have a new medical exam.

### **Variable Life Insurance**

Variable Life Insurance benefits (both the death benefit and earnings) vary based on the investment performance of the assets in which your premium payments are invested. You will generally be offered a variety of investment options (equity, bond, and money market mutual funds). Death benefits and cash values are directly related to the performance of investment options you choose. There may be a guaranteed minimum death benefit; however, you may be required to pay extra for that feature.

There are two kinds of Variable Life Insurance policies. You can buy a policy which has premiums with set times and amounts, or you can buy a policy which allows changes in premium payment times and amounts. Unlike Universal Life Insurance, however, the death benefit will also change depending on how much you pay in and the performance of the investments you choose.

The insurance company will give you a "prospectus" which will explain the policy before you buy it. The company will probably describe the different investment options in the prospectus, but you may also ask for additional information about the investment options. Study the prospectus carefully and be sure to ask the company about anything you don't understand. Agents who sell Variable Life Insurance must have both a Massachusetts insurance agent license and be registered as representatives of a broker-dealer licensed by the National Association of Securities Dealers (NASD) and be registered with the Securities and Exchange Commission (SEC) as well.

The SEC also reviews and approves the contents of the prospectus you will receive, and is currently involved in an effort to make these prospectuses much more understandable to consumers.

With a Variable Life Insurance policy, there are usually no guarantees. If the investments you choose lose money, you could find that the value of your account is far less than the amounts you have paid in.

Although some Variable Life policies may include a minimum guaranteed death benefit, others do not have this guarantee. It is possible that, if you were to die when the values were low, the death benefit your beneficiaries received would be reduced to little or nothing.

### Comparing Major Types of Life Insurance

|                     | <b>Term Life</b>                              | <b>Whole Life</b>   | <b>Universal Life</b>   | <b>Variable Life</b>                |
|---------------------|---|---|---|-------------------------------------|
| <b>Premium</b>      | Lower initially. Increases with each renewal. | Higher initially than Term Life Insurance. Normally doesn't increase. | Flexible premiums. Premiums can rise as you get older or if the company's investments do not do well. | Fixed or flexible premiums.         |
| <b>Protects for</b> | A specified period.                           | Entire life if you keep the policy.                                   | Entire life if you keep the policy.   | Entire life if you keep the policy. |

|                               |  |   |   |  |
|-------------------------------|--|---|---|--|
| <b>Policy benefits</b>        | Death benefits only, no cash surrender value.  | Death benefits, possible dividends, and eventually a cash surrender value.  | Flexible death benefits and eventually a cash surrender value.                        | Death benefits, earnings, and cash surrender values vary in relation to the performance of the investments you choose. |
| <b>Advantages to Buyer</b>    | Lower initial outlay. At first, may be able to buy more insurance for less cost.   | Fixed premium amount. Can take a loan against policy, or surrender policy for some cash.  | More flexibility. Takes advantage of current interest rates.                          | You can choose to invest your money in stocks, bonds, money market or other accounts.                                  |
| <b>Disadvantages to Buyer</b> | Premium increases each time a new term starts. The insurance company is free to substantially raise premiums if your health changes. | Dividends can be hurt by low interest rates. You will lose money if you cash it in. Usually no cash surrender value for at least 3-5 years. | Same as Whole Life Insurance and you assume greater risks due to program flexibility. | Same as Whole Life Insurance and you bear all the investment risk.   |



|                |   |   |   |   |
|----------------|---|---|---|---|
| <b>Options</b> | May be renewable and/or convertible to a whole life policy. | Partial cash surrenders may be permitted. | Minimum death benefit. Partial cash surrenders permitted. | May offer a guaranteed minimum death benefit. |
|----------------|---|---|---|---|

## How Much Will Life Insurance Cost?

Different insurance companies charge different rates for their life insurance. Comparing costs can be very difficult. For example, one company might offer a competitively priced policy for 25-year-olds, but not for 40-year-olds.

There are some common factors that insurance companies use to decide how much to charge you for the kind and amount of insurance you want to buy. These include:

- your age and gender;
- your health and health habits (such as smoking);
- your family health history;
- whether you are engaged in a hazardous occupation, or have dangerous hobbies (such as auto racing or sky diving).

The insurance company will get this information from your application, and may ask you to fill out a health questionnaire, or have a medical examination. Once they have the information, the insurance company will decide if your risk of death is average or greater than normal for your age and gender. If they believe the risk is greater, they will charge you more than normal. (This is called being [rated](#).) Remember, a different company may not believe your risk is greater than normal, and may charge you their standard rates.

If you are "rated," you should be told the reason, such as poor health or a dangerous occupation. If the reasons for the original rating improve, tell your insurance company and ask them to review the situation. Your premiums might go down.

Another major difference in determining insurance costs will be the insurance company's [administrative fees](#) and expenses, including overhead, agent commissions and other costs of doing business.

## **What Other Benefits Are Available in Life Insurance? ("Riders")**

At the time you buy a life insurance policy, you may want to buy additional benefits. These benefits are called [riders](#). If you buy riders, you can expect to pay more than if you bought simply the basic life insurance policy. Here are some common riders, but you should ask the insurance company what riders are available with the policy you are thinking of buying.

### **Accelerated Death Benefits**

These are also known as "living benefits". You may receive all or a part of the benefits of your life insurance policy before you die. Living benefits are paid out for causes such as: terminal illnesses like AIDS, organ transplant, or permanent confinement to a nursing home. The allowable reasons to receive living benefits may be different for each company, and you should check before you buy the policy. Any benefit paid to you before you die will mean that your beneficiaries will get that much less when you die.

### **Viatical Settlements**

A "viatical settlement" is not insurance. It is a contract in which the terminally-ill owner of life insurance (the "viator") sells the death benefit to a third party in return for immediate cash. This cash will be a percentage of the expected death benefit. For example, the viatical settlement company buys a life insurance policy that will pay a \$100,000 death benefit, for \$80,000.

If you sell your life insurance to a viatical company in a viatical settlement, that company will pay future premiums and will be the owner and beneficiary of your life insurance. Once you die, your original beneficiaries will get nothing from that life insurance policy.

The viator may also contract for a "viatical loan" with a viatical loan company. In this instance, the loan is secured by the value of the life insurance policy. You will be expected to make regular payments on the loan and continue to pay your life insurance premiums, but you will retain ownership of the life insurance policy.

The percentage you can expect to receive from selling your policy, or the amount and terms of the loan may vary widely from one viatical company to another. ***You should seek offers from several companies in order to get the best result.***

In determining the sales price or loan amount, the viatical settlement or loan company considers several factors, including the life expectancy of the person whose life is insured. The shorter the life expectancy, the higher the payment.

Payments generally vary between 50 to 90 percent of the policy's expected death benefit, but can be even less than 50 percent of the expected death benefit.

If you are considering a viatical contract you may want to consult with your lawyer, doctor, life insurance agent or company, and accountant or financial planner. These contracts are very complicated, and may affect other issues such as Medicaid eligibility. You may not be able to back out of a viatical contract once you have signed it, so you will need to be very certain of what you want to do before you sign.

## **Accidental Death Benefits**

Also known as a "double indemnity", this rider pays an additional amount if death is accidental. In some cases, policies may pay up to three times the normal death benefit should death occur by a specific type of travel accident, such as an airplane crash.

## **Automatic Premium Loan**

If you do not pay your premiums, the insurance company will automatically make a loan against your policy to cover the cost of the premiums. This rider can be used only if your life insurance policy has sufficient cash surrender value.

## **Guaranteed Insurability**

A [Guaranteed Insurability Rider](#) would allow you to buy additional life insurance at specific times without having to answer any questions about your health. However, the cost for the new policy would still be based on your age at the time you buy it.

## **Premium Waiver Provision**

This is a rider which takes effect if you become disabled. The disabled person will not have to pay premiums for the duration of the disability, even if it is a lifelong disability. In cases where the [policy owner](#) is not the person insured, e.g., a parent who is paying for life insurance for a child, this provision takes effect if the policy owner (in this example, the parent) becomes disabled. You are responsible for notifying the insurance company if you become disabled.

## **Life Insurance Q & A**

### ***Q. Where can I buy a life insurance policy?***

**A.** Individual life insurance can be purchased directly from an insurance company, through the mail or from an insurance agent. Insurance may also be offered over the Internet, but you will usually have to sign a paper application as well. Group life insurance may be available through your job or through a group to which you belong.

Most life insurance agents and brokers are honest; they sincerely want to help you meet your insurance needs. However, many consumer complaints are from people who had "complete faith in my agent," or "never doubted my broker because he was referred to me by a member of my family". A good agent or broker will work hard to make sure you really understand what you are buying, and will not be impatient when you ask to "see it in writing".

An independent financial planner or accountant can help you clarify your financial needs and review insurance proposals you are considering. A professional who does not work for the insurance company that wants to sell you insurance can provide an unbiased opinion on what is available.

**Q. *Do I have time to think about my purchase?***

**A.** Make sure you understand the policy before you buy it. But, you will also have at least ten days after the policy is delivered to you to return the policy. This is called a [free look period](#). If you do this within ten days, the company will return all of the premiums you have paid.

**Q. *How can I buy the most insurance for the least cost?***

**A.** Term Life Insurance usually gives you the most insurance for the least amount of money. Also, you may save money by buying a policy with low administrative fees. These "low-[load](#)" policies are sold primarily by a handful of insurers through direct mail or toll-free telephone numbers. Low-load policies also may be sold by financial planners licensed as insurance counselors who charge a service fee rather than a commission. Since the initial fees are low, low-load policies also cut your risk of losing money if you surrender your policy early.

**Q. *How else can I save money on life insurance?***

**A.** Group policies, available through employers, are often cheaper than individual ones. You usually don't have to take a medical exam, nor do you have to answer health questions to qualify. In some group insurance, for example insurance available through your work, you may have to show that you have good health if you apply for the insurance later than 60 or 90 days after you were hired.

Group insurance also may be available through professional, civic or religious associations. Group life insurance may be offered at a single rate per person, or there may be only a few categories, such as age and gender. This is particularly true if the insurance is Term Life Insurance.

**Q. *Will I need life insurance when I retire?***

**A.** It depends on your individual financial circumstances. Social Security and some retirement plans available through employment cover burial costs and may provide a continuing income for dependents after a retiree's death. Some consumers are able to use the accelerated death benefit rider available in some life insurance policies to cover nursing home costs, but this will usually not provide the same amount of protection as long-term care insurance.

**Q. *Can a company refuse to pay a claim in case of suicide or if I do not tell the truth on the application or in the medical exam?***

**A.** In the first two years after you buy a policy, the company can refuse to pay if the cause of death is suicide, or if you have made a material misrepresentation in the application. A "[material misrepresentation](#)" happens if you do not tell the truth about a situation or medical condition which would have caused the company to deny you insurance if they had known the truth. If you understate your age to obtain a more favorable premium, the insurance company will reduce the death benefit to be equal to what your premiums would have purchased at the correct age.

After the policy has been in force for two years, the company cannot contest the claim as long as you have paid the premiums. This is called [incontestability](#). If you change companies or policies, you may be required to go through another two year period in which the company could deny a claim because of suicide or a material misrepresentation in the application.

**Q. *What happens if I miss a premium payment?***

A. During the [grace period](#), the 30-day period after the date your premium is due, you can pay your premium with no interest charged. If you die during the grace period, your beneficiaries would receive the death benefit of the policy minus the premium owed.

If you do not pay the premium within the grace period, your policy will [lapse](#). That means that you have ended your relationship with that insurer and, if you were to die, your beneficiaries would not get any death benefits. Most companies will allow you to reinstate a lapsed policy for up to three years. To reinstate a lapsed policy, you would have to pay all overdue premiums with interest, plus reinstate or repay any loans you have taken against the policy. You might also be required to fill out a new health questionnaire or have a medical exam.

**What Is a Variable Annuity?**

A variable annuity is a contract between you and an insurance company, under which the insurer agrees to make periodic payments to you, beginning either immediately or at some future date. You purchase a variable annuity contract by making either a single purchase payment or a series of purchase payments.

A variable annuity offers a range of investment options. The value of your investment as a variable annuity owner will vary depending on the performance of the investment options you choose. The investment options for a variable annuity are typically mutual funds that invest in stocks, bonds, money market instruments, or some combination of the three.

Although variable annuities are typically invested in mutual funds, variable annuities differ from mutual funds in several important ways:

First, variable annuities let you receive **periodic payments** for the rest of your life (or the life of your spouse or any other person you designate). This feature offers protection against the possibility that, after you retire, you will outlive your assets.

Second, variable annuities have a **death benefit**. If you die before the insurer has started making payments to you, your beneficiary is guaranteed to receive a specified amount – typically at least the amount of your purchase payments. Your beneficiary will get a benefit from this feature if, at the time of your death, your account value is less than the guaranteed amount.

Third, variable annuities are **tax-deferred**. That means you pay no taxes on the income and investment gains from your annuity until you withdraw your money. You may also transfer your money from one investment option to another within a variable annuity without paying tax at the time of the transfer. When you take your money out of a variable annuity, however, you will be taxed on the earnings at ordinary income tax rates rather than lower capital gains rates. In general, the benefits of tax deferral will outweigh the costs of a variable annuity only if you hold it as a long-term investment to meet retirement and other long-range goals.

**Caution!** Other investment vehicles, such as IRAs and employer-sponsored 401(k) plans, also may provide you with tax-deferred growth and other tax advantages. For most investors, it will be advantageous to make the maximum allowable contributions to IRAs and 401(k) plans before investing in a variable annuity. In addition, if you are investing in a variable annuity through a tax-advantaged retirement plan (such as a 401(k) plan or IRA), you will get no additional tax advantage from the variable annuity. Under these circumstances, consider buying a variable annuity only if it makes sense because of the annuity's other features, such as lifetime income payments and death benefit protection. The tax rules that apply to variable annuities can be complicated – before investing, you may want to consult a tax adviser about the tax consequences to you of investing in a variable annuity.



**Remember:** Variable annuities are designed to be long-term investments, to meet retirement and other long-range goals. Variable annuities are not suitable for meeting short-term goals because substantial taxes and insurance company charges may apply if you withdraw your money early. Variable annuities also involve investment risks, just as mutual funds do.

### How Variable Annuities Work

A variable annuity has two phases: an **accumulation phase** and a **payout phase**.

During the **accumulation phase**, you make purchase payments, which you can allocate to a number of investment options. For example, you could designate 40% of your purchase payments to a bond fund, 40% to a U.S. stock fund, and 20% to an international stock fund. The money you have allocated to each mutual fund investment option will increase or decrease over time, depending on the fund's performance. In addition, variable annuities often allow you to allocate part of your purchase payments to a fixed account. A fixed account, unlike a mutual fund, pays a fixed rate of interest. The insurance company may reset this interest rate periodically, but it will usually provide a guaranteed minimum (*e.g.*, 3% per year).

**Example:** You purchase a variable annuity with an initial purchase payment of \$10,000. You allocate 50% of that purchase payment (\$5,000) to a bond fund, and 50% (\$5,000) to a stock fund. Over the following year, the stock fund has a 10% return, and the bond fund has a 5% return. At the end of the year, your account has a value of \$10,750 (\$5,500 in the stock fund and \$5,250 in the bond fund), minus fees and charges (discussed below).

Your most important source of information about a variable annuity's investment options is the prospectus. Request the prospectuses for the mutual fund investment options.

Read them carefully before you allocate your purchase payments among the investment options offered. You should consider a variety of factors with respect to each fund option, including the fund's investment objectives and policies, management fees and other expenses that the fund charges, the risks and volatility of the fund, and whether the fund contributes to the diversification of your overall investment portfolio.

During the accumulation phase, you can typically transfer your money from one investment option to another without paying tax on your investment income and gains, although you may be charged by the insurance company for transfers. However, if you withdraw money from your account during the early years of the accumulation phase, you may have to pay "surrender charges," which are discussed below. In addition, you may have to pay a 10% federal tax penalty if you withdraw money before the age of 59½.

At the beginning of the **payout phase**, you may receive your purchase payments plus investment income and gains (if any) as a lump-sum payment, or you may choose to receive them as a stream of payments at regular intervals (generally monthly).

If you choose to receive a stream of payments, you may have a number of choices of how long the payments will last. Under most annuity contracts, you can choose to have your annuity payments last for a period that you set (such as 20 years) or for an indefinite period (such as your lifetime or the lifetime of you and your spouse or other beneficiary). During the payout phase, your annuity contract may permit you to choose between receiving payments that are fixed in amount or payments that vary based on the performance of mutual fund investment options.

The amount of each periodic payment will depend, in part, on the time period that you select for receiving payments. Be aware that some annuities do not allow you to withdraw money from your account once you have started receiving regular annuity payments.

In addition, some annuity contracts are structured as **immediate annuities**, which means that there is no accumulation phase and you will start receiving annuity payments right after you purchase the annuity.

### The Death Benefit and Other Features

A common feature of variable annuities is the **death benefit**. If you die, a person you select as a beneficiary (such as your spouse or child) will receive the greater of: (i) all the money in your account, or (ii) some guaranteed minimum (such as all purchase payments minus prior withdrawals).

**Example:** You own a variable annuity that offers a death benefit equal to the greater of account value or total purchase payments minus withdrawals. You have made purchase payments totaling \$50,000. In addition, you have withdrawn \$5,000 from your account. Because of these withdrawals and investment losses, your account value is currently \$40,000. If you die, your designated beneficiary will receive \$45,000 (the \$50,000 in purchase payments you put in minus \$5,000 in withdrawals).

Some variable annuities allow you to choose a "stepped-up" death benefit. Under this feature, your guaranteed minimum death benefit may be based on a greater amount than purchase payments minus withdrawals. For example, the guaranteed minimum might be your account value as of a specified date, which may be greater than purchase payments minus withdrawals if the underlying investment options have performed well. The purpose of a stepped-up death benefit is to "lock in" your investment performance and prevent a later decline in the value of your account from eroding the amount that you expect to leave to your heirs. This feature carries a charge, however, which will reduce your account value.

Variable annuities sometimes offer other optional features, which also have extra charges. One common feature, the guaranteed minimum income benefit, guarantees a particular minimum level of annuity payments, even if you do not have enough money in your account (perhaps because of investment losses) to support that level of payments. Other features may include long-term care insurance, which pays for home health care or nursing home care if you become seriously ill.

You may want to consider the financial strength of the insurance company that sponsors any variable annuity you are considering buying. This can affect the company's ability to pay any benefits that are greater than the value of your account in mutual fund investment options, such as a death benefit, guaranteed minimum income benefit, long-term care benefit, or amounts you have allocated to a fixed account investment option.

**Caution!**

You will pay for each benefit provided by your variable annuity. Be sure you understand the charges. Carefully consider whether you need the benefit. If you do, consider whether you can buy the benefit more cheaply as part of the variable annuity or separately (e.g., through a long-term care insurance policy).

### **Variable Annuity Charges**

You will pay several charges when you invest in a variable annuity. Be sure you understand all the charges before you invest. **These charges will reduce the value of your account and the return on your investment.**

Often, they will include the following:

- **Surrender charges** – If you withdraw money from a variable annuity within a certain period after a purchase payment (typically within six to eight years, but sometimes as long as ten years), the insurance company usually will assess a "surrender" charge, which is a type of sales charge. This charge is used to pay your financial professional a commission for selling the variable annuity to you. Generally, the surrender charge is a percentage of the amount withdrawn, and declines gradually over a period of several years, known as the "**surrender period.**" For example, a 7% charge might apply in the first year after a purchase payment, 6% in the second year, 5% in the third year, and so on until the eighth year, when the surrender charge no longer applies. Often, contracts will allow you to withdraw part of your account value each year – 10% or 15% of your account value, for example – without paying a surrender charge.

**Example:** You purchase a variable annuity contract with a \$10,000 purchase payment. The contract has a schedule of surrender charges, beginning with a 7% charge in the first year, and declining by 1% each year. In addition, you are allowed to withdraw 10% of your contract value each year free of surrender charges. In the first year, you decide to withdraw \$5,000, or one-half of your contract value of \$10,000 (assuming that your contract value has not increased or decreased because of investment performance). In this case, you could withdraw \$1,000 (10% of contract value) free of surrender charges, but you would pay a surrender charge of 7%, or \$280, on the other \$4,000 withdrawn.

- **Mortality and expense risk charge** – This charge is equal to a certain percentage of your account value, typically in the range of 1.25% per year. This charge compensates the insurance company for insurance risks it assumes under the annuity contract. Profit from the mortality and expense risk charge is sometimes used to pay the insurer's costs of selling the variable annuity, such as a commission paid to your financial professional for selling the variable annuity to you.

**Example:** Your variable annuity has a mortality and expense risk charge at an annual rate of 1.25% of account value. Your average account value during the year is \$20,000, so you will pay \$250 in mortality and expense risk charges that year.

- **Administrative fees** – The insurer may deduct charges to cover record-keeping and other administrative expenses. This may be charged as a flat account maintenance fee (perhaps \$25 or \$30 per year) or as a percentage of your account value (typically in the range of 0.15% per year).

**Example:** Your variable annuity charges administrative fees at an annual rate of 0.15% of account value. Your average account value during the year is \$50,000. You will pay \$75 in administrative fees.

- **Underlying Fund Expenses** – You will also indirectly pay the fees and expenses imposed by the mutual funds that are the underlying investment options for your variable annuity.
- **Fees and Charges for Other Features** – Special features offered by some variable annuities, such as a [stepped-up death benefit](#), a [guaranteed minimum income benefit](#), or [long-term care insurance](#), often carry additional fees and charges.

Other charges, such as initial sales loads, or fees for transferring part of your account from one investment option to another, may also apply. You should ask your financial professional to explain to you all charges that may apply. You can also find a description of the charges in the prospectus for any variable annuity that you are considering.

## Tax-Free “1035” Exchanges

Section 1035 of the U.S. tax code allows you to exchange an existing variable annuity contract for a new annuity contract without paying any tax on the income and investment gains in your current variable annuity account. These tax-free exchanges, known as 1035 exchanges, can be useful if another annuity has features that you prefer, such as a larger death benefit, different annuity payout options, or a wider selection of investment choices.

You may, however, be required to pay surrender charges on the old annuity if you are still in the surrender charge period. In addition, a new surrender charge period generally begins when you exchange into the new annuity. This means that, for a significant number of years (as many as 10 years), you typically will have to pay a surrender charge (which can be as high as 9% of your purchase payments) if you withdraw funds from the new annuity. Further, the new annuity may have higher annual fees and charges than the old annuity, which will reduce your returns.

If you are thinking about a 1035 exchange, you should compare both annuities carefully. Unless you plan to hold the new annuity for a significant amount of time, you may be better off keeping the old annuity because the new annuity typically will impose a new surrender charge period. Also, if you decide to do a 1035 exchange, you should talk to your financial professional or tax adviser to make sure the exchange will be tax-free. If you surrender the old annuity for cash and then buy a new annuity, you will have to pay tax on the surrender.

## Bonus Credits

Some insurance companies are now offering variable annuity contracts with "bonus credit" features. These contracts promise to add a bonus to your contract value based on a specified percentage (typically ranging from 1% to 5%) of purchase payments.

**Example:** You purchase a variable annuity contract that offers a bonus credit of 3% on each purchase payment. You make a purchase payment of \$20,000. The insurance company issuing the contract adds a bonus of \$600 to your account.

Variable annuities with bonus credits may carry a downside, however – higher expenses that can outweigh the benefit of the bonus credit offered.

Frequently, insurers will charge you for bonus credits in one or more of the following ways:

- **Higher surrender charges** – Surrender charges may be higher for a variable annuity that pays you a bonus credit than for a similar contract with no bonus credit.
- **Longer surrender periods** – Your purchase payments may be subject to surrender charges for a longer period than they would be under a similar contract with no bonus credit.
- **Higher mortality and expense risk charges and other charges** – Higher annual mortality and expense risk charges may be deducted for a variable annuity that pays you a bonus credit. Although the difference may seem small, over time it can add up. In addition, some contracts may impose a separate fee specifically to pay for the bonus credit.



Before purchasing a variable annuity with a bonus credit, ask yourself – and the financial professional who is trying to sell you the contract – whether the bonus is worth more to you than any increased charges you will pay for the bonus. This may depend on a variety of factors, including the amount of the bonus credit and the increased charges, how long you hold your annuity contract, and the return on the underlying investments. You also need to consider the other features of the annuity to determine whether it is a good investment for you.

**Example:** You make purchase payments of \$10,000 in Annuity A and \$10,000 in Annuity B. Annuity A offers a bonus credit of 4% on your purchase payment, and deducts annual charges totaling 1.75%. Annuity B has no bonus credit and deducts annual charges totaling 1.25%. Let's assume that both annuities have an annual rate of return, prior to expenses, of 10%. By the tenth year, your account value in Annuity A will have grown to \$22,978. But your account value in Annuity B will have grown more, to \$23,136, because Annuity B deducts lower annual charges, even though it does not offer a bonus.

You should also note that a bonus may only apply to your initial premium payment, or to premium payments you make within the first year of the annuity contract. Further, under some annuity contracts the insurer will take back all bonus payments made to you within the prior year or some other specified period if you make a withdrawal, if a death benefit is paid to your beneficiaries upon your death, or in other circumstances.

**Caution!**

If you already own a variable annuity and are thinking of exchanging it for a different annuity with a bonus feature, you should be careful. Even if the surrender period on your current annuity contract has expired, a new surrender period generally will begin when you exchange that contract for a new one.

This means that, by exchanging your contract, you will forfeit your ability to withdraw money from your account without incurring substantial surrender charges. And as described above, the schedule of surrender charges and other fees may be higher on the variable annuity with the bonus credit than they were on the annuity that you exchanged.

**Example:** You currently hold a variable annuity with an account value of \$20,000, which is no longer subject to surrender charges. You exchange that annuity for a new variable annuity, which pays a 4% bonus credit and has a surrender charge period of eight years, with surrender charges beginning at 9% of purchase payments in the first year. Your account value in this new variable annuity is now \$20,800. During the first year you hold the new annuity, you decide to withdraw all of your account value because of an emergency situation. Assuming that your account value has not increased or decreased because of investment performance, you will receive \$20,800 minus 9% of your \$20,000 purchase payment, or \$19,000. This is \$1,000 less than you would have received if you had stayed in the original variable annuity, where you were no longer subject to surrender charges.

**In short:** Take a hard look at bonus credits. In some cases, the "bonus" may not be in your best interest.

### Ask Questions Before You Invest

Financial professionals who sell variable annuities have a duty to advise you as to whether the product they are trying to sell is suitable to your particular investment needs. Don't be afraid to ask them questions. And write down their answers, so there won't be any confusion later as to what was said.

Variable annuity contracts typically have a "free look" period of ten or more days, during which you can terminate the contract without paying any surrender charges and get back your purchase payments (which may be adjusted to reflect charges and the performance of your investment).

You can continue to ask questions in this period to make sure you understand your variable annuity before the "free look" period ends.

Before you decide to buy a variable annuity, consider the following questions:

- Will you use the variable annuity primarily to save for retirement or a similar long-term goal?
- Are you investing in the variable annuity through a retirement plan or IRA (which would mean that you are not receiving any additional tax-deferral benefit from the variable annuity)?
- Are you willing to take the risk that your account value may decrease if the underlying mutual fund investment options perform badly?
- Do you understand the features of the variable annuity?
- Do you understand all of the fees and expenses that the variable annuity charges?
- Do you intend to remain in the variable annuity long enough to avoid paying any surrender charges if you have to withdraw money?
- If a variable annuity offers a bonus credit, will the bonus outweigh any higher fees and charges that the product may charge?
- Are there features of the variable annuity, such as long-term care insurance, that you could purchase more cheaply separately?
- Have you consulted with a tax adviser and considered all the tax consequences of purchasing an annuity, including the effect of annuity payments on your tax status in retirement?
- If you are exchanging one annuity for another one, do the benefits of the exchange outweigh the costs, such as any surrender charges you will have to pay if you withdraw your money before the end of the surrender charge period for the new annuity?

**Remember:** Before purchasing a variable annuity, you owe it to yourself to learn as much as possible about how they work, the benefits they provide, and the charges you will pay.

## **US Treasury Investments Basics**

### **What are U.S. Treasury securities?**

U.S. Treasury securities are debt instruments. The [U.S. Treasury](#) issues securities to raise the money needed to operate the Federal Government and to pay off maturing obligations - its debt, in other words.

### **Why should I buy a Treasury security?**

Treasury securities are a safe and secure investment option because the full faith and credit of the United States government guarantees that interest and principal payments will be paid on time. Also, most Treasury securities are liquid, which means they can easily be sold for cash.

### **What types of securities do you sell to individual investors?**

We sell [Treasury bills, notes, bonds, TIPS](#), and [U.S. savings bonds](#) to individual investors.

### **What are Treasury bills?**

Treasury bills (or T-bills) are short-term securities that mature in one year or less from their issue date. You buy T-bills for a price less than their par (face) value, and when they mature we pay you their par value. Your interest is the difference between the purchase price of the security and what we pay you at maturity (or what you get if you sell the bill before it matures). For example, if you bought a \$10,000 26-week Treasury bill for \$9,750 and held it until maturity, your interest would be \$250.

## **What are Treasury notes, bonds, and TIPS?**

Treasury notes and bonds are securities that pay a fixed rate of interest every six months until your security matures, which is when we pay you their par value. The only difference between them is their length until maturity. Treasury notes mature in more than a year, but not more than 10 years from their issue date. Bonds, on the other hand, mature in more than 10 years from their issue date.

Treasury also sells Treasury inflation-protected securities (TIPS). They pay interest twice a year and the principal value of [TIPS](#) is adjusted to reflect inflation as measured by the [Consumer Price Index](#) -- the Bureau of Labor Statistics' Consumer Price Index for All Urban Consumers (CPI-U). With TIPS, we calculate your semiannual interest payments and maturity payment based on the inflation-adjusted principal value of your security.

## **What are U.S. savings bonds?**

[Savings bonds](#) are Treasury securities that are payable only to the person to whom they are registered. Savings bonds can earn interest for up to 30 years, but you can cash them after 6 months if purchased before February 1, 2003 or 12 months if purchased on or after February 1, 2003.

## **What types of savings bonds are available?**

You can buy two types of savings bonds for cash: the [Series EE bond](#) or the [Series I bond](#). For more information on these types of securities and how to purchase them, visit our [Savings Bonds website](#).

## **How do Treasury bills, notes, bonds, and TIPS differ from savings bonds?**

Unlike savings bonds, Treasury bills, notes, bonds and TIPS are transferable, so you can buy or sell them in the securities market. Also, bills, notes, bonds, and TIPS are electronic - they're not paper securities like savings bonds. You can buy Treasury bills, notes, bonds and TIPS for a minimum of \$1,000, and you can buy savings bonds for as little as \$25.

## **How can I buy a Treasury bill, note, bond, or TIPS?**

It's easy. Buy Treasury bills, notes, bonds, or TIPS either at one of the [auctions](#) we conduct or in the securities market. If you want to buy a Treasury security at auction, contact us, a Federal Reserve Bank, a financial institution, or a government securities broker or dealer. If you want to buy a Treasury security in the securities market, contact your financial institution, broker, or dealer for more information.

## **What is a Treasury auction?**

Each Treasury bill, note, bond or TIPS (except savings bonds, of course) is sold at a public auction. In Treasury's auctions, all successful bidders (we'll discuss bids in a little bit) are awarded securities at the same price, which is the price equal to the highest rate or yield of the competitive bids we accept. You can find a complete explanation of the auction process in our [Uniform Offering Circular](#), which is in the Code of Federal Regulations (CFR) at 31 CFR Part 356.

## **How can I find out when an auction will be held?**

Usually a couple days before each auction, we issue a press release announcing the security being sold, the amount we're selling, the auction date, and other pertinent information. This information is available [from us](#) and from your financial institution, broker, or dealer. Many newspapers also report Treasury auction schedules in their financial sections.

### **How can I participate in an auction?**

Simply submit a bid for the security you want to buy. You can bid either noncompetitively or a competitively, but not both in the same auction.

If you bid noncompetitively, you'll receive the full amount of the security you want at the return determined at that auction. Therefore, you don't have to specify the return you'd like to receive. You can't bid for more than \$5 million in a bill, note, bond or TIPS auction. Most individual investors bid noncompetitively.

If you bid competitively, on the other hand, you have to specify the return -- the rate for bills or the yield for notes, bonds and TIPS -- that you would like to receive. If the return you specify is too high, you might not receive any securities, or just a portion of what you bid for. However, you can bid competitively for much larger amounts than you can noncompetitively.

### **How do I submit my bid?**

Once we announce the auction of a security, you can submit a bid for an auction directly to us, to a Federal Reserve Bank, or through a financial institution, broker, or dealer. We accept bids by mail or, for current customers, over the Internet and by touch-tone phone. A financial institution, government securities broker, or dealer can also submit bids on your behalf. Although we don't charge fees to process a bid, some financial institutions, brokers, and dealers may charge for that service.

### **What is the minimum purchase amount for Treasury securities?**

The minimum amount that you can purchase of any given Treasury bill, note, bond, or TIPS is \$1,000. Additional amounts must be in multiples of \$1,000.

## **Do I have a choice as to where my Treasury securities are kept?**

All Treasury securities are issued in what we call "book-entry" form - an entry in a central electronic ledger. You can hold your Treasury securities in one of three systems: TreasuryDirect, Legacy Treasury Direct, or the commercial book-entry system. TreasuryDirect and Legacy Treasury Direct are direct holding systems where you have a direct relationship with us. The commercial book-entry system is an indirect holding system where you hold your securities with your financial institution, government securities broker, or dealer. The commercial book-entry system is a multi-level arrangement that involves the Treasury, the Federal Reserve System (acting as Treasury's agent), banks, brokers, dealers, and other financial institutions. So, in the commercial book-entry system, there can be one or more entities between you (the ultimate owner of the security) and Treasury.

## **What features does TreasuryDirect offer?**

TreasuryDirect provides a completely online environment for buying and holding Treasury bills, notes, bonds, and TIPS, as well as savings bonds.

You use our web site to open an account, conduct transactions, and access account information. All services are available 24 hours a day, seven days a week. You designate the financial account or accounts into which we make payments and from which we make withdrawals. We don't charge any fees when you open an account or buy securities.

## **What features does Legacy Treasury Direct offer?**

Legacy Treasury Direct allows you to conduct transactions online, over the phone, and by paper and mail. In this program, you can buy Treasury bills, notes, bonds, and TIPS, and hold those securities. You designate the financial account into which we make payments and from which we make withdrawals. We (Legacy) send account statements to you by mail.



We don't charge any fees when you open an account or buy securities. (We impose an annual maintenance fee, but ONLY IF your account has a total par amount of more than \$100,000.) You can reinvest most maturing securities. Although you have a direct relationship with us, your financial institution, government securities broker, or dealer can submit a bid for a security to be delivered to Legacy Treasury Direct for you.

### **What features does the commercial book-entry system offer?**

In the commercial book-entry system, you'll maintain your relationship with your financial institution, broker, or dealer and potentially pay fees for their services. The commercial book-entry system allows you to easily buy and sell securities as well as, unlike Legacy Treasury Direct, use them for collateral. You can also hold Treasury securities in stripped form, known as [STRIPS](#) or zero-coupon Treasuries, in the commercial book-entry system.

### **What are STRIPS or zero-coupon Treasuries?**

[STRIPS](#), also known as zero-coupon securities, are Treasury securities that don't make periodic interest payments. Market participants create STRIPS by separating the interest and principal parts of a Treasury note, bond, or TIPS. For example, a 10-year Treasury note consists of 20 interest payments -- one every six months for 10 years -- and a principal payment payable at maturity. When this security is "stripped," each of the 20 interest payments and the principal payment become separate securities and can be held and transferred separately. STRIPS can only be bought and sold through a financial institution, broker, or dealer and held in the commercial book-entry system.

### **How can I sell my Treasury security before maturity?**

If you hold your security in the commercial book-entry system, contact your financial institution, government securities dealer, broker, or investment advisor. Normally there is a fee for this service. If you hold your security in TreasuryDirect or Legacy Treasury Direct, you can transfer it to an account in the commercial book-entry system or let us sell your security through our Sell Direct program for a modest fee.

### **How do I receive my interest and principal payments in each system?**

In the TreasuryDirect and Legacy Treasury Direct, Treasury makes interest and principal payments directly to the financial account you choose. In the commercial book-entry system, Treasury's interest and principal payments may flow through several institutions on their way to you. For example, a payment could go from the Federal Reserve to a large bank to a smaller bank to your bank or broker before it gets to you.

### **What happens when my security matures?**

When your security matures, we pay you the principal and the final interest payment through TreasuryDirect, Legacy Treasury Direct, or the commercial book-entry system. Rather than take payment of the principal, customers of TreasuryDirect and Legacy Treasury Direct can choose to roll the principal into another security. In TreasuryDirect you do this by scheduling a repeat purchase. In Legacy Treasury Direct, you do it by scheduling a [reinvestment](#). Legacy Treasury Direct allows you to reinvest any securities except TIPS, and to schedule reinvestments by mail, phone, or over the Internet.

## **How can I get more information about Treasury securities?**

You can get information about Treasury securities on [our website](#) or your financial institution, broker, or dealer. If you're interested in Legacy Treasury Direct, ask for our Investor Kit (PD P 009).

## **Online Investing**

### ***What You Need to Know About Trading In Fast-Moving Markets***

The price of some stocks, especially recent "hot" IPOs and high tech stocks, can soar and drop suddenly. In these fast markets when many investors want to trade at the same time and prices change quickly, delays can develop across the board. Executions and confirmations slow down, while reports of prices lag behind actual prices. In these markets, investors can suffer unexpected losses very quickly.

Investors trading over the Internet or online, who are used to instant access to their accounts and near instantaneous executions of their trades, especially need to understand how they can protect themselves in fast-moving markets.

You can limit your losses in fast-moving markets if you

- know what you are buying and the risks of your investment; and
- know how trading changes during fast markets and take additional steps to guard against the typical problems investors face in these markets.

## **Online trading is quick and easy, online investing takes time**

With a click of mouse, you can buy and sell stocks from more than 100 online brokers offering executions as low as \$5 per transaction. Although online trading saves investors time and money, it does *not* take the homework out of making investment decisions. You may be able to make a trade in a nanosecond, but making wise investment decisions takes time. Before you trade, know why you are buying or selling, and the risk of your investment.

## **Set your price limits on fast-moving stocks: market orders vs. limit orders**

To avoid buying or selling a stock at a price higher or lower than you wanted, you need to place a *limit* order rather than a *market* order. A limit order is an order to buy or sell a security at a specific price. A buy limit order can only be executed at the limit price or lower, and a sell limit order can only be executed at the limit price or higher. When you place a market order, you can't control the price at which your order will be filled.

For example, if you want to buy the stock of a "hot" IPO that was initially offered at \$9, but don't want to end up paying more than \$20 for the stock, you can place a limit order to buy the stock at any price up to \$20. By entering a limit order rather than a market order, you will not be caught buying the stock at \$90 and then suffering immediate losses as the stock drops later in the day or the weeks ahead.

Remember that your limit order may never be executed because the market price may quickly surpass your limit before your order can be filled. But by using a limit order you also protect yourself from buying the stock at too high a price.

## **Online trading is not always instantaneous**

Investors may find that technological "choke points" can slow or prevent their orders from reaching an online firm. For example, problems can occur where:

- an investor's modem, computer, or Internet Service Provider is slow or faulty;
- a broker-dealer has inadequate hardware or its Internet Service Provider is slow or delayed; or
- traffic on the Internet is heavy, slowing down overall usage.

A capacity problem or limitation at any of these choke points can cause a delay or failure in an investor's attempt to access an online firm's automated trading system.

## **Know your options for placing a trade if you are unable to access your account online**

Most online trading firms offer alternatives for placing trades. These alternatives may include touch-tone telephone trades, faxing your order, or doing it the low-tech way--talking to a broker over the phone. Make sure you know whether using these different options may increase your costs. And remember, if you experience delays getting online, you may experience similar delays when you turn to one of these alternatives.

## **If you place an order, don't assume it didn't go through**

Some investors have mistakenly assumed that their orders have not been executed and place another order. They end up either owning twice as much stock as they could afford or wanted, or with sell orders, selling stock they do not own. Talk with your firm about how you should handle a situation where you are unsure if your original order was executed.

**If you cancel an order, make sure the cancellation worked before placing another trade**

When you cancel an online trade, it is important to make sure that your original transaction was not executed. Although you may receive an electronic receipt for the cancellation, don't assume that that means the trade was canceled. Orders can only be canceled if they have not been executed. Ask your firm about how you should check to see if a cancellation order actually worked.

**If you purchase a security in a cash account, you must pay for it before you can sell it**

In a cash account, you must pay for the purchase of a stock before you sell it. If you buy and sell a stock before paying for it, you are *freeriding*, which violates the credit extension provisions of the Federal Reserve Board. If you *freeride*, your broker must "freeze" your account for 90 days. You can still trade during the freeze, but you must fully pay for any purchase on the date you trade while the freeze is in effect.

You can avoid the freeze if you fully pay for the stock within five days from the date of the purchase with funds that do not come from the sale of the stock. You can always ask your broker for an extension or waiver, but you may not get it.

**If you trade on margin, your broker can sell your securities without giving you a margin call**

Now is the time to reread your margin agreement and pay attention to the fine print. If your account has fallen below the firm's maintenance margin requirement, your broker has the legal right to sell your securities at any time without consulting you first.

Some investors have been rudely surprised that "margin calls" are a courtesy, not a requirement. Brokers are not required to make margin calls to their customers.

Even when your broker offers you time to put more cash or securities into your account to meet a margin call, the broker can act without waiting for you to meet the call. In a rapidly declining market your broker can sell your entire margin account at a substantial loss to you, because the securities in the account have declined in value.

### **No regulations require a trade to be executed within a certain time**

There are no Securities and Exchange Commission regulations that require a trade to be executed within a set period of time. But if firms advertise their speed of execution, they must not exaggerate or fail to tell investors about the possibility of significant delays.

### **More Information**

For more information on online trading problems, read former SEC Chairman Arthur Levitt's [message to investors](#), and the National Association of Securities Dealers' [Notice to Members 99-11](#), dealing with online trading.

Are you gambling? Or Investing? [The Connecticut Council on Problem Gambling](#) has a quiz on their website that you can take to help you decide if you have a problem, and suggests where you can go for help.

### **What To Do If You Have a Complaint**

Act promptly. By law, you only have a limited time to take legal action. Follow these steps to solve your problem:

1. Talk to your broker or online firm and ask for an explanation. Take notes of the answers you receive.

2. If you are dissatisfied with the response and believe that you have been treated unfairly, ask to talk with the broker's branch manager. In the case of an online firm, go directly to step number three.

3. If you are still dissatisfied, write to the compliance department at the firm's main office. Explain your problem clearly, and tell the firm how you want it resolved. Ask the compliance office to respond to you in writing within 30 days.

## **Stocks and Financial Research**

### **Getting Info About Companies**

This page tells you how to get information about companies from a variety of sources. We'll cover corporate reports, reference books, and commercial databases that provide information. If you have questions about corporate [bankruptcy](#) or the worth of an [old stock certificate](#), we have information that may help you.

### **Corporate Reports**

Corporate reports are a treasure trove of information for investors: they tell you whether a company is making money or losing money and why. You'll find this information in the company's quarterly reports on Form 10-Q, annual reports (with audited financial statements) on Form 10-K, and periodic reports of significant events on Form 8-K.

It's usually easy to find information about large companies from the companies themselves, newspapers, brokerage firms, and the SEC. By contrast, it can be extremely difficult to find information about small companies. Generally, smaller companies only have to file reports with the SEC if they have \$10 million or more in assets and 500 or more shareholders, or list their securities on an exchange or Nasdaq.



To invest wisely and avoid investment scams, research each investment opportunity thoroughly and [ask questions](#). If you'd like to learn more about the SEC's registration and reporting requirements, read [Q&A: Small Business and the SEC](#).

You can get corporate reports from the following sources:

- **The SEC** You can find out whether a company files reports by using the SEC's database known as [EDGAR](#). For companies that do not file on EDGAR, you can contact the SEC at:

Office of Public Reference  
450 5th Street, NW, Room 1300  
Washington, D.C. 20549-0102  
phone: (202) 551-8090  
fax: (202) 628-9001  
e-mail: [publicinfo@sec.gov](mailto:publicinfo@sec.gov)

- **The company** Ask the company if it is registered with the SEC and files reports with us. That information may be listed on its Web site.
- **Other government regulators** Banks do not have to file reports with the SEC, but file with banking regulators. Visit the Web sites at the [Federal Reserve System's National Information Center of Banking Information](#), the [Office of the Comptroller of the Currency](#), or the [Federal Deposit Insurance Corporation](#).

### Other Types of Information

To find out whether a company has been cleared to sell its securities in a particular state and whether it is in good standing, you can contact the following:

- **Your state securities regulator** Contact the [North American Securities Administrators Association](#) to get the name and phone number of your state securities regulator to see if the company has been cleared to sell securities in your state.

- **The Secretary of State where the company is incorporated** You can find out whether the company is a corporation in good standing and has filed annual reports with the state through the secretary of state where the company is incorporated. [Click here](#) to connect to The National Association of Secretaries of State's Web site for a list of most secretaries of state.

You can find general financial information about companies from reference books and commercial databases. The SEC cannot recommend or endorse any particular research firm, its personnel, or its products. But there are a number of resources you may consult:

- **Bloomberg News Service** and **Lexis/Nexis** provide news stories about a company. **Dun & Bradstreet**, **Moody's**, **Hoover's Profiles**, and **Standard & Poor's Corporate Profiles** provide financial data about companies. These and other sources are available in many libraries or law and business school libraries.

## **Mutual Funds**

Over the past decade, American investors increasingly have turned to mutual funds to save for retirement and other financial goals. Mutual funds can offer the advantages of diversification and professional management. But, as with other investment choices, investing in mutual funds involves risk. And fees and taxes will diminish a fund's returns. It pays to understand both the upsides and the downsides of mutual fund investing and how to choose products that match your goals and tolerance for risk.

This brochure explains the basics of mutual fund investing — how mutual funds work, what factors to consider before investing, and how to avoid common pitfalls.

## Key Points to Remember

- Mutual funds are **not** guaranteed or insured by the FDIC or any other government agency — even if you buy through a bank and the fund carries the bank's name. You can lose money investing in mutual funds.
- Past performance is not a reliable indicator of future performance. So don't be dazzled by last year's high returns. But past performance can help you assess a fund's volatility over time.
- All mutual funds have costs that lower your investment returns. Shop around, and use a mutual fund cost calculator at [www.sec.gov/investor/tools.shtml](http://www.sec.gov/investor/tools.shtml) to compare many of the costs of owning different funds *before* you buy.

## How Mutual Funds Work

### What They Are

A mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. The combined holdings the mutual fund owns are known as its portfolio. Each share represents an investor's proportionate ownership of the fund's holdings and the income those holdings generate.

### Other Types of Investment Companies

Legally known as an "open-end company," a mutual fund is one of three basic types of investment companies. While this brochure discusses **only** mutual funds, you should be aware that other pooled investment vehicles exist and may offer features that you desire. The two other basic types of investment companies are:

**Closed-end funds** — which, unlike mutual funds, sell a fixed number of shares at one time (in an initial public offering) that later trade on a secondary market; and

**Unit Investment Trusts (UITs)** — which make a one-time public offering of only a specific, fixed number of redeemable securities called "units" and which will terminate and dissolve on a date specified at the creation of the UIT.

"Exchange-traded funds" (ETFs) are a type of investment company that aims to achieve the same return as a particular market index. They can be either open-end companies or UITs. But ETFs are not considered to be, and are not permitted to call themselves, mutual funds.

Some of the traditional, distinguishing characteristics of mutual funds include the following:

- ▶ Investors purchase mutual fund shares from the fund itself (or through a broker for the fund) instead of from other investors on a secondary market, such as the New York Stock Exchange or Nasdaq Stock Market.
- ▶ The price that investors pay for mutual fund shares is the fund's per share net asset value (NAV) plus any shareholder fees that the fund imposes at the time of purchase (such as sales loads).
- ▶ Mutual fund shares are "redeemable," meaning investors can sell their shares back to the fund (or to a broker acting for the fund).

- ▶ Mutual funds generally create and sell new shares to accommodate new investors. In other words, they sell their shares on a continuous basis, although some funds stop selling when, for example, they become too large.
- ▶ The investment portfolios of mutual funds typically are managed by separate entities known as "investment advisers" that are registered with the SEC.

### **A Word About Hedge Funds and "Funds of Hedge Funds"**

"Hedge fund" is a general, non-legal term used to describe private, unregistered investment pools that traditionally have been limited to sophisticated, wealthy investors. Hedge funds are *not* mutual funds and, as such, are *not* subject to the numerous regulations that apply to mutual funds for the protection of investors — including regulations requiring a certain degree of liquidity, regulations requiring that mutual fund shares be redeemable at any time, regulations protecting against conflicts of interest, regulations to assure fairness in the pricing of fund shares, disclosure regulations, regulations limiting the use of leverage, and more.

"Funds of hedge funds," a relatively new type of investment product, are investment companies that invest in hedge funds. Some, but not all, register with the SEC and file semi-annual reports. They often have lower minimum investment thresholds than traditional, unregistered hedge funds and can sell their shares to a larger number of investors. Like hedge funds, funds of hedge funds are not mutual funds. Unlike open-end mutual funds, funds of hedge funds offer very limited rights of redemption. And, unlike ETFs, their shares are not typically listed on an exchange.

You'll find more information about [hedge funds](#) on the SEC website. To learn more about funds of hedge funds, please read NASD's Investor Alert entitled [Funds of Hedge Funds: Higher Costs and Risks for Higher Potential Returns](#).

## Advantages and Disadvantages

Every investment has advantages and disadvantages. But it's important to remember that features that matter to one investor may not be important to you. Whether any particular feature is an advantage for you will depend on your unique circumstances. For some investors, mutual funds provide an attractive investment choice because they generally offer the following features:

- **Professional Management** — Professional money managers research, select, and monitor the performance of the securities the fund purchases.
- **Diversification** — Diversification is an investing strategy that can be neatly summed up as "Don't put all your eggs in one basket." Spreading your investments across a wide range of companies and industry sectors can help lower your risk if a company or sector fails. Some investors find it easier to achieve diversification through ownership of mutual funds rather than through ownership of individual stocks or bonds.
- **Affordability** — Some mutual funds accommodate investors who don't have a lot of money to invest by setting relatively low dollar amounts for initial purchases, subsequent monthly purchases, or both.
- **Liquidity** — Mutual fund investors can readily redeem their shares at the current NAV — plus any fees and charges assessed on redemption — at any time.

But mutual funds also have features that some investors might view as disadvantages, such as:

- **Costs Despite Negative Returns** — Investors must pay sales charges, annual fees, and other expenses (which we'll discuss below) regardless of how the fund performs. And, depending on the timing of their investment, investors may also have to pay taxes on any capital gains distribution they receive — even if the fund went on to perform poorly after they bought shares.
- **Lack of Control** — Investors typically cannot ascertain the exact make-up of a fund's portfolio at any given time, nor can they directly influence which securities the fund manager buys and sells or the timing of those trades.
- **Price Uncertainty** — With an individual stock, you can obtain real-time (or close to real-time) pricing information with relative ease by checking financial websites or by calling your broker. You can also monitor how a stock's price changes from hour to hour — or even second to second. By contrast, with a mutual fund, the price at which you purchase or redeem shares will typically depend on the fund's NAV, which the fund might not calculate until many hours after you've placed your order. In general, mutual funds must calculate their NAV at least once every business day, typically after the major U.S. exchanges close.

## Different Types of Funds

When it comes to investing in mutual funds, investors have literally thousands of choices. Before you invest in any given fund, decide whether the investment strategy and risks of the fund are a good fit for you. The first step to successful investing is figuring out your financial goals and risk tolerance — either on your own or with the help of a financial professional. Once you know what you're saving for, when you'll need the money, and how much risk you can tolerate, you can more easily narrow your choices.

Most mutual funds fall into one of three main categories — money market funds, bond funds (also called "fixed income" funds), and stock funds (also called "equity" funds). Each type has different features and different risks and rewards. Generally, the higher the potential return, the higher the risk of loss.

### **Money Market Funds**

Money market funds have relatively low risks, compared to other mutual funds (and most other investments). By law, they can invest in only certain high-quality, short-term investments issued by the U.S. government, U.S. corporations, and state and local governments. Money market funds try to keep their net asset value (NAV) — which represents the value of one share in a fund — at a stable \$1.00 per share. But the NAV may fall below \$1.00 if the fund's investments perform poorly. Investor losses have been rare, but they are possible.

Money market funds pay dividends that generally reflect short-term interest rates, and historically the returns for money market funds have been lower than for either bond or stock funds. That's why "inflation risk" — the risk that inflation will outpace and erode investment returns over time — can be a potential concern for investors in money market funds.

### **Bond Funds**

Bond funds generally have higher risks than money market funds, largely because they typically pursue strategies aimed at producing higher yields. Unlike money market funds, the SEC's rules do not restrict bond funds to high-quality or short-term investments. Because there are many different types of bonds, bond funds can vary dramatically in their risks and rewards. Some of the risks associated with bond funds include:



**Credit Risk** — the possibility that companies or other issuers whose bonds are owned by the fund may fail to pay their debts (including the debt owed to holders of their bonds). Credit risk is less of a factor for bond funds that invest in insured bonds or U.S. Treasury bonds. By contrast, those that invest in the bonds of companies with poor credit ratings generally will be subject to higher risk.

**Interest Rate Risk** — the risk that the market value of the bonds will go down when interest rates go up. Because of this, you can lose money in any bond fund, including those that invest only in insured bonds or Treasury bonds. Funds that invest in longer-term bonds tend to have higher interest rate risk.

**Prepayment Risk** — the chance that a bond will be paid off early. For example, if interest rates fall, a bond issuer may decide to pay off (or "retire") its debt and issue new bonds that pay a lower rate. When this happens, the fund may not be able to reinvest the proceeds in an investment with as high a return or yield.

## **Stock Funds**

Although a stock fund's value can rise and fall quickly (and dramatically) over the short term, historically stocks have performed better over the long term than other types of investments — including corporate bonds, government bonds, and treasury securities.

Overall "market risk" poses the greatest potential danger for investors in stocks funds. Stock prices can fluctuate for a broad range of reasons — such as the overall strength of the economy or demand for particular products or services.

Not all stock funds are the same. For example:

- *Growth* funds focus on stocks that may not pay a regular dividend but have the potential for large capital gains.
- *Income* funds invest in stocks that pay regular dividends.
- *Index* funds aim to achieve the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, by investing in all — or perhaps a representative sample — of the companies included in an index.
- *Sector* funds may specialize in a particular industry segment, such as technology or consumer products stocks.

### How to Buy and Sell Shares

You can purchase shares in some mutual funds by contacting the fund directly. Other mutual fund shares are sold mainly through brokers, banks, financial planners, or insurance agents. All mutual funds will redeem (buy back) your shares on any business day and must send you the payment within seven days.

The easiest way to determine the value of your shares is to call the fund's toll-free number or visit its website. The financial pages of major newspapers sometimes print the NAVs for various mutual funds. When you buy shares, you pay the current NAV per share plus any fee the fund assesses at the time of purchase, such as a purchase sales load or other type of purchase fee. When you sell your shares, the fund will pay you the NAV minus any fee the fund assesses at the time of redemption, such as a deferred (or back-end) sales load or redemption fee. A fund's NAV goes up or down daily as its holdings change in value.

## Exchanging Shares

A "family of funds" is a group of mutual funds that share administrative and distribution systems. Each fund in a family may have different investment objectives and follow different strategies.

Some funds offer exchange privileges within a family of funds, allowing shareholders to transfer their holdings from one fund to another as their investment goals or tolerance for risk change. While some funds impose fees for exchanges, most funds typically do not. To learn more about a fund's exchange policies, call the fund's toll-free number, visit its website, or read the "shareholder information" section of the prospectus.

Bear in mind that exchanges have tax consequences. Even if the fund doesn't charge you for the transfer, you'll be liable for any capital gain on the sale of your old shares — or, depending on the circumstances, eligible to take a capital loss. We'll discuss taxes in further detail below.

## How Funds Can Earn Money for You

You can earn money from your investment in three ways:

1. **Dividend Payments** — A fund may earn income in the form of dividends and interest on the securities in its portfolio. The fund then pays its shareholders nearly all of the income (minus disclosed expenses) it has earned in the form of dividends.
2. **Capital Gains Distributions** — The price of the securities a fund owns may increase. When a fund sells a security that has increased in price, the fund has a capital gain. At the end of the year, most funds distribute these capital gains (minus any capital losses) to investors.

- 3. Increased NAV** — If the market value of a fund's portfolio increases after deduction of expenses and liabilities, then the value (NAV) of the fund and its shares increases. The higher NAV reflects the higher value of your investment.

With respect to dividend payments and capital gains distributions, funds usually will give you a choice: the fund can send you a check or other form of payment, or you can have your dividends or distributions *reinvested* in the fund to buy more shares (often without paying an additional sales load).

[Top](#)

## **Factors to Consider**

Thinking about your long-term investment strategies and tolerance for risk can help you decide what type of fund is best suited for you. But you should also consider the effect that fees and taxes will have on your returns over time.

## **Degrees of Risk**

All funds carry some level of risk. You may lose some or all of the money you invest — your principal — because the securities held by a fund go up and down in value. Dividend or interest payments may also fluctuate as market conditions change.

Before you invest, be sure to read a fund's prospectus and shareholder reports to learn about its investment strategy and the potential risks. Funds with higher rates of return may take risks that are beyond your comfort level and are inconsistent with your financial goals.

### **A Word About Derivatives**

Derivatives are financial instruments whose performance is derived, at least in part, from the performance of an underlying asset, security, or index. Even small market movements can dramatically affect their value, sometimes in unpredictable ways.

There are many types of derivatives with many different uses. A fund's prospectus will disclose whether and how it may use derivatives. You may also want to call a fund and ask how it uses these instruments.

### **Fees and Expenses**

As with any business, running a mutual fund involves costs — including shareholder transaction costs, investment advisory fees, and marketing and distribution expenses. Funds pass along these costs to investors by imposing fees and expenses. It is important that you understand these charges because they lower your returns.

Some funds impose "shareholder fees" directly on investors whenever they buy or sell shares. In addition, every fund has regular, recurring, fund-wide "operating expenses." Funds typically pay their operating expenses out of fund assets — which means that investors indirectly pay these costs.

SEC rules require funds to disclose both shareholder fees and operating expenses in a "fee table" near the front of a fund's prospectus. The lists below will help you decode the fee table and understand the various fees a fund may impose:

## Shareholder Fees

- **Sales Charge (Load) on Purchases** — the amount you pay when you buy shares in a mutual fund. Also known as a "front-end load," this fee typically goes to the brokers that sell the fund's shares. Front-end loads reduce the amount of your investment. For example, let's say you have \$1,000 and want to invest it in a mutual fund with a 5% front-end load. The \$50 sales load you must pay comes off the top, and the remaining \$950 will be invested in the fund. According to NASD rules, a front-end load cannot be higher than 8.5% of your investment.
- **Purchase Fee** — another type of fee that some funds charge their shareholders when they buy shares. Unlike a front-end sales load, a purchase fee is paid to the fund (not to a broker) and is typically imposed to defray some of the fund's costs associated with the purchase.
- **Deferred Sales Charge (Load)** — a fee you pay when you sell your shares. Also known as a "back-end load," this fee typically goes to the brokers that sell the fund's shares. The most common type of back-end sales load is the "contingent deferred sales load" (also known as a "CDSC" or "CDSL"). The amount of this type of load will depend on how long the investor holds his or her shares and typically decreases to zero if the investor holds his or her shares long enough.
- **Redemption Fee** — another type of fee that some funds charge their shareholders when they sell or redeem shares. Unlike a deferred sales load, a redemption fee is paid to the fund (not to a broker) and is typically used to defray fund costs associated with a shareholder's redemption.

- **Exchange Fee** — a fee that some funds impose on shareholders if they exchange (transfer) to another fund within the same fund group or "family of funds."
- **Account fee** — a fee that some funds separately impose on investors in connection with the maintenance of their accounts. For example, some funds impose an account maintenance fee on accounts whose value is less than a certain dollar amount.

### **Annual Fund Operating Expenses**

- **Management Fees** — fees that are paid out of fund assets to the fund's investment adviser for investment portfolio management, any other management fees payable to the fund's investment adviser or its affiliates, and administrative fees payable to the investment adviser that are not included in the "Other Expenses" category (discussed below).
- **Distribution [and/or Service] Fees ("12b-1" Fees)** — fees paid by the fund out of fund assets to cover the costs of marketing and selling fund shares and sometimes to cover the costs of providing shareholder services. "Distribution fees" include fees to compensate brokers and others who sell fund shares and to pay for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature. "Shareholder Service Fees" are fees paid to persons to respond to investor inquiries and provide investors with information about their investments.
- **Other Expenses** — expenses not included under "Management Fees" or "Distribution or Service (12b-1) Fees," such as any shareholder service expenses that are not already included in the 12b-1 fees, custodial expenses, legal and accounting expenses, transfer agent expenses, and other administrative expenses.

- **Total Annual Fund Operating Expenses ("Expense Ratio")** — the line of the fee table that represents the total of all of a fund's annual fund operating expenses, expressed as a percentage of the fund's average net assets. Looking at the expense ratio can help you make comparisons among funds.

#### **A Word About "No-Load" Funds**

Some funds call themselves "no-load." As the name implies, this means that the fund does not charge any type of sales load. But, as discussed above, not every type of shareholder fee is a "sales load." A no-load fund may charge fees that are not sales loads, such as purchase fees, redemption fees, exchange fees, and account fees. No-load funds will also have operating expenses.

Be sure to review carefully the fee tables of any funds you're considering, including no-load funds. Even small differences in fees can translate into large differences in returns over time. For example, if you invested \$10,000 in a fund that produced a 10% annual return before expenses and had annual operating expenses of 1.5%, then after 20 years you would have roughly \$49,725. But if the fund had expenses of only 0.5%, then you would end up with \$60,858 — an 18% difference.

A [mutual fund cost calculator](#) can help you understand the impact that many types of fees and expenses can have over time. It takes only minutes to compare the costs of different mutual funds.

#### **A Word About Breakpoints**

Some mutual funds that charge front-end [sales loads](#) will charge lower sales loads for larger investments. The investment levels required to obtain a reduced sales load are commonly referred to as "breakpoints."



The SEC does not require a fund to offer breakpoints in the fund's sales load. But, if breakpoints exist, the fund must disclose them. In addition, a NASD member brokerage firm should not sell you shares of a fund in an amount that is "just below" the fund's sales load breakpoint simply to earn a higher commission. Each fund company establishes its own formula for how they will calculate whether an investor is entitled to receive a breakpoint. For that reason, it is important to seek out breakpoint information from your financial advisor or the fund itself. You'll need to ask how a particular fund establishes eligibility for breakpoint discounts, as well as what the fund's breakpoint amounts are.

## Classes of Funds

Many mutual funds offer more than one class of shares. For example, you may have seen a fund that offers "Class A" and "Class B" shares. Each class will invest in the same "pool" (or investment portfolio) of securities and will have the same investment objectives and policies. But each class will have different shareholder services and/or distribution arrangements with different fees and expenses. As a result, each class will likely have different performance results. A multi-class structure offers investors the ability to select a fee and expense structure that is most appropriate for their investment goals (including the time that they expect to remain invested in the fund). Here are some key characteristics of the most common mutual fund share classes offered to individual investors:

- **Class A Shares** — Class A shares typically impose a front-end sales load. They also tend to have a lower 12b-1 fee and lower annual expenses than other mutual fund share classes. Be aware that some mutual funds reduce the front-end load as the size of your investment increases. If you're considering Class A shares, be sure to inquire about breakpoints.

- **Class B Shares** — Class B shares typically do not have a front-end sales load. Instead, they may impose a contingent deferred sales load and a 12b-1 fee (along with other annual expenses). Class B shares also might convert automatically to a class with a lower 12b-1 fee if the investor holds the shares long enough.
- **Class C Shares** — Class C shares might have a 12b-1 fee, other annual expenses, and either a front- or back-end sales load. But the front- or back-end load for Class C shares tends to be lower than for Class A or Class B shares, respectively. Unlike Class B shares, Class C shares generally do not convert to another class. Class C shares tend to have higher annual expenses than either Class A or Class B shares.

## Tax Consequences

When you buy and hold an individual stock or bond, you must pay **income tax** each year on the dividends or interest you receive. But you won't have to pay any **capital gains tax** until you actually sell and unless you make a profit.

**Mutual funds are different.** When you buy and hold mutual fund shares, you will owe income tax on any ordinary dividends in the year you receive or reinvest them. And, in addition to owing taxes on any *personal capital gains* when you sell your shares, you may also have to pay taxes each year on *the fund's capital gains*. That's because the law requires mutual funds to distribute capital gains to shareholders if they sell securities for a profit that can't be offset by a loss.

**Tax Exempt Funds** If you invest in a tax-exempt fund — such as a municipal bond fund — some or all of your dividends will be exempt from federal (and sometimes state and local) income tax. You will, however, owe taxes on any capital gains.

Bear in mind that if you receive a capital gains distribution, you will likely owe taxes — even if the fund has had a negative return from the point during the year when you purchased your shares. For this reason, you should call the fund to find out when it makes distributions so you won't pay more than your fair share of taxes. Some funds post that information on their websites. SEC rules require mutual funds to disclose in their prospectuses after-tax returns. In calculating after-tax returns, mutual funds must use standardized formulas similar to the ones used to calculate before-tax average annual total returns. You'll find a fund's after-tax returns in the "Risk/Return Summary" section of the prospectus. When comparing funds, be sure to take taxes into account.

### **Avoiding Common Pitfalls**

If you decide to invest in mutual funds, be sure to obtain as much information about the fund *before* you invest. And don't make assumptions about the soundness of the fund based solely on its past performance or its name.

### **Sources of Information - Prospectus**

When you purchase shares of a mutual fund, the fund *must* provide you with a prospectus. But you can — and should — request and read a fund's prospectus *before* you invest. The prospectus is the fund's selling document and contains valuable information, such as the fund's investment objectives or goals, principal strategies for achieving those goals, principal risks of investing in the fund, fees and expenses, and past performance. The prospectus also identifies the fund's managers and advisers and describes how to purchase and redeem fund shares.

While they may seem daunting at first, mutual fund prospectuses contain a treasure trove of valuable information. The SEC requires funds to include specific categories of information in their prospectuses and to present key data (such as fees and past performance) in a standard format so that investors can more easily compare different funds.

Here's some of what you'll find in mutual fund prospectuses:

- **Date of Issue** — The date of the prospectus should appear on the front cover. Mutual funds must update their prospectuses at least once a year, so always check to make sure you're looking at the most recent version.
- **Risk/Return Bar Chart and Table** — Near the front of the prospectus, right after the fund's narrative description of its investment objectives or goals, strategies, and risks, you'll find a **bar chart** showing the fund's annual total returns for each of the last 10 years (or for the life of the fund if it is less than 10 years old). All funds that have had annual returns for at least one calendar year must include this chart.

Except in limited circumstances, funds also must include a **table** that sets forth returns — both before and after taxes — for the past 1-, 5-, and 10-year periods. The table will also include the returns of an appropriate broad-based index for comparison purposes. Here's what the table will look like:

|   | <u>1-<br/>year</u> | <u>5-year (or<br/>life of fund)</u> | <u>10-year (or<br/>life of fund)</u> |
|---|--------------------|-------------------------------------|--------------------------------------|
| <b>Return before taxes</b>  | ___%               | ___%                                | ___%                                 |
| <b>Return after taxes on distributions</b>                                      | ___%               | ___%                                | ___%                                 |
| <b>Return after taxes on distributions and sale of fund shares</b>              | ___%               | ___%                                | ___%                                 |
| <hr/>   |                    |                                     |                                      |
| <b><i>Index</i><br/>(reflects no deductions for [fees, expenses, or taxes])</b> | ___%               | ___%                                | ___%                                 |

- Note: Be sure to read any footnotes or accompanying explanations to make sure that you fully understand the data the fund provides in the bar chart and table. Also, bear in mind that the bar chart and table for a multiple-class fund (that offers more than one class of fund shares in the prospectus) will typically show performance data and returns for *only one* class.
- **Fee Table** — Following the performance bar chart and annual returns table, you'll find a table that describes the fund's fees and expenses. These include the shareholder fees and annual fund operating expenses described in greater detail above. The fee table includes an example that will help you compare costs among different funds by showing you the costs associated with investing a hypothetical \$10,000 over a 1-, 3-, 5-, and 10-year period.
- **Financial Highlights** — This section, which generally appears towards the back of the prospectus, contains audited data concerning the fund's financial performance for each of the past 5 years. Here you'll find net asset values (for both the beginning and end of each period), total returns, and various ratios, including the ratio of expenses to average net assets, the ratio of net income to average net assets, and the portfolio turnover rate.

## Profile

Some mutual funds also furnish investors with a "profile," which summarizes key information contained in the fund's prospectus, such as the fund's investment objectives, principal investment strategies, principal risks, performance, fees and expenses, after-tax returns, identity of the fund's investment adviser, investment requirements, and other information.

## **Statement of Additional Information ("SAI")**

Also known as "Part B" of the registration statement, the SAI explains a fund's operations in greater detail than the prospectus — including the fund's financial statements and details about the history of the fund, fund policies on borrowing and concentration, the identity of officers, directors, and persons who control the fund, investment advisory and other services, brokerage commissions, tax matters, and performance such as yield and average annual total return information. If you ask, the fund must send you an SAI. The back cover of the fund's prospectus should contain information on how to obtain the SAI.

## **Shareholder Reports**

A mutual fund also must provide shareholders with annual and semi-annual reports within 60 days after the end of the fund's fiscal year and 60 days after the fund's fiscal mid-year. These reports contain a variety of updated financial information, a list of the fund's portfolio securities, and other information. The information in the shareholder reports will be current as of the date of the particular report (that is, the last day of the fund's fiscal year for the annual report, and the last day of the fund's fiscal mid-year for the semi-annual report).

Investors can obtain all of these documents by:

- Calling or writing to the fund (all mutual funds have toll-free telephone numbers);
- Visiting the fund's website;
- Contacting a broker that sells the fund's shares;
- Searching the SEC's [EDGAR database](#) and downloading the documents for free; or
- Contacting the SEC's Office of Public Reference by telephone at (202) 551-8090, by fax at (202) 942-9001 (fax), or by email at [publicinfo@sec.gov](mailto:publicinfo@sec.gov). Please be aware that we charge \$0.24 per page for photocopying.

## Past Performance

A fund's past performance is not as important as you might think. Advertisements, rankings, and ratings often emphasize how well a fund has performed in the past. But studies show that the future is often different. This year's "number one" fund can easily become next year's below average fund.

Be sure to find out how long the fund has been in existence. Newly created or small funds sometimes have excellent short-term performance records. Because these funds may invest in only a small number of stocks, a few successful stocks can have a large impact on their performance. But as these funds grow larger and increase the number of stocks they own, each stock has less impact on performance. This may make it more difficult to sustain initial results.

While past performance does not necessarily predict future returns, it *can* tell you how volatile (or stable) a fund has been over a period of time. Generally, the more volatile a fund, the higher the investment risk. If you'll need your money to meet a financial goal in the near-term, you probably can't afford the risk of investing in a fund with a volatile history because you will not have enough time to ride out any declines in the stock market.

### Looking Beyond a Fund's Name

Don't assume that a fund called the "XYZ Stock Fund" invests **only** in stocks or that the "Martian High-Yield Fund" invests **only** in the securities of companies headquartered on the planet Mars. The SEC requires that any mutual fund with a name suggesting that it focuses on a particular type of investment must invest at least 80% of its assets in the type of investment suggested by its name. But funds can still invest up to one-fifth of their holdings in other types of securities — including securities that you might consider too risky or perhaps not aggressive enough.

### Bank Products versus Mutual Funds

Many banks now sell mutual funds, some of which carry the bank's name. But mutual funds sold in banks, including money market funds, are *not* bank deposits. As a result, they are *not* federally insured by the Federal Deposit Insurance Corporation (FDIC).



### **Money Market Matters**

Don't confuse a "money market fund" with a "money market deposit account." The names are similar, but they are completely different:

- A money market fund is a type of mutual fund. It *is not* guaranteed or FDIC insured. When you buy shares in a money market fund, you should receive a prospectus.
- A money market deposit account is a bank deposit. It *is* guaranteed and FDIC insured. When you deposit money in a money market deposit account, you should receive a Truth in Savings form.

### **If You Have Problems**

If you encounter a problem with your mutual fund, you can send us your complaint using our [online complaint form](#). You can also reach us by regular mail at:

Securities and Exchange Commission  
Office of Investor Education and Assistance  
100 F Street, N.E.  
Washington, D.C. 20549-0213

For more information about investing wisely and avoiding fraud, please check out the [Investor Information](#) section of our website.

### **Glossary of Key Mutual Fund Terms**

**12b-1 Fees** — fees paid by the fund out of fund assets to cover the costs of marketing and selling fund shares and sometimes to cover the costs of providing shareholder services. "Distribution fees" include fees to compensate brokers and others who sell fund shares and to pay for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature.

"Shareholder Service Fees" are fees paid to persons to respond to investor inquiries and provide investors with information about their investments.

**Account Fee** — a fee that some funds separately impose on investors for the maintenance of their accounts. For example, accounts below a specified dollar amount may have to pay an account fee.

**Back-end Load** — a sales charge (also known as a "deferred sales charge") investors pay when they redeem (or sell) mutual fund shares, generally used by the fund to compensate brokers.

**Classes** — different types of shares issued by a single fund, often referred to as *Class A* shares, *Class B* shares, and so on. Each class invests in the same "pool" (or investment portfolio) of securities and has the same investment objectives and policies. But each class has different shareholder services and/or distribution arrangements with different fees and expenses and therefore different performance results.

**Closed-End Fund** — a type of investment company that does not continuously offer its shares for sale but instead sells a fixed number of shares at one time (in the initial public offering) which then typically trade on a secondary market, such as the New York Stock Exchange or the Nasdaq Stock Market. Legally known as a "closed-end company."

**Contingent Deferred Sales Load** — a type of back-end load, the amount of which depends on the length of time the investor held his or her shares. For example, a contingent deferred sales load might be (X)% if an investor holds his or her shares for one year, (X-1)% after two years, and so on until the load reaches zero and goes away completely.

**Conversion** — a feature some funds offer that allows investors to automatically change from one class to another (typically with lower annual expenses) after a set period of time. The fund's prospectus or profile will state whether a class ever converts to another class.

**Distribution Fees** — fees paid out of fund assets to cover expenses for marketing and selling fund shares, including advertising costs, compensation for brokers and others who sell fund shares, and payments for printing and mailing prospectuses to new investors and sales literature prospective investors. Sometimes referred to as "12b-1 fees."

**Exchange Fee** — a fee that some funds impose on shareholders if they exchange (transfer) to another fund within the same fund group.

**Exchange-Traded Funds** — a type of an investment company (either an open-end company or UIT) whose objective is to achieve the same return as a particular market index. ETFs differ from traditional open-end companies and UITs, because, pursuant to SEC exemptive orders, shares issued by ETFs trade on a secondary market and are only redeemable from the fund itself in very large blocks (blocks of 50,000 shares for example).

**Expense Ratio** — the fund's total annual operating expenses (including management fees, distribution (12b-1) fees, and other expenses) expressed as a percentage of average net assets.

**Front-end Load** — an upfront sales charge investors pay when they purchase fund shares, generally used by the fund to compensate brokers. A front-end load reduces the amount available to purchase fund shares.

**Index Fund** — describes a type of mutual fund or Unit Investment Trust (UIT) whose investment objective typically is to achieve the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, the Russell 2000 Index, or the Wilshire 5000 Total Market Index.

**Investment Adviser** — generally, a person or entity who receives compensation for giving individually tailored advice to a specific person on investing in stocks, bonds, or mutual funds. Some investment advisers also manage portfolios of securities, including mutual funds.

**Investment Company** — a company (corporation, business trust, partnership, or limited liability company) that issues securities and is primarily engaged in the business of investing in securities. The three basic types of investment companies are mutual funds, closed-end funds, and unit investment trusts.

**Load** — see "Sales Charge."

**Management Fee** — fee paid out of fund assets to the fund's investment adviser or its affiliates for managing the fund's portfolio, any other management fee payable to the fund's investment adviser or its affiliates, and any administrative fee payable to the investment adviser that are not included in the "Other Expenses" category. A fund's management fee appears as a category under "Annual Fund Operating Expenses" in the Fee Table.

**Market Index** — a measurement of the performance of a specific "basket" of stocks considered to represent a particular market or sector of the U.S. stock market or the economy. For example, the Dow Jones Industrial Average (DJIA) is an index of 30 "blue chip" U.S. stocks of industrial companies (excluding transportation and utility companies).

**Mutual Fund** — the common name for an open-end investment company. Like other types of investment companies, mutual funds pool money from many investors and invest the money in stocks, bonds, short-term money-market instruments, or other securities. Mutual funds issue redeemable shares that investors purchase directly from the fund (or through a broker for the fund) instead of purchasing from investors on a secondary market.

**NAV (Net Asset Value)** — the value of the fund's assets minus its liabilities. SEC rules require funds to calculate the NAV at least once daily. To calculate the NAV per share, simply subtract the fund's liabilities from its assets and then divide the result by the number of shares outstanding.

**No-load Fund** — a fund that does not charge any type of sales load. But not every type of shareholder fee is a "sales load," and a no-load fund may charge fees that are not sales loads. No-load funds also charge operating expenses.

**Open-End Company** — the legal name for a mutual fund. An open-end company is a type of investment company

**Operating Expenses** — the costs a fund incurs in connection with running the fund, including management fees, distribution (12b-1) fees, and other expenses.

**Portfolio** — an individual's or entity's combined holdings of stocks, bonds, or other securities and assets.

**Profile** — summarizes key information about a mutual fund's costs, investment objectives, risks, and performance. Although every mutual fund has a prospectus, not every mutual fund has a profile.

**Prospectus** — describes the mutual fund to prospective investors. Every mutual fund has a prospectus. The prospectus contains information about the mutual fund's costs, investment objectives, risks, and performance. You can get a prospectus from the mutual fund company (through its website or by phone or mail). Your financial professional or broker can also provide you with a copy.

**Purchase Fee** — a shareholder fee that some funds charge when investors purchase mutual fund shares. Not the same as (and may be in addition to) a front-end load.

**Redemption Fee** — a shareholder fee that some funds charge when investors redeem (or sell) mutual fund shares. Redemption fees (which must be paid to the fund) are not the same as (and may be in addition to) a back-end load (which is typically paid to a broker). The SEC generally limits redemption fees to 2%.

**Sales Charge (or "Load")** — the amount that investors pay when they purchase (front-end load) or redeem (back-end load) shares in a mutual fund, similar to a commission. The SEC's rules do not limit the size of sales load a fund may charge, but NASD rules state that mutual fund sales loads cannot exceed 8.5% and must be even lower depending on other fees and charges assessed.

**Shareholder Service Fees** — fees paid to persons to respond to investor inquiries and provide investors with information about their investments. See also "12b-1 fees."

**Statement of Additional Information (SAI)** — conveys information about an open- or closed-end fund that is not necessarily needed by investors to make an informed investment decision, but that some investors find useful. Although funds are not required to provide investors with the SAI, they must give investors the SAI upon request and without charge. Also known as "Part B" of the fund's registration statement.

**Total Annual Fund Operating Expense** — the total of a fund's annual fund operating expenses, expressed as a percentage of the fund's average net assets. You'll find the total in the fund's fee table in the prospectus.

**Unit Investment Trust (UIT)** — a type of investment company that typically makes a one-time "public offering" of only a specific, fixed number of units. A UIT will terminate and dissolve on a date established when the UIT is created (although some may terminate more than fifty years after they are created). UITs do not actively trade their investment portfolios.

## **Retirement Planning**

### **Retirement Strategies for All Ages: A "To-Do" List**

A successful retirement depends largely on the steps you take during different stages of your life. Here are some moves to consider. *Note: Investment portfolios shown are illustrations only. You must decide what percentages and investments are right for you.*

#### **Your 20s and 30s (Early Career)**

Contribute as much as you can to IRAs, 401(k)s, Keoghs and other retirement savings while meeting other goals, such as buying a home or starting a family.

Keep your debt from credit cards and other sources manageable.

If you don't already own a home, consider if this is a good option for you. While a home purchase can be expensive, it also can be an excellent investment and source of tax breaks.

Given your years until retirement, you probably can afford to be fairly aggressive with your investments. Possible portfolio: 60 to 80 percent in stocks or stock mutual funds and most of the rest in certificates of deposit (CDs), bonds, bond funds or money market accounts.

#### **Your 40s and 50s (Mid-Career)**

Continue putting as much as you can into IRAs, 401(k)s, Keoghs and other retirement savings accounts. Once you reach age 50, you can make "catch-up" (extra) contributions to IRAs, 401(k)s and other retirement savings accounts.

If you haven't bought a house already, consider doing so as a source of equity and a place to live in retirement. If you have a mortgage, periodically compare your interest rate to current market rates. If current rates are better, consider refinancing.

As you get closer to retirement, consider reducing stock investments and adding more conservative, income-producing investments. Possible portfolio: 50 to 70 percent in stocks or stock mutual funds and most of the rest in CDs, bonds, bond funds or money market accounts.

### **Your Early 60s (Late Career)**

Ask the Social Security Administration, your accountant or your employer's personnel office to help you determine how much Social Security and pension income you'd get if you "retire early" – and how much you'd lose compared to holding off on retirement

Discuss with a financial advisor when to withdraw money from your tax-deferred retirement accounts, such as employer-sponsored retirement plans and traditional IRAs. After age 59 ½, you can withdraw your money without penalty but subject to income taxes. Under IRS rules, you must withdraw a minimum amount from 401(k)s, traditional IRAs and certain other retirement savings plans by April 1 of the year after you reach age 70 ½ and each year after that. There is an exception to the rules for someone still working for the employer who sponsors the plan.

Consult with your legal or financial advisors about estate planning – organizing your financial affairs so that your money, property and other assets can go to your heirs with a minimum of costs, taxes and hassles.

You may need or want to buy health insurance or long-term care (including nursing home) insurance. Consider the need for disability (wage replacement) or life insurance coverage.



Reduce your consumer debt as much as possible and consider the pros and cons of paying off your mortgage early. But if you think you'll need to borrow money during retirement, determine whether you want to refinance your mortgage, take out a home-equity loan, apply for a credit card or otherwise take out a loan *before* you retire. You might have more options for getting a loan when you still have employment income. No matter what loans you have or how old you are, it's important to keep your debts manageable.

Consider reducing your stock ownership and increasing your conservative investments. Possible portfolio: 30 to 60 percent in stocks or stock mutual funds and most of the rest in CDs, bonds, bond funds or money market accounts.

## **Your Retirement**

The rules governing retirement can be complicated. So, about a year before you plan to retire, discuss your situation with a Social Security Administration claims representative. After you decide on a retirement date, apply for your Social Security benefits and other pensions about three months in advance. If you plan to work part-time, find out how this will affect your Social Security income or taxes.

Arrange to have your periodic payments, such as Social Security benefits, directly deposited into your checking account. Ask your personnel department or financial advisor about whether to receive your 401(k) money in a lump sum or periodic payments.

Reduce your debts as much as possible. Be careful before taking on new debt, such as a home-equity loan or a reverse mortgage.

Lean toward conservative, income-producing investments, but don't rule out stocks or stock funds. Possible portfolio: 20 to 40 percent in stock or stock mutual funds and most of the rest in CDs, bonds, bond funds or money market accounts.

## **10 Tips for Retirement**

### **Know Your Retirement Needs**

Retirement is expensive. Experts estimate that you'll need about 70 percent of your preretirement income – lower earners, 90 percent or more – to maintain your standard of living when you stop working. Take charge of your financial future.

### **Find Out About Your Social Security Benefits**

Social Security pays the average retiree about 40 percent of preretirement earnings. Call the Social Security Administration at 1.800.772.1213 for a free Social Security Statement and find out more about your benefits at [www.socialsecurity.gov](http://www.socialsecurity.gov).

### **Learn About Your Employer's Pension Or Profit Sharing Plan**

If your employer offers a plan, check to see what your benefit is worth. Most employers will provide an individual benefit statement if you request one. Before you change jobs, find out what will happen to your pension. Learn what benefits you may have from previous employment. Find out if you will be entitled to benefits from your spouse's plan.

### **Contribute To A Tax-Sheltered Savings Plan**

If your employer offers a tax-sheltered savings plan, such as a 401(k), sign up and contribute all you can. Your taxes will be lower, your company may kick in more, and automatic deductions make it easy. Over time, compound interest and tax deferrals make a big difference in the amount you will accumulate.

### **Ask Your Employer To Start A Plan**

If your employer doesn't offer a retirement plan, suggest that it start one. Simplified plans can be set up by certain employers.

### **Put Your Money Into An Individual Retirement Account**

You can put up to \$3,000 a year into an Individual Retirement Account (IRA) and gain tax advantages. The chart below illustrates the way your account can grow in an IRA.



When you open an IRA, you have two options – a traditional IRA or the newer Roth IRA. The tax treatment of your contributions and withdrawals will depend on which option you select. Also, you should know that the after-tax value of your withdrawal will depend on inflation and the type of IRA you choose.

### **Don't Touch Your Savings**

Don't dip into your retirement savings. You'll lose principal and interest, and you may lose tax benefits. If you change jobs, roll over your savings directly into an IRA or your new employer's retirement plan.

### **Start Now, Set Goals, And Stick To Them**

Start early. The sooner you start saving, the more time your money has to grow. Put time on your side. Make retirement savings a high priority. Devise a plan, stick to it, and set goals for yourself. Remember, it's never too early or too late to start saving. So start now, whatever your age!

### **Consider Basic Investment Principles**

How you save can be as important as how much you save. Inflation and the type of investments you make play important roles in how much you'll have saved at retirement. Know how your pension or savings plan is invested. Financial security and knowledge go hand in hand.

## Ask Questions

These tips point you in the right direction. But you'll need more information. Talk to your employer, your bank, your union, or a financial advisor. Ask questions and make sure the answers make sense to you. Get practical advice and act now. Financial security doesn't just happen. It takes planning and commitment and, yes, money.

## Facts

Today, only 42 percent of Americans have calculated how much they need to save for retirement.

In 2001, of those who had 401(k) coverage available, 30 percent didn't participate.

The average American spends 18 years in retirement.

Putting money away for retirement is a habit we can all live with. Remember ... Saving Matters!

The following Web sites can also be helpful:

[AARP](http://www.aarp.com) [www.aarp.com](http://www.aarp.com)

[American Savings Education Council](http://www.asec.org) [www.asec.org](http://www.asec.org)

[Wealth Management Board of Standards](http://www.financialanlayst.org)

[www.financialanlayst.org](http://www.financialanlayst.org)

[Consumer Federation of America](http://www.consumerfed.org)

[The Investor's Clearinghouse](http://www.theinvestorclearinghouse.com)

[U.S. Securities and Exchange Commission](http://www.sec.gov) [www.sec.gov](http://www.sec.gov)

## Home Mortgages and Loans for your Home

### Obtain All Important Cost Information

Be sure to get information about [mortgages](#) from several lenders or brokers. Know how much of a down payment you can afford, and find out all the costs involved in the loan. Knowing just the amount of the monthly payment or the interest rate is *not* enough. Ask for information about the same loan amount, loan term, and type of loan so that you can *compare* the information. The following information is important to get from each lender and broker:

#### Rates

- Ask each lender and broker for a list of its current mortgage interest rates and whether the rates being quoted are the lowest for that day or week.
- Ask whether the rate is [fixed](#) or [adjustable](#). Keep in mind that when interest rates for adjustable-rate loans go up, generally so does the monthly payment.
- If the rate quoted is for an adjustable-rate loan, ask how your rate and loan payment will vary, including whether your loan payment will be reduced when rates go down.
- Ask about the loan's [annual percentage rate \(APR\)](#). The APR takes into account not only the interest rate but also points, broker fees, and certain other credit charges that you may be required to pay, expressed as a yearly rate.

#### Points

[Points](#) are fees paid to the lender or broker for the loan and are often linked to the interest rate; usually the more points you pay, the lower the rate.

- Check your local newspaper for information about rates and points currently being offered.
- Ask for points to be quoted to you as a dollar amount--rather than just as the number of points--so that you will actually know how much you will have to pay.

**Fees** - A home loan often involves many fees, such as [loan origination or underwriting fees](#), broker fees, and [transaction, settlement, and closing costs](#). Every lender or broker should be able to give you an estimate of its fees. Many of these fees are negotiable. Some fees are paid when you apply for a loan (such as application and appraisal fees), and others are paid at closing. In some cases, you can borrow the money needed to pay these fees, but doing so will increase your loan amount and total costs. "No cost" loans are sometimes available, but they usually involve higher rates.

- Ask what each fee includes. Several items may be lumped into one fee.
- Ask for an explanation of any fee you do not understand. Some common fees associated with a home loan closing are listed on the Mortgage Shopping Worksheet in this brochure.

**Down Payments and Private Mortgage Insurance** Some lenders require 20 percent of the home's purchase price as a down payment. However, many lenders now offer loans that require less than 20 percent down--sometimes as little as 5 percent on [conventional loans](#). If a 20 percent down payment is not made, lenders usually require the home buyer to purchase [private mortgage insurance \(PMI\)](#) to protect the lender in case the home buyer fails to pay. When government-assisted programs such as FHA (Federal Housing Administration), VA (Veterans Administration), or Rural Development Services are available, the down payment requirements may be substantially smaller.

- Ask about the lender's requirements for a down payment, including what you need to do to verify that funds for your down payment are available.

- Ask your lender about special programs it may offer.

If PMI is required for your loan,

- Ask what the total cost of the insurance will be.
- Ask how much your monthly payment will be when including the PMI premium.
- Ask how long you will be required to carry PMI.

---

### Obtain the Best Deal That You Can

Once you know what each lender has to offer, negotiate for the best deal that you can. On any given day, lenders and brokers may offer different prices for the same loan terms to different consumers, even if those consumers have the same loan qualifications. The most likely reason for this difference in price is that loan officers and brokers are often allowed to keep some or all of this difference as extra compensation. Generally, the difference between the lowest available price for a loan product and any higher price that the borrower agrees to pay is an [overage](#). When overages occur, they are built into the prices quoted to consumers. They can occur in both fixed and variable-rate loans and can be in the form of points, fees, or the interest rate. Whether quoted to you by a loan officer or a broker, the price of any loan may contain overages. Have the lender or broker write down all the costs associated with the loan. Then ask if the lender or broker will waive or reduce one or more of its fees or agree to a lower rate or fewer points. You'll want to make sure that the lender or broker is not agreeing to lower one fee while raising another or to lower the rate while raising points. There's no harm in asking lenders or brokers if they can give better terms than the original ones they quoted or than those you have found elsewhere.

Once you are satisfied with the terms you have negotiated, you may want to obtain a written [lock-in](#) from the lender or broker. The lock-in should include the rate that you have agreed upon, the period the lock-in lasts, and the number of points to be paid. A fee may be charged for locking in the loan rate. This fee may be refundable at closing. Lock-ins can protect you from rate increases while your loan is being processed; if rates fall, however, you could end up with a less favorable rate. Should that happen, try to negotiate a compromise with the lender or broker.

---

### **Remember: Shop, Compare, Negotiate**

When buying a home, remember to shop around, to compare costs and terms, and to negotiate for the best deal. Your local newspaper and the Internet are good places to start shopping for a loan. You can usually find information both on interest rates and on points for several lenders. Since rates and points can change daily, you'll want to check your newspaper often when shopping for a home loan. But the newspaper does not list the fees, so be sure to ask the lenders about them.

The Mortgage Shopping Worksheet that follows may also help you. Take it with you when you speak to each lender or broker and write down the information you obtain. Don't be afraid to make lenders and brokers compete with each other for your business by letting them know that you are shopping for the best deal.

---

### **Fair Lending Is Required by Law**

The *Equal Credit Opportunity Act* prohibits lenders from discriminating against credit applicants in any aspect of a credit transaction on the basis of race, color, religion, national origin, sex, marital status, age, whether all or part of the applicant's income comes from a public assistance program, or whether the applicant has in good faith exercised a right under the Consumer Credit Protection Act.



The *Fair Housing Act* prohibits discrimination in residential real estate transactions on the basis of race, color, religion, sex, handicap, familial status, or national origin.

Under these laws, a consumer cannot be *refused* a loan based on these characteristics nor be *charged more* for a loan or *offered less favorable terms* based on such characteristics.

---

### Credit Problems? Still Shop, Compare, and Negotiate

Don't assume that minor credit problems or difficulties stemming from unique circumstances, such as illness or temporary loss of income, will limit your loan choices to only high-cost lenders. If your credit report contains negative information that is accurate, but there are good reasons for trusting you to repay a loan, be sure to explain your situation to the lender or broker. If your credit problems cannot be explained, you will probably have to pay more than borrowers who have good credit histories. But don't assume that the only way to get credit is to pay a high price. Ask how your past credit history affects the price of your loan and what you would need to do to get a better price. Take the time to shop around and negotiate the best deal that you can.

Whether you have credit problems or not, it's a good idea to review your credit report for accuracy and completeness before you apply for a loan. To order a copy of your credit report, contact:

Equifax: (800) 685-1111  
TransUnion: (800) 888-4213  
Experian: (888) 397-3742

---

### Glossary

**Adjustable-rate loans**, also known as variable-rate loans, usually offer a lower initial interest rate than fixed-rate loans. The interest rate fluctuates over the life of the loan based on market conditions, but the loan agreement generally sets maximum and minimum rates. When interest rates rise, generally so do your loan payments; and when interest rates fall, your monthly payments may be lowered.

**Annual percentage rate (APR)** is the cost of credit expressed as a yearly rate. The APR includes the interest rate, points, broker fees, and certain other credit charges that the borrower is required to pay.

**Conventional loans** are mortgage loans other than those insured or guaranteed by a government agency such as the FHA (Federal Housing Administration), the VA (Veterans Administration), or the Rural Development Services (formerly known as Farmers Home Administration, or FmHA).

**Escrow** is the holding of money or documents by a neutral third party prior to closing. It can also be an account held by the lender (or servicer) into which a homeowner pays money for taxes and insurance.

**Fixed-rate loans** generally have repayment terms of 15, 20, or 30 years. Both the interest rate and the monthly payments (for principal and interest) stay the same during the life of the loan.

The **interest rate** is the cost of borrowing money expressed as a percentage rate. Interest rates can change because of market conditions.

**Loan origination fees** are fees charged by the lender for processing the loan and are often expressed as a percentage of the loan amount.

**Lock-in** refers to a written agreement guaranteeing a home buyer a specific interest rate on a home loan provided that the loan is closed within a certain period of time, such as 60 or 90 days. Often the agreement also specifies the number of points to be paid at closing.

A **mortgage** is a document signed by a borrower when a home loan is made that gives the lender a right to take possession of the property if the borrower fails to pay off the loan.

**Overages** are the difference between the lowest available price and any higher price that the home buyer agrees to pay for the loan. Loan officers and brokers are often allowed to keep some or all of this difference as extra compensation.

**Points** are fees paid to the lender for the loan. One point equals 1 percent of the loan amount. Points are usually paid in cash at closing. In some cases, the money needed to pay points can be borrowed, but doing so will increase the loan amount and the total costs.

**Private mortgage insurance (PMI)** protects the lender against a loss if a borrower defaults on the loan. It is usually required for loans in which the down payment is less than 20 percent of the sales price or, in a refinancing, when the amount financed is greater than 80 percent of the appraised value.

**Thrift institution** is a general term for savings banks and savings and loan associations.

**Transaction, settlement, or closing costs** may include application fees; title examination, abstract of title, title insurance, and property survey fees; fees for preparing deeds, mortgages, and settlement documents; attorneys' fees; recording fees; and notary, appraisal, and credit report fees. Under the Real Estate Settlement Procedures Act, the borrower receives a good faith estimate of closing costs at the time of application or within three days of application. The good faith estimate lists each expected cost either as an amount or a range.

|  | Lender 1   |            | Lender 2   |            |
|--|------------|------------|------------|------------|
| <b>Name of Lender:</b>   |            |            |            |            |
| <b>Name of Contact:</b>  |            |            |            |            |
| <b>Date of Contact:</b>  |            |            |            |            |
| <b>Mortgage Amount:</b>  |            |            |            |            |
|  | mortgage 1 | mortgage 2 | mortgage 1 | mortgage 2 |
| <b>Basic Information on the Loans</b>  |            |            |            |            |
| Type of Mortgage:<br>fixed rate,<br>adjustable rate,<br>conventional, FHA,<br>other? If adjustable,<br>see below |            |            |            |            |
| Minimum down<br>payment required   |            |            |            |            |
| Loan term (length of<br>loan)  |            |            |            |            |
| Contract interest<br>rate  |            |            |            |            |
| Annual percentage<br>rate (APR)  |            |            |            |            |
| Points (may be<br>called loan discount<br>points)  |            |            |            |            |
| Monthly Private<br>Mortgage Insurance<br>(PMI) premiums  |            |            |            |            |
| How long must you<br>keep PMI?   |            |            |            |            |
| Estimated monthly  |            |            |            |            |

|  |  |  |  |  |
|--|--|--|--|--|
| escrow for taxes and hazard insurance  |  |  |  |  |
| Estimated monthly payment (Principal, Interest, Taxes, Insurance, PMI)   |  |  |  |  |
| <p><b>Fees</b><br/> Different institutions may have different names for some fees and may charge different fees. We have listed some typical fees you may see on loan documents.</p> |  |  |  |  |
| Application fee or Loan processing fee   |  |  |  |  |
| Origination fee or Underwriting fee  |  |  |  |  |
| Lender fee or Funding fee  |  |  |  |  |
| Appraisal fee  |  |  |  |  |
| Attorney fees  |  |  |  |  |
| Document preparation and recording fees  |  |  |  |  |
| Broker fees (may be quoted as points, origination fees, or interest rate add-on)   |  |  |  |  |

|   |            |                 |                 |            |
|---|------------|-----------------|-----------------|------------|
| Credit report fee   |            |                 |                 |            |
| Other fees  |            |                 |                 |            |
| <b>Other Costs at Closing/Settlement</b>  |            |                 |                 |            |
| Title search/Title insurance  |            |                 |                 |            |
| For lender  |            |                 |                 |            |
| For you   |            |                 |                 |            |
| Estimated prepaid amounts for interest, taxes, hazard insurance, payments to escrow |            |                 |                 |            |
| State and local taxes, stamp taxes, transfer taxes                                  |            |                 |                 |            |
| Flood determination   |            |                 |                 |            |
| Prepaid Private Mortgage Insurance (PMI)  |            |                 |                 |            |
| Surveys and home inspections  |            |                 |                 |            |
| <b>Total Fees and Other Closing/Settlement Cost Estimates</b>                       |            |                 |                 |            |
|   |            | <b>Lender 1</b> | <b>Lender 2</b> |            |
| <b>Name of Lender:</b>  |            |                 |                 |            |
|   | mortgage 1 | mortgage 2      | mortgage 1      | mortgage 2 |
| <b>Other Questions and</b>  |            |                 |                 |            |

|   |  |  |  |  |
|---|--|--|--|--|
| <p><b>Considerations about the Loan</b></p> <p>Are any of the fees or costs waivable?</p> |  |  |  |  |
| <p><b>Prepayment penalties</b></p> <p>Is there a prepayment penalty?</p>                  |  |  |  |  |
| <p>If so, how much is it?</p>   |  |  |  |  |
| <p>How long does the penalty period last? (for example, 3 years? 5 years?)</p>            |  |  |  |  |
| <p>Are extra principal payments allowed?</p>  |  |  |  |  |
| <p><b>Lock-ins</b></p> <p>Is the lock-in agreement in writing?</p>                        |  |  |  |  |
| <p>Is there a fee to lock-in?</p>   |  |  |  |  |
| <p>When does the lock-in occur—at application, approval, or another time?</p>             |  |  |  |  |
| <p>How long will the lock-in last?</p>  |  |  |  |  |
| <p>If the rate drops before closing, can you lock-in at a</p>                             |  |  |  |  |

|   |  |  |  |  |
|---|--|--|--|--|
| lower rate?   |  |  |  |  |
| <b>If the loan is an adjustable rate mortgage:</b><br>What is the initial rate?                                   |  |  |  |  |
| What is the maximum the rate could be next year?  |  |  |  |  |
| What are the rate and payment caps each year and over the life of the loan?                                       |  |  |  |  |
| What is the frequency of rate change and of any changes to the monthly payment?                                   |  |  |  |  |
| What is the index that the lender will use?   |  |  |  |  |
| What margin will the lender add to the index?   |  |  |  |  |
| <b>Credit life insurance</b><br>Does the monthly amount quoted to you include a charge for credit life insurance? |  |  |  |  |
| If so, does the lender require credit life insurance as a   |  |  |  |  |



|  |  |  |  |  |
|--|--|--|--|--|
| condition of the loan?   |  |  |  |  |
| How much does the credit life insurance cost?  |  |  |  |  |
| How much lower would your monthly payment be without the credit life insurance?  |  |  |  |  |
| If the lender does not require credit life insurance, and you still want to buy it, what rates can you get from other insurance providers? |  |  |  |  |

## **How the USA Economy Works**

In every economic system, entrepreneurs and managers bring together natural resources, labor, and technology to produce and distribute goods and services. But the way these different elements are organized and used also reflects a nation's political ideals and its culture.

The United States is often described as a "capitalist" economy, a term coined by 19th-century German economist and social theorist Karl Marx to describe a system in which a small group of people who control large amounts of money, or capital, make the most important economic decisions. Marx contrasted capitalist economies to "socialist" ones, which vest more power in the political system. Marx and his followers believed that capitalist economies concentrate power in the hands of wealthy business people, who aim mainly to maximize profits; socialist economies, on the other hand, would be more likely to feature greater control by government, which tends to put political aims -- a more equal distribution of society's resources, for instance -- ahead of profits.

While those categories, though oversimplified, have elements of truth to them, they are far less relevant today. If the pure capitalism described by Marx ever existed, it has long since disappeared, as governments in the United States and many other countries have intervened in their economies to limit concentrations of power and address many of the social problems associated with unchecked private commercial interests. As a result, the American economy is perhaps better described as a "mixed" economy, with government playing an important role along with private enterprise.

Although Americans often disagree about exactly where to draw the line between their beliefs in both free enterprise and government management, the mixed economy they have developed has been remarkably successful.

## Basic Ingredients of the U.S. Economy

The first ingredient of a nation's economic system is its natural resources. The United States is rich in mineral resources and fertile farm soil, and it is blessed with a moderate climate. It also has extensive coastlines on both the Atlantic and Pacific Oceans, as well as on the Gulf of Mexico. Rivers flow from far within the continent, and the Great Lakes -- five large, inland lakes along the U.S. border with Canada -- provide additional shipping access. These extensive waterways have helped shape the country's economic growth over the years and helped bind America's 50 individual states together in a single economic unit.

The second ingredient is labor, which converts natural resources into goods. The number of available workers and, more importantly, their productivity help determine the health of an economy. Throughout its history, the United States has experienced steady growth in the labor force, and that, in turn, has helped fuel almost constant economic expansion. Until shortly after World War I, most workers were immigrants from Europe, their immediate descendants, or African-Americans whose ancestors were brought to the Americas as slaves.

In the early years of the 20th century, large numbers of Asians immigrated to the United States, while many Latin American immigrants came in later years.

Although the United States has experienced some periods of high unemployment and other times when labor was in short supply, immigrants tended to come when jobs were plentiful. Often willing to work for somewhat lower wages than acculturated workers, they generally prospered, earning far more than they would have in their native lands. The nation prospered as well, so that the economy grew fast enough to absorb even more newcomers.

The quality of available labor -- how hard people are willing to work and how skilled they are -- is at least as important to a country's economic success as the number of workers. In the early days of the United States, frontier life required hard work, and what is known as the Protestant work ethic reinforced that trait. A strong emphasis on education, including technical and vocational training, also contributed to America's economic success, as did a willingness to experiment and to change. Labor mobility has likewise been important to the capacity of the American economy to adapt to changing conditions. When immigrants flooded labor markets on the East Coast, many workers moved inland, often to farmland waiting to be tilled. Similarly, economic opportunities in industrial, northern cities attracted black Americans from southern farms in the first half of the 20th century.

Labor-force quality continues to be an important issue. Today, Americans consider "human capital" a key to success in numerous modern, high-technology industries. As a result, government leaders and business officials increasingly stress the importance of education and training to develop workers with the kind of nimble minds and adaptable skills needed in new industries such as computers and telecommunications.

But natural resources and labor account for only part of an economic system. These resources must be organized and directed as efficiently as possible. In the American economy, managers, responding to signals from markets, perform this function. The traditional managerial structure in America is based on a top-down chain of command; authority flows from the chief executive in the boardroom, who makes sure that the entire business runs smoothly and efficiently, through various lower levels of management responsible for coordinating different parts of the enterprise, down to the foreman on the shop floor. Numerous tasks are divided among different divisions and workers. In early 20th-century America, this specialization, or division of labor, was said to reflect "scientific management" based on systematic analysis.

Many enterprises continue to operate with this traditional structure, but others have taken changing views on management. Facing heightened global competition, American businesses are seeking more flexible organization structures, especially in high-technology industries that employ skilled workers and must develop, modify, and even customize products rapidly. Excessive hierarchy and division of labor increasingly are thought to inhibit creativity. As a result, many companies have "flattened" their organizational structures, reduced the number of managers, and delegated more authority to interdisciplinary teams of workers. Before managers or teams of workers can produce anything, of course, they must be organized into business ventures.

In the United States, the corporation has proved to be an effective device for accumulating the funds needed to launch a new business or to expand an existing one. The corporation is a voluntary association of owners, known as stockholders, who form a business enterprise governed by a complex set of rules and customs.

Corporations must have financial resources to acquire the resources they need to produce goods or services. They raise the necessary capital largely by selling stock (ownership shares in their assets) or bonds (long-term loans of money) to insurance companies, banks, pension funds, individuals, and other investors. Some institutions, especially banks, also lend money directly to corporations or other business enterprises. Federal and state governments have developed detailed rules and regulations to ensure the safety and soundness of this financial system and to foster the free flow of information so investors can make well-informed decisions.

The gross domestic product measures the total output of goods and services in a given year. In the United States it has been growing steadily, rising from more than \$3.4 trillion in 1983 to around \$8.5 trillion by 1998. But while these figures help measure the economy's health, they do not gauge every aspect of national well-being. GDP shows the market value of the goods and services an economy produces, but it does not weigh a nation's quality of life. And some important variables -- personal happiness and security, for instance, or a clean environment and good health -- are entirely beyond its scope.

### A Mixed Economy: The Role of the Market

The United States is said to have a mixed economy because privately owned businesses and government both play important roles. Indeed, some of the most enduring debates of American economic history focus on the relative roles of the public and private sectors.

The American free enterprise system emphasizes private ownership. Private businesses produce most goods and services, and almost two-thirds of the nation's total economic output goes to individuals for personal use (the remaining one-third is bought by government and business). The consumer role is so great, in fact, that the nation is sometimes characterized as having a "consumer economy." This emphasis on private ownership arises, in part, from American beliefs about personal freedom. From the time the nation was created, Americans have feared excessive government power, and they have sought to limit government's authority over individuals -- including its role in the economic realm. In addition, Americans generally believe that an economy characterized by private ownership is likely to operate more efficiently than one with substantial government ownership.

Why? When economic forces are unfettered, Americans believe, supply and demand determine the prices of goods and services. Prices, in turn, tell businesses what to produce; if people want more of a particular good than the economy is producing, the price of the good rises. That catches the attention of new or other companies that, sensing an opportunity to earn profits, start producing more of that good.

On the other hand, if people want less of the good, prices fall and less competitive producers either go out of business or start producing different goods. Such a system is called a market economy. A socialist economy, in contrast, is characterized by more government ownership and central planning. Most Americans are convinced that socialist economies are inherently less efficient because government, which relies on tax revenues, is far less likely than private businesses to heed price signals or to feel the discipline imposed by market forces. There are limits to free enterprise, however. Americans have always believed that some services are better performed by public rather than private enterprise. For instance, in the United States, government is primarily responsible for the administration of justice, education (although there are many private schools and training centers), the road system, social statistical reporting, and national defense. In addition, government often is asked to intervene in the economy to correct situations in which the price system does not work. It regulates "natural monopolies," for example, and it uses antitrust laws to control or break up other business combinations that become so powerful that they can surmount market forces. Government also addresses issues beyond the reach of market forces. It provides welfare and unemployment benefits to people who cannot support themselves, either because they encounter problems in their personal lives or lose their jobs as a result of economic upheaval; it pays much of the cost of medical care for the aged and those who live in poverty; it regulates private industry to limit air and water pollution; it provides low-cost loans to people who suffer losses as a result of natural disasters; and it has played the leading role in the exploration of space, which is too expensive for any private enterprise to handle.



In this mixed economy, individuals can help guide the economy not only through the choices they make as consumers but through the votes they cast for officials who shape economic policy. In recent years, consumers have voiced concerns about product safety, environmental threats posed by certain industrial practices, and potential health risks citizens may face; government has responded by creating agencies to protect consumer interests and promote the general public welfare. The U.S. economy has changed in other ways as well. The population and the labor force have shifted dramatically away from farms to cities, from fields to factories, and, above all, to service industries. In today's economy, the providers of personal and public services far outnumber producers of agricultural and manufactured goods. As the economy has grown more complex, statistics also reveal over the last century a sharp long-term trend away from self-employment toward working for others.

### Government's Role in the Economy

While consumers and producers make most decisions that mold the economy, government activities have a powerful effect on the U.S. economy in at least four areas.

**Stabilization and Growth.** Perhaps most importantly, the federal government guides the overall pace of economic activity, attempting to maintain steady growth, high levels of employment, and price stability. By adjusting spending and tax rates (fiscal policy) or managing the money supply and controlling the use of credit (monetary policy), it can slow down or speed up the economy's rate of growth -- in the process, affecting the level of prices and employment.

For many years following the Great Depression of the 1930s, recessions -- periods of slow economic growth and high unemployment -- were viewed as the greatest of economic threats. When the danger of recession appeared most serious, government sought to strengthen the economy by spending heavily itself or cutting taxes so that consumers would spend more, and by fostering rapid growth in the money supply, which also encouraged more spending. In the 1970s, major price increases, particularly for energy, created a strong fear of inflation -- increases in the overall level of prices.

As a result, government leaders came to concentrate more on controlling inflation than on combating recession by limiting spending, resisting tax cuts, and reining in growth in the money supply.

Ideas about the best tools for stabilizing the economy changed substantially between the 1960s and the 1990s. In the 1960s, government had great faith in fiscal policy -- manipulation of government revenues to influence the economy. Since spending and taxes are controlled by the president and the Congress, these elected officials played a leading role in directing the economy. A period of high inflation, high unemployment, and huge government deficits weakened confidence in fiscal policy as a tool for regulating the overall pace of economic activity. Instead, monetary policy -- controlling the nation's money supply through such devices as interest rates -- assumed growing prominence. Monetary policy is directed by the nation's central bank, known as the Federal Reserve Board, with considerable independence from the president and the Congress.

**Regulation and Control.** The U.S. federal government regulates private enterprise in numerous ways. Regulation falls into two general categories. Economic regulation seeks, either directly or indirectly, to control prices. Traditionally, the government has sought to prevent monopolies such as electric utilities from raising prices beyond the level that would ensure them reasonable profits. At times, the government has extended economic control to other kinds of industries as well. In the years following the Great Depression, it devised a complex system to stabilize prices for agricultural goods, which tend to fluctuate wildly in response to rapidly changing supply and demand. A number of other industries -- trucking and, later, airlines -- successfully sought regulation themselves to limit what they considered harmful price-cutting.

Another form of economic regulation, antitrust law, seeks to strengthen market forces so that direct regulation is unnecessary. The government -- and, sometimes, private parties -- have used antitrust law to prohibit practices or mergers that would unduly limit competition.

Government also exercises control over private companies to achieve social goals, such as protecting the public's health and safety or maintaining a clean and healthy environment. The U.S. Food and Drug Administration bans harmful drugs, for example; the Occupational Safety and Health Administration protects workers from hazards they may encounter in their jobs; and the Environmental Protection Agency seeks to control water and air pollution.

American attitudes about regulation changed substantially during the final three decades of the 20th century. Beginning in the 1970s, policy-makers grew increasingly concerned that economic regulation protected inefficient companies at the expense of consumers in industries such as airlines and trucking. At the same time, technological changes spawned new competitors in some industries, such as telecommunications, that once were considered natural monopolies. Both developments led to a succession of laws easing regulation.

While leaders of both political parties generally favored economic deregulation during the 1970s, 1980s, and 1990s, there was less agreement concerning regulations designed to achieve social goals. Social regulation had assumed growing importance in the years following the Depression and World War II, and again in the 1960s and 1970s. But during the presidency of Ronald Reagan in the 1980s, the government relaxed rules to protect workers, consumers, and the environment, arguing that regulation interfered with free enterprise, increased the costs of doing business, and thus contributed to inflation. Still, many Americans continued to voice concerns about specific events or trends, prompting the government to issue new regulations in some areas, including environmental protection.

Some citizens, meanwhile, have turned to the courts when they feel their elected officials are not addressing certain issues quickly or strongly enough. For instance, in the 1990s, individuals, and eventually government itself, sued tobacco companies over the health risks of cigarette smoking.

A large financial settlement provided states with long-term payments to cover medical costs to treat smoking-related illnesses.

**Direct Services.** Each level of government provides many direct services. The federal government, for example, is responsible for national defense, backs research that often leads to the development of new products, conducts space exploration, and runs numerous programs designed to help workers develop workplace skills and find jobs. Government spending has a significant effect on local and regional economies -- and even on the overall pace of economic activity.

State governments, meanwhile, are responsible for the construction and maintenance of most highways. State, county, or city governments play the leading role in financing and operating public schools. Local governments are primarily responsible for police and fire protection. Government spending in each of these areas can also affect local and regional economies, although federal decisions generally have the greatest economic impact. Overall, federal, state, and local spending accounted for almost 18 percent of gross domestic product in 1997.

**Direct Assistance.** Government also provides many kinds of help to businesses and individuals. It offers low-interest loans and technical assistance to small businesses, and it provides loans to help students attend college. Government-sponsored enterprises buy home mortgages from lenders and turn them into securities that can be bought and sold by investors, thereby encouraging home lending. Government also actively promotes exports and seeks to prevent foreign countries from maintaining trade barriers that restrict imports.

Government supports individuals who cannot adequately care for themselves. Social Security, which is financed by a tax on employers and employees, accounts for the largest portion of Americans' retirement income. The Medicare program pays for many of the medical costs of the elderly. The Medicaid program finances medical care for low-income families. In many states, government maintains institutions for the mentally ill or people with severe disabilities. The federal government provides Food Stamps to help poor families obtain food, and the federal and state governments jointly provide welfare grants to support low-income parents with children.

Many of these programs, including Social Security, trace their roots to the "New Deal" programs of Franklin D. Roosevelt, who served as the U.S. president from 1933 to 1945. Key to Roosevelt's reforms was a belief that poverty usually resulted from social and economic causes rather than from failed personal morals. This view repudiated a common notion whose roots lay in New England Puritanism that success was a sign of God's favor and failure a sign of God's displeasure. This was an important transformation in American social and economic thought. Even today, however, echoes of the older notions are still heard in debates around certain issues, especially welfare.

Many other assistance programs for individuals and families, including Medicare and Medicaid, were begun in the 1960s during President Lyndon Johnson's (1963-1969) "War on Poverty." Although some of these programs encountered financial difficulties in the 1990s and various reforms were proposed, they continued to have strong support from both of the United States' major political parties.

Critics argued, however, that providing welfare to unemployed but healthy individuals actually created dependency rather than solving problems. Welfare reform legislation enacted in 1996 under President Bill Clinton (1993-2001) requires people to work as a condition of receiving benefits and imposes limits on how long individuals may receive payments.

### Poverty and Inequality

Americans are proud of their economic system, believing it provides opportunities for all citizens to have good lives. Their faith is clouded, however, by the fact that poverty persists in many parts of the country. Government anti-poverty efforts have made some progress but have not eradicated the problem. Similarly, periods of strong economic growth, which bring more jobs and higher wages, have helped reduce poverty but have not eliminated it entirely.

The federal government defines a minimum amount of income necessary for basic maintenance of a family of four. This amount may fluctuate depending on the cost of living and the location of the family. In 1998, a family of four with an annual income below \$16,530 was classified as living in poverty.

The percentage of people living below the poverty level dropped from 22.4 percent in 1959 to 11.4 percent in 1978. But since then, it has fluctuated in a fairly narrow range.

In 1998, it stood at 12.7 percent. What is more, the overall figures mask much more severe pockets of poverty. In 1998, more than one-quarter of all African-Americans (26.1 percent) lived in poverty; though distressingly high, that figure did represent an improvement from 1979, when 31 percent of blacks were officially classified as poor, and it was the lowest poverty rate for this group since 1959. Families headed by single mothers are particularly susceptible to poverty. Partly as a result of this phenomenon, almost one in five children (18.9 percent) was poor in 1997. The poverty rate was 36.7 percent among African-American children and 34.4 percent among Hispanic children.

Some analysts have suggested that the official poverty figures overstate the real extent of poverty because they measure only cash income and exclude certain government assistance programs such as Food Stamps, health care, and public housing. Others point out, however, that these programs rarely cover all of a family's food or health care needs and that there is a shortage of public housing. Some argue that even families whose incomes are above the official poverty level sometimes go hungry, skimping on food to pay for such things as housing, medical care, and clothing. Still others point out that people at the poverty level sometimes receive cash income from casual work and in the "underground" sector of the economy, which is never recorded in official statistics. In any event, it is clear that the American economic system does not apportion its rewards equally.



In 1997, the wealthiest one-fifth of American families accounted for 47.2 percent of the nation's income, according to the Economic Policy Institute, a Washington-based research organization. In contrast, the poorest one-fifth earned just 4.2 percent of the nation's income, and the poorest 40 percent accounted for only 14 percent of income.

Despite the generally prosperous American economy as a whole, concerns about inequality continued during the 1980s and 1990s. Increasing global competition threatened workers in many traditional manufacturing industries, and their wages stagnated. At the same time, the federal government edged away from tax policies that sought to favor lower-income families at the expense of wealthier ones, and it also cut spending on a number of domestic social programs intended to help the disadvantaged. Meanwhile, wealthier families reaped most of the gains from the booming stock market.

In the late 1990s, there were some signs these patterns were reversing, as wage gains accelerated -- especially among poorer workers. But at the end of the decade, it was still too early to determine whether this trend would continue.

### The Growth of Government

The U.S. government grew substantially beginning with President Franklin Roosevelt's administration. In an attempt to end the unemployment and misery of the Great Depression, Roosevelt's New Deal created many new federal programs and expanded many existing ones.

The rise of the United States as the world's major military power during and after World War II also fueled government growth. The growth of urban and suburban areas in the postwar period made expanded public services more feasible. Greater educational expectations led to significant government investment in schools and colleges. An enormous national push for scientific and technological advances spawned new agencies and substantial public investment in fields ranging from space exploration to health care in the 1960s. And the growing dependence of many Americans on medical and retirement programs that had not existed at the dawn of the 20th century swelled federal spending further.

While many Americans think that the federal government in Washington has ballooned out of hand, employment figures indicate that this has not been the case. There has been significant growth in government employment, but most of this has been at the state and local levels. From 1960 to 1990, the number of state and local government employees increased from 6.4 million to 15.2 million, while the number of civilian federal employees rose only slightly, from 2.4 million to 3 million. Cutbacks at the federal level saw the federal labor force drop to 2.7 million by 1998, but employment by state and local governments more than offset that decline, reaching almost 16 million in 1998. (The number of Americans in the military declined from almost 3.6 million in 1968, when the United States was embroiled in the war in Vietnam, to 1.4 million in 1998.)

The rising costs of taxes to pay for expanded government services, as well as the general American distaste for "big government" and increasingly powerful public employee unions, led many policy-makers in the 1970s, 1980s, and 1990s to question whether government is the most efficient provider of needed services. A new word -- "privatization" -- was coined and quickly gained acceptance worldwide to describe the practice of turning certain government functions over to the private sector.

In the United States, privatization has occurred primarily at the municipal and regional levels. Major U.S. cities such as New York, Los Angeles, Philadelphia, Dallas, and Phoenix began to employ private companies or nonprofit organizations to perform a wide variety of activities previously performed by the municipalities themselves, ranging from streetlight repair to solid-waste disposal and from data processing to management of prisons. Some federal agencies, meanwhile, sought to operate more like private enterprises; the United States Postal Service, for instance, largely supports itself from its own revenues rather than relying on general tax dollars.

Privatization of public services remains controversial, however. While advocates insist that it reduces costs and increases productivity, others argue the opposite, noting that private contractors need to make a profit and asserting that they are not necessarily being more productive. Public sector unions, not surprisingly, adamantly oppose most privatization proposals.

They contend that private contractors in some cases have submitted very low bids in order to win contracts, but later raised prices substantially. Advocates counter that privatization can be effective if it introduces competition. Sometimes the spur of threatened privatization may even encourage local government workers to become more efficient.

As debates over regulation, government spending, and welfare reform all demonstrate, the proper role of government in the nation's economy remains a hot topic for debate more than 200 years after the United States became an independent nation.

### **The USA Stock Markets and Financial Markets**

Capital markets in the United States provide the lifeblood of capitalism. Companies turn to them to raise funds needed to finance the building of factories, office buildings, airplanes, trains, ships, telephone lines, and other assets; to conduct research and development; and to support a host of other essential corporate activities. Much of the money comes from such major institutions as pension funds, insurance companies, banks, foundations, and colleges and universities. Increasingly, it comes from individuals as well. As noted in chapter 3, more than 40 percent of U.S. families owned common stock in the mid-1990s.

Very few investors would be willing to buy shares in a company unless they knew they could sell them later if they needed the funds for some other purpose. The stock market and other capital markets allow investors to buy and sell stocks continuously.

The markets play several other roles in the American economy as well. They are a source of income for investors. When stocks or other financial assets rise in value, investors become wealthier; often they spend some of this additional wealth, bolstering sales and promoting economic growth. Moreover, because investors buy and sell shares daily on the basis of their expectations for how profitable companies will be in the future, stock prices provide instant feedback to corporate executives about how investors judge their performance.

Stock values reflect investor reactions to government policy as well. If the government adopts policies that investors believe will hurt the economy and company profits, the market declines; if investors believe policies will help the economy, the market rises. Critics have sometimes suggested that American investors focus too much on short-term profits; often, these analysts say, companies or policy-makers are discouraged from taking steps that will prove beneficial in the long run because they may require short-term adjustments that will depress stock prices. Because the market reflects the sum of millions of decisions by millions of investors, there is no good way to test this theory.

In any event, Americans pride themselves on the efficiency of their stock market and other capital markets, which enable vast numbers of sellers and buyers to engage in millions of transactions each day. These markets owe their success in part to computers, but they also depend on tradition and trust -- the trust of one broker for another, and the trust of both in the good faith of the customers they represent to deliver securities after a sale or to pay for purchases. Occasionally, this trust is abused. But during the last half century, the federal government has played an increasingly important role in ensuring honest and equitable dealing. As a result, markets have thrived as continuing sources of investment funds that keep the economy growing and as devices for letting many Americans share in the nation's wealth.

To work effectively, markets require the free flow of information. Without it, investors cannot keep abreast of developments or gauge, to the best of their ability, the true value of stocks. Numerous sources of information enable investors to follow the fortunes of the market daily, hourly, or even minute-by-minute. Companies are required by law to issue quarterly earnings reports, more elaborate annual reports, and proxy statements to tell stockholders how they are doing. In addition, investors can read the market pages of daily newspapers to find out the price at which particular stocks were traded during the previous trading session. They can review a variety of indexes that measure the overall pace of market activity; the most notable of these is the Dow Jones Industrial Average (DJIA), which tracks 30 prominent stocks. Investors also can turn to magazines and newsletters devoted to analyzing particular stocks and markets. Certain cable television programs provide a constant flow of news about movements in stock prices. And now, investors can use the Internet to get up-to-the-minute information about individual stocks and even to arrange stock transactions.

### **The Stock Exchanges**

There are thousands of stocks, but shares of the largest, best-known, and most actively traded corporations generally are listed on the New York Stock Exchange (NYSE). The exchange dates its origin back to 1792, when a group of stockbrokers gathered under a buttonwood tree on Wall Street in New York City to make some rules to govern stock buying and selling. By the late 1990s, the NYSE listed some 3,600 different stocks. The exchange has 1,366 members, or "seats," which are bought by brokerage houses at hefty prices and are used for buying and selling stocks for the public. Information travels electronically between brokerage offices and the exchange, which requires 200 miles (320 kilometers) of fiber-optic cable and 8,000 phone connections to handle quotes and orders.

How are stocks traded? Suppose a schoolteacher in California wants to take an ocean cruise. To finance the trip, she decides to sell 100 shares of stock she owns in General Motors Corporation. So she calls her broker and directs him to sell the shares at the best price he can get. At the same time, an engineer in Florida decides to use some of his savings to buy 100 GM shares, so he calls his broker and places a "buy" order for 100 shares at the market price. Both brokers wire their orders to the NYSE, where their representatives negotiate the transaction. All this can occur in less than a minute. In the end, the schoolteacher gets her cash and the engineer gets his stock, and both pay their brokers a commission. The transaction, like all others handled on the exchange, is carried out in public, and the results are sent electronically to every brokerage office in the nation. Stock exchange "specialists" play a crucial role in the process, helping to keep an orderly market by deftly matching buy and sell orders. If necessary, specialists buy or sell stock themselves when there is a paucity of either buyers or sellers. The smaller American Stock Exchange, which lists numerous energy industry-related stocks, operates in much the same way and is located in the same Wall Street area as the New York exchange. Other large U.S. cities host smaller, regional stock exchanges.

The largest number of different stocks and bonds traded are traded on the National Association of Securities Dealers Automated Quotation system, or Nasdaq. This so-called over-the-counter exchange, which handles trading in about 5,240 stocks, is not located in any one place; rather, it is an electronic communications network of stock and bond dealers.

The National Association of Securities Dealers, which oversees the over-the-counter market, has the power to expel companies or dealers that it determines are dishonest or insolvent. Because many of the stocks traded in this market are from smaller and less stable companies, the Nasdaq is considered a riskier market than either of the major stock exchanges. But it offers many opportunities for investors. By the 1990s, many of the fastest growing high-technology stocks were traded on the Nasdaq.

### A Nation of Investors

An unprecedented boom in the stock market, combined with the ease of investing in stocks, led to a sharp increase in public participation in securities markets during the 1990s. The annual trading volume on the New York Stock Exchange, or "Big Board," soared from 11,400 million shares in 1980 to 169,000 million shares in 1998. Between 1989 and 1995, the portion of all U.S. households owning stocks, directly or through intermediaries like pension funds, rose from 31 percent to 41 percent.

Public participation in the market has been greatly facilitated by mutual funds, which collect money from individuals and invest it on their behalf in varied portfolios of stocks. Mutual funds enable small investors, who may not feel qualified or have the time to choose among thousands of individual stocks, to have their money invested by professionals. And because mutual funds hold diversified groups of stocks, they shelter investors somewhat from the sharp swings that can occur in the value of individual shares.



There are dozens of kinds of mutual funds, each designed to meet the needs and preferences of different kinds of investors. Some funds seek to realize current income, while others aim for long-term capital appreciation. Some invest conservatively, while others take bigger chances in hopes of realizing greater gains. Some deal only with stocks of specific industries or stocks of foreign companies, and others pursue varying market strategies. Overall, the number of funds jumped from 524 in 1980 to 7,300 by late 1998.

Attracted by healthy returns and the wide array of choices, Americans invested substantial sums in mutual funds during the 1980s and 1990s. At the end of the 1990s, they held \$5.4 trillion in mutual funds, and the portion of U.S. households holding mutual fund shares had increased to 37 percent in 1997 from 6 percent in 1979.

### How Stock Prices Are Determined

Stock prices are set by a combination of factors that no analyst can consistently understand or predict. In general, economists say, they reflect the long-term earnings potential of companies. Investors are attracted to stocks of companies they expect will earn substantial profits in the future; because many people wish to buy stocks of such companies, prices of these stocks tend to rise. On the other hand, investors are reluctant to purchase stocks of companies that face bleak earnings prospects; because fewer people wish to buy and more wish to sell these stocks, prices fall.

When deciding whether to purchase or sell stocks, investors consider the general business climate and outlook, the financial condition and prospects of the individual companies in which they are considering investing, and whether stock prices relative to earnings already are above or below traditional norms. Interest rate trends also influence stock prices significantly. Rising interest rates tend to depress stock prices -- partly because they can foreshadow a general slowdown in economic activity and corporate profits, and partly because they lure investors out of the stock market and into new issues of interest-bearing investments. Falling rates, conversely, often lead to higher stock prices, both because they suggest easier borrowing and faster growth, and because they make new interest-paying investments less attractive to investors.

A number of other factors complicate matters, however. For one thing, investors generally buy stocks according to their expectations about the unpredictable future, not according to current earnings. Expectations can be influenced by a variety of factors, many of them not necessarily rational or justified. As a result, the short-term connection between prices and earnings can be tenuous.

Momentum also can distort stock prices. Rising prices typically woo more buyers into the market, and the increased demand, in turn, drives prices higher still. Speculators often add to this upward pressure by purchasing shares in the expectation they will be able to sell them later to other buyers at even higher prices.

Analysts describe a continuous rise in stock prices as a "bull" market. When speculative fever can no longer be sustained, prices start to fall. If enough investors become worried about falling prices, they may rush to sell their shares, adding to downward momentum. This is called a "bear" market.

### Market Strategies

During most of the 20th century, investors could earn more by investing in stocks than in other types of financial investments -- provided they were willing to hold stocks for the long term.

In the short term, stock prices can be quite volatile, and impatient investors who sell during periods of market decline easily can suffer losses. Peter Lynch, a renowned former manager of one of America's largest stock mutual funds, noted in 1998, for instance, that U.S. stocks had lost value in 20 of the previous 72 years.

According to Lynch, investors had to wait 15 years after the stock market crash of 1929 to see their holdings regain their lost value. But people who held their stock 20 years or more never lost money. In an analysis prepared for the U.S. Congress, the federal government's General Accounting Office said that in the worst 20-year period since 1926, stock prices increased 3 percent. In the best two decades, they rose 17 percent. By contrast, 20-year bond returns, a common investment alternative to stocks, ranged between 1 percent and 10 percent.

Economists conclude from analyses like these that small investors fare best if they can put their money into a diversified portfolio of stocks and hold them for the long term. But some investors are willing to take risks in hopes of realizing bigger gains in the short term. And they have devised a number of strategies for doing this.

**Buying on Margin.** Americans buy many things on credit, and stocks are no exception. Investors who qualify can buy "on margin," making a stock purchase by paying 50 percent down and getting a loan from their brokers for the remainder. If the price of stock bought on margin rises, these investors can sell the stock, repay their brokers the borrowed amount plus interest and commissions, and still make a profit.

If the price goes down, however, brokers issue "margin calls," forcing the investors to pay additional money into their accounts so that their loans still equal no more than half of the value of the stock. If an owner cannot produce cash, the broker can sell some of the stock -- at the investor's loss -- to cover the debt.

Buying stock on margin is one kind of leveraged trading. It gives speculators -- traders willing to gamble on high-risk situations -- a chance to buy more shares. If their investment decisions are correct, speculators can make a greater profit, but if they misjudge the market, they can suffer bigger losses. The Federal Reserve Board (frequently called "the Fed"), the U.S. government's central bank, sets the minimum margin requirements specifying how much cash investors must put down when they buy stock. The Fed can vary margins.

If it wishes to stimulate the market, it can set low margins. If it sees a need to curb speculative enthusiasm, it sets high margins. In some years, the Fed has required a full 100 percent payment, but for much of the time during the last decades of the 20th century, it left the margin rate at 50 percent.

**Selling Short.** Another group of speculators are known as "short sellers." They expect the price of a particular stock to fall, so they sell shares borrowed from their broker, hoping to profit by replacing the stocks later with shares purchased on the open market at a lower price. While this approach offers an opportunity for gains in a bear market, it is one of the riskiest ways to trade stocks. If a short seller guesses wrong, the price of stock he or she has sold short may rise sharply, hitting the investor with large losses.

**Options.** Another way to leverage a relatively small outlay of cash is to buy "call" options to purchase a particular stock later at close to its current price. If the market price rises, the trader can exercise the option, making a big profit by then selling the shares at the higher market price (alternatively, the trader can sell the option itself, which will have risen in value as the price of the underlying stock has gone up). An option to sell stock, called a "put" option, works in the opposite direction, committing the trader to sell a particular stock later at close to its current price. Much like short selling, put options enable traders to profit from a declining market. But investors also can lose a lot of money if stock prices do not move as they hope.

### Commodities and Other Futures

Commodity "futures" are contracts to buy or sell certain goods at set prices at a predetermined time in the future. Futures traditionally have been linked to commodities such as wheat, livestock, copper, and gold, but in recent years growing amounts of futures also have been tied to foreign currencies or other financial assets as well. They are traded on about a dozen commodity exchanges in the United States, the most prominent of which include the Chicago Board of Trade, the Chicago Mercantile Exchange, and several exchanges in New York City. Chicago is the historic center of America's agriculture-based industries. Overall, futures activity rose to 417 million contracts in 1997, from 261 million in 1991.

Commodities traders fall into two broad categories: hedgers and speculators. Hedgers are business firms, farmers, or individuals that enter into commodity contracts to be assured access to a commodity, or the ability to sell it, at a guaranteed price. They use futures to protect themselves against unanticipated fluctuations in the commodity's price. Thousands of individuals, willing to absorb that risk, trade in commodity futures as speculators. They are lured to commodity trading by the prospect of making huge profits on small margins (futures contracts, like many stocks, are traded on margin, typically as low as 10 to 20 percent on the value of the contract).

Speculating in commodity futures is not for people who are averse to risk. Unforeseen forces like weather can affect supply and demand, and send commodity prices up or down very rapidly, creating great profits or losses.

While professional traders who are well versed in the futures market are most likely to gain in futures trading, it is estimated that as many as 90 percent of small futures traders lose money in this volatile market.

Commodity futures are a form of "derivative" -- complex instruments for financial speculation linked to underlying assets. Derivatives proliferated in the 1990s to cover a wide range of assets, including mortgages and interest rates. This growing trade caught the attention of regulators and members of Congress after some banks, securities firms, and wealthy individuals suffered big losses on financially distressed, highly leveraged funds that bought derivatives, and in some cases avoided regulatory scrutiny by registering outside the United States.

### The Regulators

The Securities and Exchange Commission (SEC), which was created in 1934, is the principal regulator of securities markets in the United States. Before 1929, individual states regulated securities activities. But the stock market crash of 1929, which triggered the Great Depression, showed that arrangement to be inadequate. The Securities Act of 1933 and the Securities Exchange Act of 1934 consequently gave the federal government a preeminent role in protecting small investors from fraud and making it easier for them to understand companies' financial reports.

The commission enforces a web of rules to achieve that goal. Companies issuing stocks, bonds, and other securities must file detailed financial registration statements, which are made available to the public. The SEC determines whether these disclosures are full and fair so that investors can make well-informed and realistic evaluations of various securities. The SEC also oversees trading in stocks and administers rules designed to prevent price manipulation; to that end, brokers and dealers in the over-the-counter market and the stock exchanges must register with the SEC. In addition, the commission requires companies to tell the public when their own officers buy or sell shares of their stock; the commission believes that these "insiders" possess intimate information about their companies and that their trades can indicate to other investors their degree of confidence in their companies' future.

The agency also seeks to prevent insiders from trading in stock based on information that has not yet become public. In the late 1980s, the SEC began to focus not just on officers and directors but on insider trades by lower-level employees or even outsiders like lawyers who may have access to important information about a company before it becomes public.

The SEC has five commissioners who are appointed by the president. No more than three can be members of the same political party; the five-year term of one of the commissioners expires each year.



The Commodity Futures Trading Commission oversees the futures markets. It is particularly zealous in cracking down on many over-the-counter futures transactions, usually confining approved trading to the exchanges. But in general, it is considered a more gentle regulator than the SEC. In 1996, for example, it approved a record 92 new kinds of futures and farm commodity options contracts. From time to time, an especially aggressive SEC chairman asserts a vigorous role for that commission in regulating futures business.

### "Black Monday" and the Long Bull Market

On Monday, October 19, 1987, the value of stocks plummeted on markets around the world. The Dow Jones Industrial Average fell 22 percent to close at 1738.42, the largest one-day decline since 1914, eclipsing even the famous October 1929 market crash.

The Brady Commission (a presidential commission set up to investigate the fall) the SEC, and others blamed various factors for the 1987 debacle -- including a negative turn in investor psychology, investors' concerns about the federal government budget deficit and foreign trade deficit, a failure of specialists on the New York Stock Exchange to discharge their duty as buyers of last resort, and "program trading" in which computers are programmed to launch buying or selling of large volumes of stock when certain market triggers occur. The stock exchange subsequently initiated safeguards. It said it would restrict program trading whenever the Dow Jones Industrial Average rose or fell 50 points in a single day, and it created a "circuit-breaker" mechanism to halt all trading temporarily any time the DJIA dropped 250 points. Those emergency mechanisms were later substantially adjusted to reflect the large rise in the DJIA level.

In late 1998, one change required program-trading curbs whenever the DJIA rose or fell 2 percent in one day from a certain average recent close; in late 1999, this formula meant that program trading would be halted by a market change of about 210 points. The new rules set also a higher threshold for halting all trading; during the fourth quarter of 1999, that would occur if there was at least a 1,050-point DJIA drop.

Those reforms may have helped restore confidence, but a strong performance by the economy may have been even more important. Unlike its performance in 1929, the Federal Reserve made it clear it would ease credit conditions to ensure that investors could meet their margin calls and could continue operating.

Partly as a result, the crash of 1987 was quickly erased as the market surged to new highs. In the early 1990s, the Dow Jones Industrial Average topped 3,000, and in 1999 it topped the 11,000 mark. What's more, the volume of trading rose enormously. While trading of 5 million shares was considered a hectic day on the New York Stock Exchange in the 1960s, more than a thousand-million shares were exchanged on some days in 1997 and 1998. On the Nasdaq, such share days were routine by 1998. Much of the increased activity was generated by so-called day traders who would typically buy and sell the same stock several times in one day, hoping to make quick profits on short-term swings. These traders were among the growing legions of persons using the Internet to do their trading. In early 1999, 13 percent of all stock trades by individuals and 25 percent of individual transactions in securities of all kinds were occurring over the Internet.

With the greater volume came greater volatility. Swings of more than 100 points a day occurred with increasing frequency, and the circuit-breaker mechanism was triggered on October 27, 1997, when the Dow Jones Industrial Average fell 554.26 points. Another big fall -- 512.61 points -- occurred on August 31, 1998. But by then, the market had climbed so high that the declines amounted to only about 7 percent of the overall value of stocks, and investors stayed in the market, which quickly rebounded.

## Financial Glossary

**Acceleration clause** A stipulation in a loan contract stating that the entire balance becomes due immediately if other contract conditions are not met.

**Accrued interest** Interest that has been earned but not received or recorded.

**Amortization** Liquidation of a debt by making periodic payments over a set period, at the end of which the balance is zero.

**Annuity** A series of equal payments made at regular intervals, with interest compounded at a specified rate.

**Appreciation** An increase in the value or price.

**Asset** Anything an individual or business owns that has commercial or exchange value.

**Balance** The amount owed on a loan or credit card or the amount in a savings or investment account.

**Balance sheet** A financial statement showing a "snapshot" of the assets, liabilities and net worth of an individual or organization on a given date.

**Bankruptcy** A legal proceeding declaring that an individual is unable to pay debts. Chapters 7 and 13 of the federal bankruptcy code govern personal bankruptcy.

**Budget** An itemized summary of probable income and expenses for a given period.

**Capital** Cash or other resources accumulated and available for use in producing wealth.

**Cash flow** Money coming to an individual or business less money being paid out during a given period.

**Certificate of deposit (CD)** A type of savings account that earns a fixed interest rate over a specified period of time.

**Collateral** Assets pledged to secure a loan.

**Common stock** A kind of ownership in a corporation that entitles the investor to share any profits remaining after all other obligations have been met.

**Compound interest** Interest computed on the sum of the original principal and accrued interest.

**Credit** The granting of money or something else of value in exchange for a promise of future repayment.

**Credit bureau** An organization that compiles credit information on individuals and businesses and makes it available to businesses for a fee.

**Credit card** A plastic card from a financial services company that allows cardholders to buy goods and services on credit.

**Credit rating** An estimate of the amount of credit that can be extended to an individual or business without undue risk.

**Credit report** A loan and bill payment history, kept by a credit bureau and used by financial institutions and other potential creditors to determine the likelihood a future debt will be repaid.

**Credit union** A cooperative organization that provides financial services to its members.

**Creditor** A person, financial institution or other business that lends money.

**Debt** Money owed; also known as a liability.

**Debt service** Periodic payment of the principal and interest on a loan.

**Debit** Charges to an account.

**Debit card** A plastic card similar to a credit card that allows money to be withdrawn or the cost of purchases paid directly from the holder's bank account.

**Delinquency** The failure to make timely payments under a loan or other credit agreement.

**Diversification** The distribution of investments among several companies to lessen the risk of loss.

**Dividend** A share of profits paid to a stockholder.

**Equity** Ownership interest in an asset after liabilities are deducted.

**Face value** The principal amount of a bond, which will be paid off at maturity.

**Fair market value** The price a willing buyer will pay and a willing seller will accept for real or personal property.

**Federal Deposit Insurance Corp. (FDIC)** A federally chartered corporation that insures bank deposits up to \$100,000.

**Finance company** A company that makes loans to individuals.

**Financing fee** The fee a lender charges to originate a loan. The fee is based on a percentage of the loan amount; one point is equivalent to 1 percent.

**Foreclosure** The legal process used to force the payment of debt secured by collateral whereby the property is sold to satisfy the debt.

**401(k) plan** A tax-deferred investment and savings plan that serves as a personal retirement fund for employees.

**General obligation bond** A type of municipal bond backed by the full faith and credit of the governmental unit that issues it.

**Individual development account (IDA)** A type of savings account, offered in some communities, for people whose income is below a certain level.

**Individual retirement account (IRA)** A retirement plan, offered by banks, brokerage firms and insurance companies, to which individuals can contribute each year on a tax-deferred basis.

**Industrial bond** A financial instrument issued by businesses primarily to fund expansion or acquisitions.

**Interest** A fee for the use of money over time. It is an expense to the borrower and revenue to the lender. Also, money earned on a savings account.

**Interest rate** The percentage charged for a loan, usually a percentage of the amount lent. Also, the percentage paid on a savings account.

**Investor** An organization, corporation, individual or other entity that acquires an ownership position in an investment, assuming risk of loss in exchange for anticipated returns.

**Installment plan** A plan requiring a borrower to make payments at specified intervals over the life of a loan.

**Investing** The act of using money to make more money.

**Leverage** The ability to use a small amount of money to attract other funds, including loans, grants and equity investments.

**Liability** Money an individual or organization owes; same as debt.

**Lien** A creditor's claim against a property, which may entitle the creditor to seize the property if a debt is not repaid.

**Liquidity** The ease with which an investment can be converted into cash.

**Load** The fee a brokerage firm charges an investor for handling transactions.

**Loan** A sum of money lent at interest.

**Management fee** The fee paid to a company for managing an investment portfolio.

**Market value** The amount a seller can expect to receive on the open market for merchandise, services or securities.

**Maturity** The time when a note, bond or other investment option comes due for payment to investors.

**Money market savings account** A type of savings account offered by a financial institution.

**Mortgage** A temporary and conditional pledge of property to a creditor as security for the repayment of a debt.

**Municipal bond** A bond issued by cities, counties, states and local governmental agencies to finance public projects, such as construction of bridges, schools and highways.

**Mutual fund** A pool of money managed by an investment company.



**Net worth** The difference between the total assets and total liabilities of an individual.

**Par value** The nominal, or face, value of a stock or bond, expressed as a specific amount on the security.

**Pretax** A person's salary before state and federal income taxes are calculated.

**Predatory lending** Targeting loans to elderly, low-income and other people to take advantage of their financial status or lack of financial knowledge.

**Prime rate** The lowest interest rate on bank loans, offered to preferred borrowers.

**Principal** The unpaid balance on a loan, not including interest; the amount of money invested.

**Promissory note** A written promise on a financial instrument to repay the money plus interest.

**Qualified plan** A tax-deferred retirement plan for the self-employed.

**Risk** The possibility of loss on an investment.

**Return** The profit made on an investment.

**Revenue bond** A type of municipal bond backed by revenue from the project the bond finances.

**Savings account** A service depository institutions offer whereby people can deposit their money for future use and earn interest.

**Stockholder** A person who owns stock in a company and is eligible to share in profits and losses; same as shareholder.

**Tax-deferred** Phrase referring to money that is not subject to income tax until it is withdrawn from an account, such as an individual retirement account or a 401(k) account.

**Term** The period from when a loan is made until it is fully paid.

**Terms** Provisions specified in a loan agreement.

**Treasury bill** A short-term investment issued by the U.S. government for a year or less.

**Treasury bond** A government security with a term of more than 10 years; interest is paid semiannually.

**Treasury note** A government security with a maturity that can range from two to 10 years; interest is paid every six months.

**U.S. savings bond** A nontransferable, registered bond issued by the U.S. government in denominations of \$50 to \$10,000.

Compiled, Enhanced, and Edited By George S. Mentz, Esq.  
(Attorney at Law) All Rights Reserved 2006 Revisions and Selected Sections wholly or in part by Prof. Mentz

## Appendix B - Expanded 100+ Page Wealth Management and Trust Glossary

**10b-10** SEC Rule requiring written confirmations for securities transactions. Equivalent to FDIC Part 344.

**12b-1** SEC Rule permitting mutual funds to use a portion of the mutual fund's assets for promotional expenses. The fund must be specifically registered as 12b-1 fund and disclose the existence and amount of such charges against the fund.

**13d** SEC Rule requiring a filing by any person acquiring a direct or indirect 5% interest in a registered stock.

**13f-1** SEC Rule requiring quarterly Form 13F reports by institutions holding more than \$100 million in discretionary equities.

**13g** SEC Rule requiring an annual filing by persons holding a direct or indirect 5% interest in a registered stock for passive investment purposes.

**17f-1** SEC Rule covering lost, stolen, counterfeit and missing securities certificates, and requiring banks and transfer agents to register with the Securities Information Center.

**114** Form 114 was an old designation for the Statement of Principles of Trust Department Management.

**156** SEC Rule governing mutual fund advertising and sales literature, and prohibiting false and misleading materials.

**401(a) Plan** A savings plan in which contributions are made in after tax dollars.

**401(h) Account** A separate account of a pension plan that, under Section 401(h) of the Internal Revenue Code, may be used to fund medical benefits for retirees and dependents.

**401(h) Plan** An employee benefit that provides, through a pension or annuity plan, for the payment of benefits for sickness, accident, hospitalization and medical expenses for retirees, their spouses and dependents, subject to certain restrictions.

**401(k) Plan** A defined contribution plan established by an employer which enables employees to make pretax contributions by salary reductions structured within the format of a cash or deferred plan.

**403(b) Annuity** An annuity that provides retirement income for employees of certain tax-exempt organizations or public schools. Also known as a tax-sheltered annuity.

**403(b) Plan** A defined contribution employee benefit plan established by certain tax-exempt organizations (such as charities) and public schools for their employees. Similar to a 401(k) plan.

**457 Plan** A deferred compensation plan for employees of state and local governments. Named after the governing section of the Internal Revenue Code, a portion of their income may be deferred and is not taxable until a distribution is made.

**501(c)(9) Trust** (1) Used by employers and jointly administered welfare funds to provide group employee benefits of the following types: medical, disability, term life insurance, severance compensation, vacation benefits, recreational facilities and unemployment compensation. These trusts are governed by Section 501(c)(9) of the Internal Revenue Code. (2) A type of self-insured or self-funded plan that is a tax exempt trust. Under its terms, both employer and employee contributions are paid into the fund, with claims and expenses paid out of it. Excess funds are invested as reserves by the fund's trustees. In a tax-qualified fund, the employer's deductions are immediately deductible, the trust's investment income is tax exempt, and employee contributions are not currently taxed. See also [VEBAs](#).

**Abatement** The reduction of a gift under a will because of insufficiency of assets to satisfy the gifts after the legal obligations of the estate (debts, taxes, charges, and claims) have been paid in full. The general rule is that all gifts of the same class shall abate proportionately, unless otherwise provided.

**ACCELERATED DEATH BENEFIT (ADB)** Provision in a life insurance policy that permits a terminally ill person get a percentage of the life insurance benefit from the life insurance company prior to death. See also [Viatical Settlement](#).

**Accounting** (1) The record of an account showing the transactions therein. (2) The submission of such a record to the court or to the beneficiaries of a trust or estate by the fiduciary.

**Active Trust** A trust regarding which the trustee has some active duty to perform; opposed to bare, naked, or passive trust.

**Actuary, Enrolled** See [Enrolled Actuary](#).

**ADA** Americans With Disabilities Act of 1990.

**ADB** See [Accelerated Death Benefit](#).

**Adequate Consideration** (1) For a security with a generally recognized market value: (a) the price of the security on a national securities exchange, or (b) if not traded on a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by current bid and asked prices quoted by persons independent of the issuer and of any party in interest; (2) for other assets, the fair market value of the asset as determined in good faith by a fiduciary.

**Adjusted Gross Estate** The value of an estate after all allowable deductions have reduced the gross estate, but before Federal estate taxes.

**Ad Litem** For the purpose of the suit.

**Administrator** An individual or a trust institution appointed by a court to settle the estate of a person who has died without leaving a valid will. If the individual appointed is a woman, she is known as an administratrix.

**Administrator Ad Litem** An administrator appointed by the court to supply a party to an action at law or in equity in which the decedent or his representative was, or is, a necessary party.

**Administrator Cum Testamento Annexo** (Administrator with the will annexed): An individual or a trust institution appointed by a court to settle the estate of a deceased person in accordance with the terms of his will when no executor has been named in the will or when the one named has failed to qualify.

**Administrator Cum Testamento Annexo De Bonis Non** (Administrator with the will annexed as to property not yet distributed): An individual or a trust institution appointed by a court to complete the settlement of the estate of a deceased person in accordance with the terms of his will when the executor or the administrator with the will annexed has failed to continue in office.

**Administrator De Bonis Non** (Administrator as to property not yet distributed): An individual or a trust institution appointed by a court to complete the settlement of the estate of a person who has died without leaving a valid will when the administrator originally appointed has failed to continue in office.

**Administrator with the will annexed** An individual or a trust institution appointed by a court to settle the estate of a deceased person in accordance with the terms of his will when no executor has been named in the will or when the one named has failed to qualify.

**Administratrix** See [Administrator](#).

**ADR** See [American Depository Receipt](#).

**Advance** See [Overdraft](#).

**Agency** An account in which the title to the property constituting the agency does not pass to the trust institution but remains in the owner of the property, who is known as the principal, and in which the agent is charged with certain duties with respect to the property.

**Agent** A person who acts for another person by the latter's authority. The distinguishing characteristics of an agent are (1) that he acts on behalf and subject to the control of his principal, (2) that he does not have title to the property of his principal, and (3) that he owes the duty of obedience to his principal's orders.

**Allocation** (1) The crediting of a receipt in its entirety or the charging of a disbursement in its entirety to one account, as to the principal account or to the income account; to be distinguished from apportionment. (2) A process that determines the optimum distribution of funds among various types of assets that offer the highest probability of consistently achieving investment objectives within a given risk tolerance. The process often uses a computer model to aid in processing a myriad of data.

**Allowance** (1) The sum or sums awarded a fiduciary by a court as compensation for its services; to be distinguished from charge, commission, and fee. (2) See Widow's Allowance. (3) Waiver by a beneficiary or other interested party of certain actions performed by the fiduciary which might not conform with instrument terms, local statutes, prudent practices, etc.

**Alpha** A numerical investment measure sometimes used as a performance indicator or to aid in selection of securities. Alpha is the premium an investment would be expected to earn if the market rate of return were equal to the Treasury bill rate, e.g., a premium of zero for the market rate of return.

A positive alpha indicates that you have earned on the average a premium above that expected for the level of market variability. A negative alpha indicates, on the average, a premium lower than that expected for the level of market variability. See also [Beta](#).

**AMBAC** American Municipal Bond Assurance Corporation.

**American Depository Receipts (ADR)** American certificates issued by an approved New York bank or trust company against the original (foreign) shares with a European branch of the New York institution. These receipts facilitate the financing of foreign companies in the United States. As foreign shares are deposited abroad, the equivalent ADR's change hands, not the certificates. This eliminates the actual shipment of stock certificates between the U. S. and foreign countries.

**American Option** An option that can be exercised any time during an exercise period.

**Amortization** With respect to bonds purchased at a premium, the process by which a part of the income is set aside as received to reduce gradually the amount by which the cost of the bond exceeds its face value.

**Ancillary** Subordinate or auxiliary to something or someone else; used in such terms as ancillary administration, ancillary administrator, and ancillary guardian.

**Annuity** (1) A contract that provides an income for a specified period of time or for life; (2) the periodic payments provided under an annuity contract, (3) the specified monthly or periodic payment to a pensioner.

**Annuity Certain** A contract that provides an income for a specified number of years, regardless of life or death. If an annuitant dies, the beneficiary will receive payments for the remaining number of specified years. Also called period certain, term certain or dollar temporary annuity.



**Annuity Contract** A contract in which an insurance company unconditionally undertakes a legal obligation to provide specified pension benefits to specific individuals in return for a fixed fee or premium. An annuity contract is irrevocable and involves the transfer of significant risk from the employer to the insurance company. Also called allocated contracts.

**Apportionment** The division or distribution of a receipt or a disbursement of property between or among two or more accounts, as between principal and income; to be distinguished from allocation.

**Approved List** A list, statutory or otherwise, which contains the authorized investments that a fiduciary may acquire.

**Arbitrage** A technique employed to take advantage of price differences in separate markets. This is accomplished by purchasing in one market for immediate sale at a better price in another market. Such transactions may be executed in the same type or similar types of securities.

**Assent** Written agreement with or approval of actions of a fiduciary which have already taken place.

**Assurance** (1) A pledge or guaranty of performance or protection from loss. Generally, prohibited for banks to give such a surety or indemnification. (2) A Canadian and British term for insurance.

**At-The-Money Option** An option whose exercise price equals the spot price of the underlying instrument.

**Attorney In Fact** A person who, acting as agent, is given written authorization by another person to transact business for him out of court; to be distinguished from attorney at law. See also [Power of Attorney](#).

**Authentication** Applied to bonds, the signing, by the trustee, of a certificate on a bond for the purpose of identifying it as being issued under a certain indenture, thus validating the bond.

**Back End Load** A sales charge due upon the sale, transfer or disposition of securities (usually mutual funds), partnership interests, annuities and life insurance.

**Bankers Acceptance** An irrevocable obligation of an issuing bank and the borrower whereby both are liable for payment. Used in domestic and international commerce to finance the shipment and storage of goods or to facilitate dollar exchanges with foreign banks. Bankers acceptances are issued in a wide variety of principal amounts. Maturities can be up to 180 days, but usually are for 30-60-90 days.

**Bank Investment Certificate** See [BIC](#).

**Basis** In futures and forwards, the difference between a futures contract price for an item and the current spot price of the same item.

**Basis Convergence** In futures and forwards, the phenomenon where the market value of a futures contract approaches the spot price for the underlying item as the delivery date nears.

**Basis Swap** A variable-for-variable interest rate swap.

**Beneficiary** (1) The person for whose benefit a trust is created. (2) The person to whom the amount of an insurance policy or annuity is payable.

**Bequeath** To give personal property by will; to be distinguished from devise.

**Bequest** A gift of personal property by will; a legacy.

**Best Execution** The principal whereby a trust department has a duty to obtain the most favorable possible performance of securities purchases and sales. This is generally done through the selection of a broker for a particular transaction. Given the size and type of the transaction, its complexity and where it is traded, the most favorable mix of at least the following factors must be obtained: (1) most favorable price, (2) lowest commission or equivalent, (3) prompt and accurate execution of orders, (4) prompt and accurate confirmation of orders, (5) prompt and accurate delivery of securities or proceeds. A broker's special abilities, access to, or knowledge of a particular type of investment or transaction could also impact on best execution.

**Beta** A numerical investment measure sometimes used as a performance indicator or to aid in selection of securities. Beta measures market sensitivity: the extent to which a portfolio fluctuates with the market as represented by the S&P 500. Beta is calculated by measuring the sensitivity of a fund's portfolio to market patterns. It is a statistical estimate of the average change in a fund's rate of return corresponding to a one percent change in the market. An investment with a Beta of 1 matched the market; a beta of 1.1 indicates 10% better performance than the market in up markets, 10% worse in down markets. See also **Alpha**.

**BIC** A "BIC" is a bank investment certificate. This is a large certificate of deposit sold to institutional investors, such as employee benefit plans. There is a facts-and-circumstances test as to whether FDIC insurance covers the instrument; if so, the first \$100,000 of the BIC is insured by FDIC, and pass-through deposit insurance coverage may also apply. A BIC is the deposit industry's equivalent of a "GIC". See also "[GIC](#)", "[Bullets](#)", and "[Windows](#)".

**Bid/Ask Spread** – The difference between the quoted bid (broker will buy stock) and the quoted ask or offer (broker will sell a stock).

**Bifurcation** The separation of gains and losses on investment transactions involving foreign currencies. For instance, the amount of profit attributable to the increase in the price of a German stock on the Frankfurt DAX Stock Exchange, as opposed to the amount of profit attributable to the change in the Deutsche Mark versus the dollar. Important for provisions of IRS Code 988.

**Blackout Period** Any period of more than 3 consecutive business days during which the ability of not fewer than 50 percent of the participants or beneficiaries under all individual account plans maintained by the issuer to purchase, sell, or otherwise acquire or transfer an interest in any plan is temporarily suspended by the issuer or by a fiduciary of the plan.

**Blue Sky Laws** State securities laws that attempt to ensure that the terms of securities offerings are fair, just and equitable and meet minimum standards of quality. Generally, certain information must be filed with a state's securities regulator before the security can be offered for sale within the state.

**Bond Anticipation Note** Short-term notes sold in anticipation of a bond issue and retired with the proceeds from the sale of the bonds.

**Bond Power** A form of assignment executed by the owner of registered bonds which contains an irrevocable appointment of an attorney in fact to make the actual transfer on the books of the corporation.

**Breach of Trust** Violation of a duty of a trustee to a beneficiary.

**Bullet** A term used with BIC's and GIC's when a lump sum of money is invested at a fixed interest rate, and repaid at maturity. Interest may be compounded or paid out periodically.

**Cafeteria Plan** An approach to offering health benefits to employees where the employee may select which benefits, and how much coverage within a type of benefit, they elect to have. Such plans enable employees to tailor benefits coverage to their own situation. Some plans require a common core of benefits. Sometimes, employee contributions are permitted for additional coverage. Also known as Flexible Benefit Plans and Flexible Compensation.

**Callable** A bond issue, all or part of which may be redeemed ("called") by the issuer prior to maturity. Specific terms in the bond indenture ensure that the bonds may not be called prior to the call date(s). Call provisions in the indenture also set the price at which the bond may be called; to compensate for this privilege, a price above par is usually paid.

**Call Option** Option to buy shares of a certain stock within a given period of time at a specific price fixed in the contract.

**Cap** An option contract that protects the holder from a rise in interest rates or some other underlying index beyond a certain point.

**Cash Balance Plans** a defined benefit plan which defines benefits in terms of a stated "account balance," as opposed to a specific monthly benefit for life under traditional defined benefit pension plans. In this type of plan, employers credit a participant's account each year with a "pay credit" (typically based on a percentage of compensation) plus an "interest credit" (either a fixed rate, or a rate which is linked to an index, such as the one year treasury bill rate). When a participant retires under a cash balance plan, he or she is entitled to the balance of his or her vested benefit (similar to a defined contribution plan), which may be taken as an annuity or in a lump sum. This is opposed to retirements under traditional defined benefit pension plans, where retirees are entitled to lifetime monthly annuities based upon years of service and pay.

**Cash Equivalents** Short-term investments held in lieu of cash and readily converted into cash within a short time-span (i.e. Certificates of Deposit, commercial paper, Treasury bills, etc.).

**Cede and Company** The name of the nominee partnership for securities held at Depository Trust Company, New York.

**Cemetery Trust** A trust which has as its purpose the upkeep of a grave, burial plot, or cemetery.

**Cesop** (Tax) Credit ESOP.

**Cestui Que Trust** (plural, cestuis que trust) A person for whose benefit a trust is created; a beneficiary.

**Charge** The price fixed or demanded by a trust institution for service; compensation which a trust institution has a legal right to fix (in the form of either a commission or a fee), in contrast to an allowance which is granted by a court. See also [Allowance](#), [Commission](#), and [Fee](#).

**Chesop** Charity ESOP.

**Chinese Wall** A policy barrier between the trust department and the rest of the bank designed to stop the flow of non-public information for the purpose of preventing use by the trust department of any material inside information, which may come into the possession of other bank departments, in making investment decisions.

**CIF** See [Collective Investment Fund](#).

**Clifford Trust** See [Short-Term Trust](#).

**Cliff Vesting** Full (100%) vesting after  $x$  years of service. Benefits must be 100% vested after not more than 5 years of service, except in collectively bargained plans, where the maximum period is 10 years.

**Closed End Mutual Fund** A mutual fund which is limited in the number of shares outstanding. The shares are traded on a securities exchange or the over-the-counter market. The value is determined by bid and asked prices in the open market.

**COBRA** The Consolidated Budget Reconciliation Act of 1985.

**CODA** Cash or Deferred Arrangements. A term associated with certain employee benefit plans where the employee is given a choice of receiving an employer contribution in cash or having it deferred under a plan and/or the choice of making his or her own contribution to the plan from before-tax income. Most CODA's are either cash or deferred profit sharing plans or thrift and savings plans.

**Codicil** An amendment or supplement to a will executed with all the formalities of the will itself.

**Collar** An upper and lower limit on the coupon of a floating rate note. The issuer pays a premium for the collar.

**Collateral Heir** A person not in the direct line of the decedent from whom he inherits real property, as, for example, a nephew of the decedent who receives a share of his uncle's estate.

**Collective Investment Fund** A pooled fund, operated by a bank or trust company in conformity with Section 9.18 of OCC Regulation 9 or Revenue Ruling 81-100, for investment of the assets of separate trust accounts.

**Commercial Paper** - Negotiable, short-term, unsecured promissory notes issued in bearer form on a discount or coupon basis by a corporation to raise working capital, for up to 270 days term. A direct obligation of the issuer, it is sold in multiples of \$25,000 and is rated by Standard & Poor's (A-1, A-2, and A-3) and Moody's (Prime 1, Prime 2, and Prime 3). Interest is paid at maturity. Payment is required in Federal Funds on settlement date (usually at the buyer's option) and payment is required by Federal Funds on the maturity at the issuer's bank. The principal types are Prime Finance Paper issued by sales finance companies and certain large bank holding companies, Prime Industrial Paper issued by leading industrial companies, and Finance Paper of less-than-prime quality. For Prime Finance Paper, investors may specify both the issue and maturity dates. For Prime Industrial Paper, only those maturities listed on the market are available.

**Commission** A percentage of the principal or of the income or of both which a fiduciary receives as compensation for its services; to be distinguished from allowance, charge, and fee.

**Committee for incompetent** An individual or a trust institution appointed by a court to care for the property or the person (or both) of an incompetent; similar to a guardian, conservator, or curator.

**Common Law** The legal system prevailing in the English-speaking countries - that is, the United States of American and the British Commonwealth of Nations. It originated in England and its form of development was different from that of Roman (civil) law. Compare Civil Law.

**Common Trust Fund** A fund maintained by a bank or a trust company exclusively for the collective investment and reinvestment of money contributed to the fund by the bank or trust company in its capacity as trustee, executor, administrator, or guardian and in conformity with the rules and regulations of the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks, as well as with the statutes and regulations (if any) of the several states.



**Community Property** Property in which a husband and wife have each an undivided one-half interest by reason of their marital status; recognized in all civil law countries and in certain states of the Southwest and Pacific Coast area of the United States.

**Compliance Risk** The risk that non compliance with laws and regulations can lead to financial loss and/or damage to the institution's reputation.

**Compound Option** One type of option contract. It is an option, such as a put on a call, a call on a put, a put on a put, or a call on a call.

**Conservator** (1) Generally, an individual or a trust institution appointed by a court to care for property. (2) Specifically, an individual or a trust institution appointed by a court to care for and manage the property of an incompetent person, in the same way as a guardian cares for an manages the property of a minor.

**Contingent Liability** (1) For FDIC Trust Examinations: an estimate by the examiner of the gross possible liability of the institution resulting from the purchase of nonconforming investments for trust accounts, unwarranted retention of nonconforming assets, self-dealing, questionable practices and procedures, or other acts of omission or commission which appear not to comply with the terms of governing trust instruments or provisions of law and on which an accounting may be subject to objection by appropriate parties. Until appropriate consents, waivers or releases of liability are obtained from interested parties or nonliability is determined by a court of competent jurisdiction, the liabilities are regarded as "contingent." (2) A liability which is dependent upon certain events occurring before it becomes an active liability.

**Contractual Derivative** These investment instruments represent a one-of-a-kind arrangement between two parties and include swaps, floors, collars, and swaptions. They are not standardized contracts nor do they trade on a regulated exchange. While they offer enticing return potential, some carry high degrees of both market risk and income risk. Because they are not standardized or exchange traded, they are subject to valuation risk (the potential for inaccurate pricing) and liquidity risk (the potential that it cannot be sold at a reasonable price). See also [Derivatives](#).

**Conversion** (1) In law, wrongful appropriation to one's own use of the property of another. (2) In equity, the change of property from one form to that of another (as from real property to personal property, or the reverse) which is considered to have taken place even though no actual exchange has been effected.

**Corporate Depository** A trust institution serving as the depository of funds or other property. See also [Depository](#), and [Depository](#).

**Corporate Fiduciary** A trust institution serving in a fiduciary capacity, such as executor, administrator, trustee, or guardian.

**Corporate Trust** A trust created by a corporation, typical of which is a trust to secure a bond issue.

**Corpus (Body)** The principal or capital of an estate, as distinguished from the income.

**Counterparty** A principal party to a transaction, other than an intermediary. When looked at from the buyer's viewpoint, the seller is the counterparty and vice versa.

**Court Account** Accounts which require court accountings and approval in their normal conduct. Probate, guardianship, conservatorship, and testamentary trust accounts are the most common.

**Covered Call** A type of stock option in which a trust account sells to a third party the right (the option) to purchase a specific stock (the call) at a specific price until a specific expiration date. Possession of the stock by the trust account (covered) is the final element for a covered call option. It is different from a naked call option, in which the trust account does not own the stock.

**Covered Put** A type of option on an instrument or commodity in which the writer has a short position.

**Credit Risk** Credit risk is the possibility of loss due to a counterparty's or an issuer's default or inability to meet contractual payment terms. Default exposes the holder of the instrument to the cost of replacing the instrument under present market conditions. The amount of credit risk equals the replacement cost (also known as current exposure) of an identical instrument. The replacement cost is established by assessing the instrument's current market value rather than its value at its inception.

**Crown Loan** Refers to an interest-free or below-market-rate term or demand loan, viewed by the IRS as a taxable gift to the borrower. Name stems from the *L. Crown* case at the U.S. Court of Appeals for the Seventh Circuit [84-1 USTC]. Current precedent is Supreme Court case involving E.C. Dickman [84-1 USTC]. Refer to Section 7872 of the Internal Revenue Code and also to Revenue Procedure 86-46 (8-26-85), IR 85-86, and Announcement 85-132.

**Crummey Trust** A type of unfunded insurance trust. The trust acts as owner of a life insurance policy. The trust receives the donor's cash payments on a periodic basis, from which the beneficiary of the trust has a specified period to make a cash withdrawal. If this is not done, the cash paid by the donor is used to pay the premiums due on the life insurance policy. The IRS has ruled that such an arrangement represents a gift of present value interest has been made by the donor. Since it is a gift of present value, the donor may contribute up to \$10,000 (\$20,000 if two donors, such as husband and wife contribute) per year in premium payments and enjoy the gift tax exclusion. When the donor dies, the life insurance policy in the trust is effectively removed from the donor's estate.

**Curator** An individual or a trust institution appointed by a court to care for the property of a minor or an incompetent person. In some states a curator is essentially the same as a temporary administrator or a temporary guardian.

**Currency Coupon Swap** A variation of a currency swap in which one party's interest payments are variable-rate. Essentially a combination of a currency swap and an interest rate swap.

**Currency Swap** A swap contract in which two counterparties agree to exchange principal and interest denominated in different currencies based on an agreed-upon currency exchange rate.

**Cusip** Acronym for Committee on Uniform Security Identification Procedures. Standardized numbering system begun in 1968 for identifying individual issues of equity and debt securities in the United States and Canada to facilitate compatible automated processing by multiple organizations (banks, brokers, etc.). Not all issues meet the criteria for issuance of a CUSIP number. System operated by the CUSIP Service Bureau, a part of the Standard and Poor's Corporation. See also [FINS](#).

**Custody Account** An agency account concerning which the main duties of the custodian (agent) are to keep safe and preserve the property and to perform ministerial acts with respect to the property as directed by the principal. The agent has no investment or managerial responsibilities. To be distinguished from managing agency account and safekeeping account.

**Cy-Pres Doctrine** Cy-pres means "as nearly as may be." The doctrine, applied in English and Scots law and in some of the states of the United States, that, where a testator or settlor make a gift to or for a charitable object that cannot be carried out to the letter, the court will direct that the gift will be made as nearly as possible, in its judgment, in conformity with the intention of the donor.

**Daily Settlement** In futures and forwards, the process where futures participants are charged for their losses or credited for their gains at the end of each trading day.

**Debenture** A general debt obligation backed only by the integrity and net worth of the issuer. An obligation that is not secured by a specific lien on property, as an unsecured note of a corporation.

**Deed** - A written instrument, signed, sealed, and delivered according to applicable law, containing some transfer, bargain, or contract with respect to property. The common term for an instrument transferring the ownership of property.

**Deed of Trust** - A sealed instrument in writing duly executed and delivered, conveying or transferring property to a trustee. This is usually real property.

**Default** With regard to a bond or promissory note, the failure to make a payment either of principal or interest as or when due.

**Defective Trust** A trust designed that income taxes are paid outside of the trust by the grantor. The most commonly used provision allows the grantor the power to substitute property he or she owns for equally valued trust property.

**Defeasement** A type of municipal debt financing which enables the issuing government entity to reduce the amount of interest it pays on existing outstanding bonds. As an example, an entity that has high-rate outstanding bonds issues new debt at a lower rate. The proceeds are used to buy Treasuries, which pay enough interest to pay the interest on the old outstanding bonds. The Treasuries can be sold when the old bonds reach their call date, providing a source of funds to retire the old debt. The net effect is the government entity pays less on a current basis.

**Deferred Payment Swap** A swap that requires payments to be made at a later date than the date at which the payments are determined.

**Defined Benefit Plan** A pension plan which guarantees the payment of a specified benefit at retirement age and provides annual contributions equal to an actuarially determined amount sufficient to produce the specified benefit.

**Defined Contribution Plan** A pension plan which provides for an individual account for each participant and for benefits based upon the amount contributed to the participant's account including any income, expenses, gains, or losses. See also [Individual Account Plan](#), [Money Purchase Plans](#), [Profit Sharing Plans](#), [Target Plans](#), and [Employee Stock Ownership Plans](#) (ESOP's).

**DEFRA** Deficit Reduction Act of 1984. One part of this act was the Tax Reform Act of 1984. Another part was the Spending Reduction Act of 1984.

**Depletion** The consumption or exhaustion of wasting property - such as, royalties, patent rights, mines, oil and gas wells, quarries, timberlands, and other things that are consumed or worn out in the sing.

**Deposit Administration Contract** A funding contract with an insurance company in which an unallocated account is kept for active participants. Annuities are purchased for employees when they retire.

**Depository** One who receives a deposit of money, securities, instruments, or other property; to be distinguished from depository, which is the place of deposit.

**Depository** A place where something is deposited, such as a safe deposit vault. See [Securities Depository](#).

**Derivative** A financial contract whose value is designed to track the return on stocks, bonds, currencies, or some other benchmark. Generally, derivatives fall into two broad categories: forward-type contracts and option-type contracts. They may be traded on exchanges or traded privately. See also [Contractual Derivatives](#), [Security-Based Derivatives](#), and [Synthetic Derivatives](#).

**Determination Letter** A letter issued by the District office of the Internal Revenue Service which states whether a plan meets the qualification requirements under the Internal Revenue Code. Requesting an IRS Determination Letter is not an IRS requirement and is optional with the plan sponsor.

**Devise** A gift of real property by will; to be distinguished from bequest.

**Devisee** A person to whom a devise is given.

**Direct Heir** A person in the direct line of ascent or descent of the decedent; as, father, mother, son, daughter.

**Directed Trust** One under which a trustee has less than full managerial authority because another party or parties has the power to control some of the trustee's actions. Normally, this involves the investments of an employee benefit plan. Often, this direction is provided by an outside investment manager, a "named fiduciary", or the individual participant.

**Disbursement** Money paid out in discharge of a debt or an expense; to be distinguished from distribution.

**Disqualified Person** Term defined in Section 4975(e)(2) of the Internal Revenue Code that is roughly equivalent to ERISA's *party in interest*, but also includes highly-compensated employees. See [Party in Interest](#).

**Distribution** The apportionment of personal property (or its proceeds) among those entitled to receive the property according to the applicable statute of distribution or under the terms of the will or trust agreement; to be distinguished from disbursement.

**DOL** Department of Labor.

**Domicile** The place which a person regards as his permanent home and principal establishment; the place to which, whenever he is absent, he has the intention of returning. A person's domicile may or may not be the same as his residence at a given time. See also [Residence](#).

**Donor** One who makes a gift.

**DTC** Depository Trust Company, New York City. A noninsured limited-purpose state chartered trust company which is a member of the Federal Reserve System. Securities certificates belonging to a variety of financial institutions (banks, trust companies, broker-dealers, mutual funds, etc.) are kept at DTC, with transfers between "depositors" accomplished by bookkeeping entry. This greatly reduces the volume of physical transfers which must be made within the securities industry.

**DRP** Dividend Reinvestment Plan.

**Duration** A numerical measure of the price change of a bond due to a change in its yield to maturity. Duration summarizes the various characteristics that cause bond prices to fluctuate in response to interest rate changes. The lower the duration number, the less change that can be expected in a bond's price.



**Education IRA** is not a retirement arrangement. It is a trust or custodial account established for the purpose of paying "qualified higher education expenses" of the designated beneficiary at an "eligible educational institution." Up to \$500 per year can be contributed to an Education IRA. Contributions to the IRA are taxable. Investments grow tax free until distributed. If withdrawals are less than the beneficiary's "qualified higher education expenses," the withdrawals are tax free. Any portion of a withdrawal that is greater than the beneficiary's educational expenses is taxable to the beneficiary.

**Eleemosynary** Pertaining or devoted to legal charity; as an eleemosynary institution.

**Embedded Derivatives** Derivatives that are part of another financial instrument. For example, a callable bond consists of the bond and a call option. The call option is the embedded derivative.

**Employee Benefit Security Administration** This office was formerly known as the Pension and Welfare Benefits Administration, PWBA, and is a part of the U. S. Department of Labor.

**Employee Benefit Plan** A plan established or maintained by an employer or employee organization, or both, for the purpose of providing employees a certain benefit, such as pension profit-sharing, stock bonus, thrift medical, sickness, accident, or disability benefits.

**Employee Stock Ownership Plan** An employee benefit account in which employees may become stockholders of the employer. These plans are qualified under the Internal Revenue Code and are not subject to the 10% ERISA limits on holdings of employer stock. Typically, an employer's contributions to an ESOP are used to purchase existing or new shares of the employer's stock, thus providing a means for the employer to raise new capital while, at the same time, getting a tax deduction for the annual contributions. When such purchases are from insiders, the IRS has special requirements concerning the valuation of the stock's price. Often, ESOP's involve borrowing funds by the ESOP with which to purchase employer stock; such plans are termed "leveraged" ESOP's. When speaking of the trust account, ESOP's are sometimes called ESOT's: Employee Stock Ownership Trusts. See also [CESOP](#), [CHESOP](#), [PAYSOP](#), and [TRASOP](#).

**En Ventre Sa Mere** "In mother's womb" - a child conceived but not yet born.

**Enrolled Actuary** A person who performs actuarial services for an employee benefit plan which is subject to ERISA and who is enrolled with the federal Joint Board for Enrolling Actuaries. ERISA plans may use only Enrolled Actuaries to perform services for the plan.

**ERISA** An acronym for the Employee Retirement Income Security Act of 1974 which set up federal minimum standards for employee benefit plans, including standards regulating the conduct of plan fiduciaries and trustees. The Act also established an insurance program designed to guarantee workers receipt of pension benefits if their defined benefit pension plan should terminate.

**ERTA** Economic Recovery Tax Act of 1981. Expanded IRA and Keogh plan availability. Covered specific areas of employee compensation, including incentive stock options, deductible voluntary employee contributions, tax credit ESOP's, and withdrawal provisions in savings/thrift plans.

**Escheat** The reversion of property to the state (in the United States) in case there are no devisees, legatees, heirs, or next of kin; originally applicable only to real property but now applicable to all kinds of property.

**Escrow** Money, securities, instruments, or other property or evidences of property deposited by two or more persons with a third person, to be delivered on a certain contingency or on the happening of a certain event. The subject matter of the transaction (the money, securities, instruments, or other property) is the escrow; the terms upon which it is deposited with the third person constitute the escrow agreement; and the third person is termed the escrow agent.

**Escrow Agent** See [Escrow](#).

**ESOP** See [Employee Stock Ownership Plan](#).

**ESOT** See [Employee Stock Ownership Plan \(Trust\)](#).

**Estate** (1) The right, title, or interest which a person has in any property; to be distinguished from the property itself, which is the subject matter of the interest. (2) The property of a decedent.

**Estate Tax** A tax imposed on a decedent's estate as such and not on the distributive shares of the estate or on the right to receive the shares; to be distinguished from an inheritance tax.

**Estimated Loss** For FDIC Trust Examinations: an estimate by the examiner of the amount of loss which appears certain to be sustained by the institution as a result of its fiduciary activities.

**ETI** Acronym used by the Labor Department in ERISA Interpretive Bulletin (IB) 94-1 for Economically Targeted Investment. See [Social Investing](#).

**Eurobond** A bond denominated in U.S. dollars (or another currency) and sold to investors outside the country whose currency is used. An example might be a bond denominated in German Deutsche Mark but issued by a Dutch company and sold to Swiss investors.

**Eurodollar Certificate of Deposit** A certificate of deposit issued by banks outside the U.S., primarily in Europe, with interest and principal paid in dollars. Such CDs usually have minimum denominations of \$100,000 and short-term maturities of less than two years. Interest rates are usually pegged to [LIBOR](#).

**European Option** An option that can only be exercised on the expiration date.

**Event of Default** The non-occurrence or non-performance of something called for in a bond indenture. Examples of events of default are: (1) nonpayment of interest, (2) nonpayment of principal, (3) failure to make payments into a sinking fund, (4) filing of bankruptcy or reorganization, (5) nonpayment of a prior lien obligation, (6) failure to perform any obligation called for in the indenture (such as provide financial statements, insurance, proof of tax payments, etc.).

**Excess Benefit Plan** A non-qualified plan maintained by an employer solely for the purpose of providing benefits for certain employees in excess of those which, because of Internal Revenue Code limitations on contributions and benefits, can be provided by the employer's qualified plan.

**Exculpatory Provision** A provision in a will or trust instrument relieving or attempting to relieve an executor or trustee from liability for breach of trust; sometimes called an immunity provision.

**Executor** An individual or a trust institution nominated in a will and appointed by a court to settle the estate of the testator. If a woman, she is an executrix.

**Executor De Bonis Non** The individual or corporation named in the will to take over and complete the settlement of an estate in those cases in which the original executor, for one reason or another, has failed or been unable to do so. Unless the testator himself names such a successor executor, the court appoints an administrator de bonis non.

**Executrix** See [Executor](#).

**Exercise Period** The period of time during which an option may be exercised.

**Expiration Date** The last day an option can be exercised.

**Express Trust** A trust stated orally or in writing, with the terms of the trust definitely prescribed; to be distinguished from a resulting trust and a constructive trust.

**Family Incentive Trust**– Twist on an irrevocable family trust. Assets enter the trust in the normal fashion. However, there is specific language as to how funds may be taken out of the trust. The purpose of the trust is to provide an incentive for the beneficiary to lead a productive life. The trusts also contain a safety-net so a beneficiary will not become destitute. Examples of what distribution provisions include are (1) Matching earnings dollar for dollar, (2) Paying a parent for staying home with the children, (3) Paying an amount for completing a higher education, and (4) Starting a new business.

**FAS** Financial Accounting Standard. Authoritative accounting pronouncement on handling different specific accounting situations. Issued by FASB.

**FAS 87** Statement issued by FASB covering employer accounting for pensions.

**FAS 106** Statement issued by FASB requiring employers to record on their balance sheets the future financial liability they incur by promising health benefits to retirees.

**FASB** Financial Accounting Standards Board. Non-governmental authority for establishing accounting standards in the United States.

**Fee** (1) Fixed amount which a trust institution receives as compensation for its services; to be distinguished from allowance, charge, and commission. (2) An estate of inheritance in real property, sometimes referred to as an estate in fee or fee simple estate.

**Fee Simple** An estate of inheritance without limitation to any particular class of heirs and with no restrictions upon alienation; sometimes known as fee simple absolute; the largest interest or estate in real property a person may own.

**Fiduciary** An individual or a trust institution charged with the duty of acting for the benefit of another party as to matters coming within the scope of the relationship between them. The relationship between a guardian and his ward, an agent and his principal, an attorney and his client, one partner and another partner, a trustee and a beneficiary, each is an example of fiduciary relationship, See also ERISA Section 3(21)(A).

**FINS** Acronym for Financial Industry Number Standard. Standardized numbering system for identifying individual institutions (brokers, banks, transfer agents) in the securities industry in the United States and Canada to facilitate compatible automated processing in multiple organizations. FINS Numbers issued by Depository Trust Company, New York City. See also [CUSIP](#).

**Fiscal Agent** (1) An agent for a corporation to handle specified matters relating to taxes in connection with an issue of bonds. (2) An agent for a national, state, or municipal government or government body to pay its bonds and coupons or to perform certain other duties related to financial matters.

**Flexible Benefit Plan/Flexible Compensation** See [Cafeteria Plan](#).

**Flexible Spending Accounts or Arrangements** Employee benefit which gives employees a choice between taxable cash and nontaxable compensation in the form of payment or reimbursement of eligible, tax-favored benefits. FSAs can be funded through salary reduction, employer contributions, or a combination of the two. Employees can purchase additional benefits, pay health insurance deductibles, and copayments, or pay for child care benefits with FSAs.

**Floater** A floating rate instrument that pays interest at a rate that adjusts periodically, relative to a spread over a specific benchmark or index.

**Floor** An option contract that protects the holder against a decline in interest rates or some other underlying below a certain point.

**Form Adv** Form used to apply for registration as an investment advisor or to amend a registration. It consists of two parts. Part I contains general and personal information about the applicant. Part II contains information relating to the nature of the applicant's business, including basic operations, services offered, fees charged, types of clients advised, educational and business backgrounds of associates and other business activities of the applicant.

**Forward Contract** A cash market transaction in which two parties agree to the purchase and sale of a commodity at some future time under such conditions as the two agree. In contrast to futures contracts, the terms of forward contracts are not standardized. A forward contract is not transferable and usually can be cancelled only with the consent of the other party, which often must be obtained for consideration and under penalty. Forward contracts are not traded in federally designated contract markets.

**Forward-Start Swaps** An agreement that includes a deferred start date before the swaps' interest payments are exchanged.

**Fourth Market** The trading of securities directly from one institutional investor to another without the services of a brokerage firm.

**Fractional Share Bequest** A bequest of property, often made in connection with the establishment of a marital deduction trust, that is expressed in terms of a proportion of the assets involved rather than in terms of a specific dollar amount.

**Freddie Mac** Trade name for the Federal Home Loan Mortgage Corporation.

**Front-End Receipt Swaps** Also known as off-market swaps. A swap in which one party receives an amount equal to the present value of a future fixed rate swap payment now rather than at the respective periodic payment dates.

**Front Running** A practice where an investment manager purchases securities for his/her own personal interest prior to an anticipated purchase of the same securities by the accounts for which he/she acts as investment manager.

**Funded Insurance Trust** An insurance trust in which, in addition to life insurance policies, cash and securities have been placed in trust to provide sufficient income for the payment of premiums and other charges on or assessments against the insurance policies.

**Futures Contract** A transferable agreement to make or take delivery of standardized minimum quality grades, during a specific month, under terms and conditions established by a federally designated contract market upon which trading is conducted.

**General Account** An undivided fund maintained by an insurance company that commingles plan assets with other assets of the insurance company for investment purposes. Funds held by an insurance company that are not maintained in a *separate* account are in its *general* account.



**General Obligation (GO) Bond** A type of municipal bond that is backed by the full faith, credit and taxing power of the issuer for payment of interest and principal. Its sale finances public improvements. It is repaid by taxes.

**General Partner** A person who usually is actively engaged in the trade or business of the partnership and has unlimited personal liability in the partnership.

**General Partnership** A form of business whose partners include only general partners. Profits, losses and deductions are passed through to the individual partners involved in the business.

**Generally Accepted Accounting Principles(GAAP)** Uniform minimum standards of and guidelines to financial accounting and reporting, which govern the form and content of financial statements. GAAP encompass principles necessary to define accepted accounting practice at a particular time and include detailed procedures as well as broad guidelines.

**Generation-Skipping Tax** A tax imposed on any testamentary generation-skipping transfer, with the intention that this tax be substantially equal to the transfer tax which would have been payable if the property had actually been transferred outright to each generation.

**Generation-Skipping Trust** Any trust having beneficiaries who belong to two or more generations younger than the grantor.

**GIC** A "GIC" is a guaranteed investment contract, normally offered by insurance companies. It is similar to a financial institution's certificate of deposit in that it provides a guaranteed rate of return over a specified period. GIC's are normally used by institutional investors, such as employee benefit plans. GIC's are dependent upon the financial soundness of the issuing insurance company for their repayment. See also "[BIC](#)", "[SLIC](#)", "[Synthetic GIC](#)", "[Bullets](#)", and "[Windows](#)".

**Gift Causa Mortis** A gift of personal property made by a person in expectation of death, completed by actual delivery of the property, and effective only if the donor dies; to be distinguished from gift inter vivos.

**Gift Tax** A tax imposed by the Federal Government since 1932 and by some states on transfers of property by gift during the donor's lifetime. Gifts, under this law, may include irrevocable living trusts.

**Ginnie Mae** Colloquial for Government National Mortgage Association.

**Going Concern Value** A valuation approach used by appraisers. It implies that a company is actively and profitably in business and, therefore, should be valued on that basis rather than on the liquidation of its assets.

**Government National Mortgage Association (GNMA)** A wholly-owned government corporation within the Department of Housing and Urban Development (HUD). Also known colloquially as Ginnie Mae.

**Governmental Plan** An employee benefit plan established or maintained by the employees of the U.S. government or any state or political subdivision thereof or by any agency or instrumentality of the foregoing.

**Grantor** A person who transfers property by deed or who grants property rights by means of a trust instrument or some other document. See also [Settlor](#).

**Grantor Trust** For purposes of the income taxation of trusts and estates, a trust in which the grantor or a third party, because of certain rights to income or principal or certain power over the disposition of income and principal, is treated as the owner of the trust and taxed on the income thereof. Consequently, a grantor trust is not treated as a separate entity for income tax purposes.

**GRIT** Acronym for a grantor retained income trust, which is an irrevocable trust to which a residence is transferred for a term of years, with the grantor retaining the use of the residence for that term. At the end of the term, the residence becomes the property of the remainder beneficiary. The present value of the retained interest is not taxed for transfer tax purposes. The present value of the retained interest is the sum of: (1) the value of an income interest for the specified term, and (2) the present value of the contingent right to receive the value if the grantor dies during the specified term.

**Guaranteed Investment Contract** See "[GIC](#)"

**Guardian** An individual or a trust institution appointed by a court to care for the property or the person (or both) of a minor or an incompetent person. When the guardian's duties are limited to the property, he is known as a guardian of the property; when they are limited to the person, he is known as a guardian of the person; when they apply both to property and to the person, he is known merely as a guardian. In some states the term committee, conservator, curator, or tutor is used to designate one who performs substantially the same duties as those of a guardian.

**Guardian Ad Litem** A person appointed by a court to represent and defend a minor or an incompetent person in connection with court proceedings; sometimes called a special guardian.

**Hard Dollars** Goods or services purchased with cash are said to be purchased with "hard" dollars. Purchases made with brokerage commissions are said to be made with "soft" dollars.

**Health Stock Ownership Plan (HSOP)** Combination of an employee stock ownership plan (ESOP) and a 401(h) account. HSOPs allow the sponsor to provide for retiree medical benefits for its current employees without having to accrue such future liabilities currently for financial accounting purposes.

**Hedging** The temporary purchase and sale of a contract calling for future delivery of a specific quantity of a particular commodity at an agreed-upon price to offset a present (or anticipated) position in the cash market. An operation intended to protect against loss in another operation.

**Heir** A person who inherits real property; to be distinguished from next of kin and from distributee. An heir of the body is an heir in the direct line of the decedent. A son, for example, is the heir of the body of his father or mother. See also [Collateral Heir](#); [Direct Heir](#); [Next of Kin](#).

**Hereditament** Any kind of property that is capable of being inherited. If the property is visible and tangible, it is a corporeal hereditament; if it is not, it is an incorporeal hereditament -- for example, a right to rent or a promise to pay money.

**HH Bonds** Effective August 31, 2004. Series HH bonds are no longer offered. HH bonds issued prior to that date pay a fixed rate of interest based on market rates at the time of issuance. Interest is paid semi-annually and the bonds have a maturity of 20 years after date of issuance.

**Highly Compensated Employee (HCE)** Any employee who, during the current or preceding plan year: (1) owned more than 5% of the company; or (2) received more than \$80,000 (indexed) in annual compensation, and was in the top 20% of employees ranked on the basis of annual compensation, under Section 414(q) of the IRC; or, (3) was an officer of the company earning more than the defined benefit limit under Section 415 of the IRC. Discrimination in favor of this group is prohibited. For 2005, highly compensated employees are those earning \$95,000 or more.

**Highly Compensated Individual** For purposes of IRC § 105(h), (1) one of the five highest paid officers, (2) a 10% owner or (3) an employee who is among the highest 25% of all employees (other than the 10% owners who are not participants).

**Highly Compensation Participant** Under IRC § 125(e), an officer, a more-than-5% shareholder, a highly compensated employee, or a spouse or dependent of one of the former.

**Holographic Will** A will entirely in the handwriting of the testator.

**Hours Worked** Standard hours worked in a year is 2,080 (52 weeks x 40 hours per week).

**HR 10 Plan** See [Keogh Plan](#).

**HSOP** See [Health Stock Ownership Plan](#).

**Hurdle Rate** A minimum standard rate of return for acceptability as an investment.

**Hybrid Pension Plan** A qualified retirement plan that has characteristics typical of both defined benefit and defined contribution plans.

**Immunization** The design of a bond portfolio to achieve a target level of return in the face of changing reinvestment rates and price levels. It is the combining of short- and long-term bonds in the same portfolio to produce a predictable rate of return regardless of movements in interest rates.

**Income** The return from property, such as rent, interest, dividends, profits, and royalties; opposed to principal or capital.

**Income Beneficiary** The beneficiary of a trust who is entitled to receive the income from it.

**Incorporeal Hereditament** See [Hereditament](#).

**Indemnity** Protection or exemption from loss or damage.

**Indenture** (1) A mutual agreement in writing between or among two or more parties whereof usually each party has a counterpart or duplicate; originally so called because the parts were indented by a notched cut or line so that the two parts could be fitted together.

(2) A legal document prepared in connection with a bond issue describing the terms of the issue, such as a security, maturity date, interest rate, and remedies in case of default.

**Index Amortizing Swaps** Swaps that operate as basic swaps for an initial period, after which time the notional principal balance is amortized or extended based on a schedule linked to interest rate changes or some other index during the interim period.

**Index Fund** A collective investment fund or common trust fund which is composed of securities which are intended to duplicate the returns of a designated securities index, such as the Standard & Poor's 500 stock index. Not all of the securities which make up the designated index need to be in an index fund.

**Individual Account Plan** A defined contribution plan that allows participants to choose, from a broad range of investment options, how their own accounts will be invested. See also [Defined Contributions Plan](#) and [Money Purchase Plan](#).

**Individual Retirement Account (IRA)** A retirement savings program for individuals to which yearly tax deductible contributions up to a specified limit can be made. The amounts contributed are not taxed until withdrawal. Withdrawal is not permitted, without penalty, until the individual reaches age 59 1/2.

**Infant** A person not of legal age, which at common law was 21 years but which in some states has been changed by statute; the same as a minor.

**Inheritance Tax** A tax on the right to receive property by inheritance; to be distinguished from an estate tax.

**Initial Margin** In futures and forwards, the amount of cash that must be deposited with a broker when a futures position is initiated.

**Initial Public Offering (IPO)** The original sale of a company's securities to the public.

**In-Kind Transfer** - A distribution of property (e.g., stock, bond, partnership, etc.) from a trust or estate other than in cash. Noncash contributions to a trust or estate are also "in-kind" transfers.

**Insurance Guaranty Fund** A fund maintained by a state guaranty association which pay claims of insolvent insurance companies. The fund is financed by contributions from insurance companies.

**Insurance Trust** A trust composed partly or wholly of life insurance policy contracts.

**Insured Pension Plans** Retirement and other employee benefit plans the source of the benefits of which is life insurance paid for wholly or partially by the employer.

**Inter-Account Transaction** Transactions in which a trust department sells assets directly from one account to another, bypassing a non-affiliated third party broker. This form of transaction should be permissible under local law and the governing instrument, and it should be covered by written policy. Fiduciaries engaging in this type of activity place themselves in an onerous conflict of interest position. They must be capable of demonstrating to each party to the transaction that it simultaneously sold an asset at the highest fair market value, and purchased it at the lowest fair market value. Generally, management should be cautioned against engaging in these transactions.

**Interest Assumption** The expected rate of investment return on a plan's assets. It includes interest on debt securities, dividends on equity securities, rentals on real estate, and gains or losses on fund investments.

**Interest Rate Futures** A transferable agreement to make or take delivery of a fixed income security at a specific time, under terms and conditions established by the federally designated market upon which futures trading is conducted.

**Interest Rate Risk** One of the three types of investment risk. When interest rates rise, the market value of fixed income contracts (such as bonds) declines. Similarly, when interest rates decline, the market value of fixed income contracts increases. Interest rate risk is the risk associated with these fluctuations. See also [Credit Risk](#) and [Market Risk](#).

**Internal Revenue Code (IRC)** This is the basic federal tax law.

**Inter Vivos** Between living persons.

**Inter Vivos Trust** A trust created during the settlor's lifetime; the same as a living trust; to be distinguished from trust under will or testamentary trust.

**Intestacy** The condition resulting from a person's dying without leaving a valid will.

**Intestate** (Adjective): (1) Without having made and left a valid will. (2) Not devised or bequeathed; not disposed of by will. (Noun): A person who dies intestate.

**In The Money Option** A call option whose exercise price is lower than the spot price of the underlying or a put option whose exercise price is greater than the spot price of the underlying instrument.

**Intrinsic Value** The value of an option were it to be exercised. Only in-the-money options have intrinsic value.

**Inverse Floater** A floating rate instrument that adjusts inversely with changes in the benchmark index.



**Investment Adviser** A person who advises the public concerning the purchase or sale of securities. Such persons must generally register with the Securities and Exchange Commission under the Investment Advisers Act of 1940. Effective May 12, 2001, there is no longer a unilateral exemption afforded to banks. However, banks will continue to be exempt provided that the investment advisory services are only made available to individuals and those other than mutual funds. The category of other includes private equity issues and unregistered mutual funds. \* Please check to make sure the organization or individual is licensed to sell securities or offer advice for a fee.

**Investment Advisor Agent** An agency account in which the trust department provides investment recommendations on various types of assets, without actually having custody or safekeeping of those assets.

**Investment Management Agent** An agency account in which the trust department contracts to analyze and review the various assets, to make recommendations for changes in existing investments, and to make recommendations for new investments. The department also performs safekeeping and custodial functions for the assets of the account.

**Investment Company** Legal term for a mutual fund. The Investment Company Act of 1940 provides the framework for SEC regulatory authority over mutual fund operations.

**Investment Powers** The powers of a fiduciary regarding the investments in the account.

**IO (Interest Only)** The holder of this derivative instrument receives interest payments from a specific regular interest class or from a piece of the collateral. The holder receives no interest payments.

**IPO** See [Initial Public Offering](#).

**IRA** See [Individual Retirement Account](#).

**IRC** Internal Revenue Code. This is the basic federal tax law.

**Irrevocable Trust** A trust which by its terms (1) cannot be revoked by the settlor or (2) can be terminated by him only with the consent of someone who has an adverse interest in the trust -- that is, someone to whose interest it would be for the trust not to be terminated, such as a beneficiary; to be distinguished from a revocable trust with consented approval.

**ISN** A securities identification numbering system similar to CUSIP but used in some countries outside the United States.

**Issue** All persons who have descended from a common ancestor; a broader term than children.

**Item** A Registered Transfer Agent term defined in SEC Rule 17Ad-1(a)(1), as follows: (i) A certificate or certificates of the same issue of securities covered by one ticket (or, if there is no ticket, presented by one presenter) presented for transfer, or an instruction to a transfer agent which holds securities registered in the name of the presenter to transfer or to make available all or a portion of those securities; (ii) Each line on a "deposit shipment control list" or a "withdrawal shipment control list"; or (iii) In the case of an outside registrar, each certificate to be countersigned.

**Joint and Several Liability** Used when compensation for liability may be obtained from one or more parties either individually or jointly, whichever may be most advantageous. Example: Partners are responsible for their own and other partners' actions.

**Joint and Survivor Annuity** A contract that provides income periodically during the longer lifetime of two persons. The benefit amount may be adjusted to account for the extended life expectancy of the couple, and the benefit amount may decrease when one or the other dies. The contingent annuitant is usually the spouse.

**Joint Tenancy** The holding of property by two or more persons in such a manner that, upon the death of one joint owner, the survivor or survivors take the entire property; to be distinguished from tenancy in common and tenancy by the entirety.

**Junk Bonds** Bonds that are issued by organizations which often are encountering financial setbacks. A junk bond may be issued as a low quality security, or its issuer may encounter setbacks so that a quality bond is reduced to junk level. They offer high interest and high risk. Assurance of interest and principal payments in the future is limited; repayment often depends on asset sales rather than the ongoing profitability of the business. Junk bonds are often issued in conjunction with takeovers, leveraged buyouts and restructurings.

**KEOGH Plan** A retirement plan for self-employed persons and their employees to which yearly tax deductible contributions up to a specified limit can be made, if the plan meets certain requirements of the Internal Revenue Code.

**KSOP** 401(k) Employee Stock Ownership Plan.

**Laches** Neglect to do a thing at the proper time; such as undue delay in asserting a right or asking for a privilege.

**Land Trust** An unincorporated association for holding real property by putting the title in one or more trustees for the benefit of the members whose interests are evidenced by land-trust certificates. In general terms, it is a trust created to effectuate a real estate ownership relationship in which the trustee holds legal and equitable title to the property subject to the provisions of a trust agreement setting out the rights of the beneficiaries whose interests in the trust are declared to be personal property.

**Last Will and Testament** A legally enforceable declaration of a person's wishes regarding matters to be attended to after his death and not operative until his death; usually but not always relating to property; revocable (or amendable by means of a codicil) up to the time of his death or loss of mental capacity to make a valid will. Originally, "will" related to real property; "testament", to personal property; but at the present time, "will" is equally applicable to real and personal property. Olographic or Holographic wills are usually handwritten, dated and signed in the USA.

**Legacy** A gift of personal property by will; the same as a bequest. A person receiving such a gift is called a legatee.

**Legal Common Trust Fund** A common trust fund invested wholly in property that is legal for the investment of trust funds in the state in which the common trust is being administered. The term is employed most often in or with respect to common trust funds in states that have a statutory or court-approved list of authorized investments for trustees where the terms of the trust do not provide otherwise.

**Legal Investment** An investment that conforms to the requirements of the statutes. A term used principally with reference to investments by trustees and other fiduciaries and by savings banks; often abbreviated to "legals"; to be distinguished from an authorized investment.

**Legal List** A list of securities legal for fiduciary investments, as compiled and promulgated by a state agency (such as the state banking department) for the use and guidance of fiduciaries, lawyers, trustees, savings banks. Used infrequently now, as most states have adopted either the Prudent Man or Prudent Investor Rules.

**Legatee** See [Legacy](#).

**Letter of Attorney-** A written instrument which evidences the authority of an agent who is known as an attorney-in-fact.

**Letters of Administration** A certificate of authority to settle a particular estate issued to an administrator by the appointing court; to be distinguished from letters testamentary.

**Letters of Conservatorship** A certificate of authority issued by the court to an individual or corporate fiduciary to serve as conservator of the property of a person; corresponds with letters of guardianship.

**Letter Ruling** A private ruling issued by the IRS in response to a request from a taxpayer about the tax consequences of a proposed or completed transaction. Private letter rulings are not considered to be precedents for use by taxpayers other than the one who requested the ruling, but they do give an indication of the current IRS attitude towards the transaction in question.

**Letters Testamentary** A certificate of authority to settle a particular estate issued by the appointing court to the executor named in the will; to be distinguished from letters of administration.

**Leveraged Buyout** The purchase of assets or stock of a privately owned company, a public company, or a subsidiary thereof, in which the acquirer uses a significant amount of debt and very little (or no) capital. This is accomplished primarily by utilizing the purchased assets for collateral and the acquired earnings stream to amortize the debt.

**Leveraged ESOP** An employee stock ownership plan (ESOP) in which money is borrowed by the ESOP trust for the purpose of buying stock of the employer. The stock is normally held as security by the lender and is released for allocation to participant accounts as the loan is paid off.

**LIBOR** London InterBank Offered Rate (of interest).

**Life Beneficiary** The beneficiary of a trust usually for the term of his own life, but it may be for the life of some other person. Similar to a life estate or usufruct.

**Life Estate** Either an estate for the life of the life tenant alone or an estate for the life or lives of some other person or persons. If the estate is for the life of a person other than the life tenant, it is known as an estate pour autre vie.

**Life Insurance Trust** See [Insurance Trust](#).

**Life Interest** The estate or interest that a person has in property that will endure only during his own or someone else's lifetime.

**Limit Order** – An order to buy or sell a stock but only at a specific price or better. It allows the individual initiating the trade to set a ceiling on the purchase price they are willing to pay and a floor on the sales price they are willing to accept.. However, because of the limits the trade is not always executed.

**Listed Stock** The stock of a company that is traded on a recognized securities exchange. The various stock exchanges have different standards for listings. The New York Stock Exchange, for instance, includes national interest in the company, at least 1 million shares publicly held by at least 2,000 round lot shareholders, \$16 million in market value, more than \$2.5 million pre-tax income in the most recent year, and \$2 million in pre-tax income in each of the preceding two years.

**Lives in Being** Lives in existence at a given time. See [Rule Against Perpetuities](#).

**Living Trust** A trust that becomes operative during the lifetime of the settlor; opposed to a trust under will. The same as an inter vivos trust.

**Living Will** A document that allows a person to state in advance his/her wishes regarding the use or removal of life-sustaining or death-delaying procedures in the event of illness or injury.

**Load** A sales charge paid when purchasing or selling mutual fund shares. A "front end" load is assessed when money is initially invested. A "back end" load is assessed when shares are sold or funds withdrawn, and may be levied as a percentage of the withdrawn amount or at a flat rate. Back end loads may also be known as a redemption or exit fee. Loads may also be charged when dividends are reinvested.

**Lookback Option** One type of an option contract which confers the retroactive right to buy a given financial instrument at its minimum price, or sell at its maximum price, during a specific "lookback" period.

**Lump Sum Distribution** With respect to pension plans, the distribution of an individual's benefits in the form of one payment rather than in equal installments over a specified period of time or the individual's lifetime. The Internal Revenue Code imposes certain requirements in order for the distribution to qualify for special tax treatment.

**LUST** Acronym for leaking underground storage tank. Covered by Recourse Conservation and Recovery Act (RCRA).

**Maintenance Margin** In futures and forwards, the level to which a margin account may fall before the holder of the contract is required to bring the balance back up to the initial margin level.

**Managing Agency Accounts** An agency account concerning which the agent has managerial duties and responsibilities appropriate to the kind of property and in conformity with the terms of the agency; to be distinguished from a safekeeping or custody account.

**Marital Deduction** The portion of a decedent's estate that may be given to the surviving wife or husband without its becoming subject to the Federal estate tax levied against the decedent's estate; a term that came into general use under the Internal Revenue Act of 1954.

**Market Order** – An order to buy or sell shares at the prevailing market price. This type of order will always be complete. The individual initiating the purchase or sale has no control over the price, hence the name market.

**Marketability** The degree of investment or speculative interest that underlies any security; the ease with which it can be sold. Synonymous with "saleability."

**Market Maker** A dealer that stands prepared to buy or sell at the bid and offer prices that it quotes. The market is maintained when the dealer continues to quote bids and offerings over a period of time. See also [Specialist](#).

**Market Risk** One of three types of investment risk. Deals with the day-to-day fluctuations at which a security can be bought or sold. See also [Interest Rate Risk](#) and [Credit Risk](#).

**Massachusetts Rule** A term frequently applied to a rule for the investment of trust funds enunciated by the Supreme Judicial Court of Massachusetts in 1830; now commonly referred to as the prudent man rule. See [Prudent Man Rule](#).

**Master-Feeder Mutual Fund** A two-tiered mutual fund arrangement in which one or more mutual funds (the feeder funds) invest solely in the securities of another mutual fund (the master fund). Master-feeder funds are authorized, without prior SEC approval, under SEC Rule 18f-3. A multiple-class fund is different from a multiple-class mutual fund.

**Master Plan** A defined benefit or defined contribution employee benefit plan that has been prepared by a sponsoring organization and provides a single trust account in which all adopting employers must invest their plan contributions; the sponsoring organization must have the plan approved by the Internal Revenue Service. See also [Prototype Plan](#).



**Master Trust** An arrangement designating the custodianship and accounting for all employee benefit assets of a corporation or a controlled group of corporations to a single trustee, facilitating uniform administration of the assets of multiple plans and multiple investment managers.

**Material Information** Anything of material fact that could affect an investor's decision to buy a certain security.

**Matched Swap** An interest rate swap in which an asset or liability of the counterparty has interest payment terms similar to those of the swap.

**MBIA** Municipal Bond Insurance Association.

**MEWA** A Multiple Employer Welfare Arrangement. A means whereby small employers can pool contributions to purchase health insurance at a lower cost. Suppliers of MEWA's may offer insurance-like products, but normally are not insurance companies. These suppliers generally are not subject to state insurance regulation or reserve requirements.

**Mezzanine Financing** Use of preferred stock or convertible subordinated debentures to finance a takeover. This type of financing expands the resulting company's equity capital instead of its debt.

**MGIC** Mortgage Guaranty Insurance Corporation.

**Modern Portfolio Theory** The theoretical constructs that enable investment managers to classify, estimate and control the sources of risk and return. In popular terms, the term is applied to modern investment and portfolio theory. Refer to Appendix C, [Uniform Prudent Investor Act](#) for additional discussion.

**Money Market Instruments** Fixed income securities that mature in less than one year. Also known as cash equivalents since their marketability and characteristics provide easy liquidity. Included are U.S. government securities, negotiable certificates of deposit, commercial paper, STIF accounts, bankers acceptances and mutual funds.

**Money Purchase Plan** The basic type of a defined contribution employee benefit plan. The employer or plan sponsor's contribution to the plan is specified for each employee in terms of a flat dollar amount (\$100 per month of employment), or in terms of a percentage (10% of compensation), or on the basis of a point system. Unlike a profit sharing plan, forfeitures are not added to participants' accounts; they are used to reduce employer contributions. See also [Individual Account Plan](#).

**Mortgage Banker** An organization that originates mortgages and then sells them to investors, usually retaining servicing rights. Income is derived from origination and servicing fees. Funding for the mortgages is usually from borrowings, which are paid off when the loan is sold.

**Mortgage Pass-Through Securities** A security consisting of a pool of residential mortgages, with monthly distribution of 100% of the interest and principal to the investor. There are both government (Freddie Mac and Ginnie Mae) and commercial versions of these instruments.

**MPPAA** Multiemployer Pension Plan Amendments Act of 1980

**Multi-Employer Plan** For purposes of ERISA, a pension plan maintained pursuant to one or more collective bargaining agreements to which more than one employer is required to contribute.

**Multiple-Class Mutual Fund** A mutual fund which has multiple classes of shares. Each class participates in the same portfolio of investments and is identical to other classes of shares except that each class has different sales charges and/or other expenses. In some cases, there may also be a difference in the services rendered to different classes of the fund. Multiple-class funds are authorized, without prior SEC approval, under SEC Rule 18f-3. A multiple-class fund is different from a master-feeder mutual fund.

**Multiple Employer Welfare Arrangement (MEWA)** See [MEWA](#).

**Municipal Bonds** Debt issues of state and local governments, and their agencies. In general, interest paid on municipal bonds is exempt from federal income taxes and from state and local income taxes within the state of issue.

**Negligence** Failure, through omission or commission, to act as an ordinary, reasonable and prudent person would act. Consideration must be given to the particular situation, circumstances involved, and knowledge of the parties.

**Next of Kin** The person or persons in the nearest degree of blood relationship to the decedent. As the term is usually employed, those entitled by law to the personal property of a person who has died without leaving a valid will (such persons do not include the surviving spouse and wife except where specifically so provided by statute); to be distinguished from the heirs, who take the real property.

**Nominee** The partnership in whose name registered securities are held. This facilitates the making of "good" delivery of securities to brokers at the time of sale or exchange. Nominee names are usually registered with the American Society of Corporate Secretaries, to preclude the possibility of more than one nominee with the same name.

**Non Compos Mentis** (Not of sound mind): A term that includes all forms of mental unsoundness.

**Nonlegal Investment** An investment that does not conform to the requirements of the statutes; a term used principally with references to trust investments; to be distinguished from unauthorized investment.

**Notional Principal Amount** In an interest rate swap, the contractual amount on which interest payments are calculated.

**Nuncupative Will** An oral will made by a person on his deathbed or by one who is conscious of the possibility of meeting death in the near future -- as by a person in active military service. It is declared in the presence of at least two witnesses and later reduced to writing by someone other than the testator and offered for probate in the manner prescribed by statute.

**OBRA** Omnibus Budget Reconciliation Acts of 1986, 1987, 1988 and 1989. OBRA 1989 partially repealed the interest exclusion on ESOP loans, provided Labor Department civil money penalties for fiduciary violations, and created a tax penalty for overstatement of pension liabilities in determining deductibility.

**OCC** Office of the Comptroller of the Currency.

**Off-Market Swaps** See [Front-end receipt swaps](#).

**Open End Mutual Funds** These funds issue shares to investors continuously and stand ready to repurchase them at any time based on Net Asset Value. Both load and no-load funds are included.

**Operating (Transactional) Risk** The possibility that inadequate internal controls or procedures, human error, system failure or fraud can cause loss.

**Optimization** The process of selecting a securities portfolio that minimizes risk for a given level of risk. An example would be an aim that a portfolio have no more than 5% of its value in a single stock and/or that the current yield be at least 4%. Optimization includes expected return, variances of expected return, and covariance of return with every other security under consideration.

**Option** A contract for which the buyer pays a fee in exchange for the right, but not the obligation, to buy or sell, a fixed amount of a given financial instrument at a set price within a specified time. Options are considered a type of "price insurance" because they protect buyers from adverse swings in the price of the underlying asset. The buyer can never lose more than the price paid for the option, but the seller's losses are potentially unlimited. See also [Call Option](#), [Compound Option](#), [Lookback Option](#), and [Put Option](#).

**Optionee** Buyer of the option. The person who received an option on property.

**Optioner** Seller of the option. The person who gives an option on his/her property.

**Option Overriding** A type of options management where an options manager writes options on stocks managed by another manager. The goal is to provide an incremental return to the equity portfolio without interfering with the equity manager.

**Option Premiums** The dollar amounts paid to the writer for the option. The amount is determined generally by supply and demand, duration of the contract and difference between the fluctuations, among various considerations.

**Order Flow** Practice whereby securities brokers agree to receive cash payments in exchange for routine customer orders to specific dealers for execution.

**Ordinary Care** Generally considered to be the prudent man standard, subject to the facts and circumstances of a particular case.

**Out of the Money** An option whose exercise price is above the stock's current price.

**Overdraft-** The amount by which a debit or charge against an account exceeds the balance of the trust account.

**PAC (Planned Amortization Class)** A type of derivative instrument with scheduled payments over a range of prepayment speeds (PAC bands or ranges).

**Parol Evidence** (Pronounced *payroll*) Legal proof based on oral statements; with regard to a document, any evidence extrinsic to the document itself.

**Participant** An employee or former employee who is (or may become) eligible to receive a benefit of any type from an employee benefit plan. Also includes eligible beneficiaries.

**Party In Interest** A person or other entity which has control or close affinity to an employee benefit plan; an "insider". Defined by Section 3(14) of ERISA to include fiduciaries, trustees, and custodians, the plan administrator, the plan sponsor (employer and/or union), those who control 50% or more of these insiders, 10% or more stockholders of these insiders. Also covered are the outside interests of such insiders. Certain relatives of insiders are also included. See also [Disqualified Person](#).

**Paying Agent** An agent to receive funds from an obligor to pay maturing bonds and coupons, or from a corporation for the payment of dividends.

**PAYSOP** An ESOP eligible for tax credits based on employee payroll. PAYSOP's replaced TRASOP's in 1983. The tax credits were repealed by the Tax Reform Act of 1986. See also [Employee Stock Ownership Plan](#).

**PBGC** See [Pension Benefit Guaranty Corporation](#).

**Pecuniary Bequest** A bequest of property, often made in connection with the establishment of a marital deduction trust, that is expressed in terms of a specific dollar amount rather than in terms of a proportion of the assets involved.

**Pennsylvania Rule** A rule that requires credit of extraordinary dividends received in trust on the basis of the source of such dividends; to income if declared from earnings of the corporation during the life of the trust, and to principal if from earnings accumulated before commencement of the trust.

**Pension Benefit Guaranty Corporation (PBGC)** Congressionally-chartered corporation responsible for guaranteeing private defined benefit pension plans. Membership in PBGC is mandatory for all such plans. If a covered plan terminates, retirees and beneficiaries are entitled to the benefit calculated under the plan (subject to certain phase-in rules for new plans to preclude abuse), up to a maximum monthly benefit payment. The maximum monthly payment is based on the year a plan terminated and was set in 1974 at \$750 per month, indexed for inflation. Plans terminating in 2004 have a maximum monthly benefit of \$3,698 or \$44,386 per year for those who have attained age 65. The guarantee is increased for those over 65 and decreased for those under 65.

**Pension Trust** A trust established by an employer (commonly a corporation) to provide benefits for incapacitated, retired, or superannuated employees, with or without contributions by the employees.

**PEPPRA** Public Employee Pension Plan Reporting and Accountability Act.

**Per Capita** (By the head): A term used in the distribution of property; distribution to persons as individuals (per capita) and not as members of a family (per stirpes). For example, "I give my estate in equal shares to my son A and to my grandsons C, D, and E (the sons of my deceased son B) per capita". C, D, and E take as individuals (not as the sons of B), each taking the same share as A, namely, one-fourth of the estate.

**Performance-Based Fees** Investment management fees that are related to investment results, not to the size of the assets managed. Also known as incentive fees.

**Person** An individual, partnership, joint venture, corporation, mutual company, joint stock company, trust, estate, unincorporated organization, association or employee organization.

**Personal Property** All property other than real property.

**Personal Representative** A general term applicable to both executor and administrator.

**Personalty** Personal property.

**Per Stirpes** (*By the branch*): A term used in the distribution of property; distribution to persons as members of a family (per stirpes) and not as individuals (per capita). Two or more children of the same parent take per stirpes when together they take what the parent, if living, would take. For example, "I give my estate to my son A and to my grandsons C, D, and E (the sons of my deceased son B). My grandsons are to take per stirpes." C, D, and E take as the sons of B (not as individuals), each receiving one-sixth of the estate (one-third of the one-half to which B would be entitled if living), while A receives one-half of the estate. Taking per stirpes is also known as taking by right of representation.

**Pink Sheets** Quotation lists of various over-the-counter securities published daily on pink paper by the National Quotation Bureau, Inc.

**Plain Vanilla Interest Rate Swap** A single-currency swap agreement in which one counterparty agrees to pay a fixed rate of interest to the other counterparty in exchange for a variable rate of interest on a fixed notional principal amount over a specified period of time.

**Plan Administrator** See [Administrator](#).

**Plan Sponsor** See [Sponsor](#).



**Plan Year** The 12-month period on which employee benefit records are kept. Normally a fiscal year, but may be a calendar year.

**PO (Principal Only)** The holder of this instrument receives principal payments only and does not receive any interest. POs are offered at substantial discounts to their original principal amounts.

**Point** (1) *Bonds*: A point means 1%. Since bonds are quoted based on \$1,000 face value, it also means \$10. A bond that has increased by 3 points has gone up \$3% or \$30. (2) *Stocks*: A point means \$1. If XYZ stock goes up 3 points, it has increased \$3 per share. (3) *Mortgages*: A point is 1% of the principal amount of the mortgage. For Truth in Lending/Regulation Z purposes, a point is considered part of the Finance Charge disclosure and is included when calculating the APR.

**Potential Loss** For FDIC Trust Examinations: the examiner's estimate of the portion of a contingent liability which may develop into a loss to the institution. The amount of the loss indicated is potential rather than definite and fixed, pending settlement of the accounts. Also see [Contingent Liability](#).

**Pour-Over** A term referring to the transfer of property from an estate or trust to another estate or trust upon the happening of an event as provided in the instrument.

**Power of Attorney** A document, witnessed and acknowledged, authorizing the person named therein to act as his agent, called attorney-in-fact, for the person signing the document. If the attorney-in-fact is authorized to act for his principal in all matters, he has a general power of attorney; if he has authority to do only certain specified things, he has a **special power of attorney**. If the authority granted in the power of attorney survives the disability of the principal, the attorney in fact has a **durable power of attorney**. If the authority granted in the power of attorney commences in the future only upon the occurrence of a specific event or contingency, the power of attorney is known as a **springing power**. A power of attorney can be limited to property concerns or to health care matters. See also [Bond Power](#); [Letter of Attorney](#); [Stock Power](#).

**Power of Retention** Power expressed or implied in will or trust agreement permitting the trustee to retain certain or all of the investments comprising the trust property at inception, even though they may not be of a type suitable for new investments made by the trustee.

**Precatory Words** Expressions in a will praying or requesting (but not directing) that a thing be done or not done.

**Preemptive Right** A right accorded present shareholders, before any new shareholders, to subscribe to new shares in a company at a stipulated price on or before a fixed date. See also [Rights](#).

**Principal** (1) One who employs an agent to act for him. (2) One who is primarily liable on an obligation. (3) The property of an estate other than the income from the property; the same as capital.

**Private Foundations** In general, all charitable foundations except those deriving substantial support from the public. They fall into two categories; private operating foundations, those where substantially all of the assets and income are used to carry on its exempt function, e.g., a museum; or private nonoperating foundations, which include most family foundations.

**Private Placement** The sale of stocks, bonds, or other investments directly to an institutional investor, such as an insurance company or employee benefit plan. This precludes SEC registration requirements and may provide the purchases with (for debt issues) a higher interest rate and a customized maturity.

**Probate** (Verb): To present a will to the court for appointment of the executor or administrator c.t.a., which is the first step in the settlement of an estate.

**Probate Court** The court that has jurisdiction with respect to wills and intestacies and sometimes guardianships and adoptions; also called court of probate, surrogate's court, ordinary court, orphan's court, and prefect's court.

**Profit Sharing Plan** A defined contribution employee benefit plan established by an employer (usually a corporation) as a means of having the employees share in the profits of the enterprise.

**Prototype Plan** A standardized plan, approved and qualified as to its concept by the Internal Revenue Service, that is made available by banks, insurance companies and mutual funds for the use of employers. See also [Master Plan](#).

**Prudent Investor Rule** The latest development in evaluating fiduciary prudence. The current (1992) model uniform act differs from the traditional Prudent Man Rule in that it indicates that: (1) no asset is automatically imprudent, but must be suitable to the needs of the beneficiaries, (2) the entire portfolio is viewed when evaluating the prudence of a fiduciary, and (3) certain actions can be delegated to other agents and fiduciaries. ERISA [ § 404(a)(1)(C) ] generally follows the approach of the Prudent Investor Rule. The [Uniform Prudent Investor Rule](#) is found in Appendix C. Caution: review state statutes before applying to discretionary nonERISA trust accounts.

**Prudent Man Rule** A rule originally stated in 1830 by the Supreme Judicial Court of Massachusetts in *Harvard College v. Amory* [ 9 Pick. (Mass.) 446 ], that, in investing, all that can be required of a trustee is that he conduct himself faithfully and exercise a sound discretion and observe how men of prudence, discretion, and intelligence manage their own affairs not in regard to speculation, but in regard to the permanent disposition of their funds considering the probable income as well as the probable safety of the capital to be invested. The current (1959) model uniform rule categorizes certain types of assets as automatically imprudent, looks at each investment separately in determining prudence, and prohibits the delegation of responsibilities. Most states have adopted the Rule as a part of state fiduciary law, usually with certain different specifics from state to state. The [Prudent Man Rule](#) is found in Appendix C

**Purchase-Money Mortgage** A mortgage given by a purchaser of real property to the seller in part payment of the purchase price.

**Put Option** Option to sell shares of a particular stock within a given period of time at a specific price fixed in the contract.

**PWBA** Pension and Welfare Benefits Administration, U.S. Department of Labor. This agency is now known as the Employee Benefit Security Administration, EBSA.

**QDRO** (*Pronounced "Cue-Dro"*) Qualified Domestic Relations Order. Court order which may be issued upon a divorce, specifying a spouse's share in certain employee benefit plans. IRA's, 401(k) plans, and defined benefit pension plans are often covered by QDRO's.

**QERP** Acronym for Qualified Employee Real Property. Involves the investment of ERISA plan assets in real property leased to the plan sponsor or an affiliate thereof. See ERISA § 407(d)(4).

**QPAM** Qualified Professional Asset Manager. Term used in ERISA Prohibited Transaction Class Exemption (PTE) 84-14 for a bank, thrift, insurance company or registered investment adviser which meets certain minimum capital, net worth, or total managed assets thresholds.

**QTIP** Qualified Terminable Interest Property Trust. A type of personal trust which allows assets to be transferred between spouses. The grantor directs income from the assets to his/her spouse for life, but has the power to distribute the trust's assets upon the death of the spouse. Such trusts qualify for the unlimited marital deduction if the spouse should die first. A QTIP trust is often used to provide for the welfare of a spouse while keeping the assets out of the estate of another (such as a future marriage partner) if the grantor dies first.

**Qualified Domestic Relations Order** See [QDRO](#).

**Qualified Plan or Trust** An employer's trust or plan that qualifies under the Internal Revenue Code of 1954 for the exclusive benefit of his employees or their beneficiaries in such manner and form as to entitle the payments made by the employer to the plan or trust to the deductions and income tax benefits as set forth in the Code.

**Rabbi Trust** A form of employee benefit in which an employer establishes a trust to provide non-qualified deferred compensation to certain key employees. The trust usually contains restrictions on revocation and is subject to claims of general creditors of the employer. Employer contributions are not taxable as income to the employee at the time of contribution. Any income earned prior to distribution to the employee is taxed to the employer. The term "*rabbi*" arose because the first trust of this type approved by the Internal Revenue Service involved a rabbi.

**Rabbicular Trust** A form of employee benefit which attempts to combine the rabbi trust with a secular trust. The plan originates as a rabbi trust and remains such as long as the sponsor company remains financially healthy. If certain defined situations arise, the rabbi trust becomes a secular trust. The covered employee then must pay any applicable tax, but is assured of receiving what is held in the trust, instead of being just another unsecured creditor.

**REA** Retirement Equity Act of 1984. Provided for greater pension equity for female workers and surviving spouses.

**Real Estate Investment Trust** See [REIT](#).

**Reciprocal Trust** A trust created by one person in consideration of the creation by the beneficiary of a similar trust for him.

**Record Date** The date on which a shareholder must be listed in a company's shareholder records in order to receive a declared dividend or vote on company matters.

**Registrar** (1) In connection with stock, the agent which affixes its signature to each stock certificate issued, the object being the prevention of over-issuance. (2) In connection with bonds, the agent which maintains the records of who owns an issue of registered bonds, similar to a transfer agent.

**Regulation 9** A regulation issued by the Comptroller of the Currency under authority of Section 1(j) of the Act of September 28, 1962 [ 76 Stat. 668, 12 USC 92a ] relating to the conduct of fiduciary business by national banks. The full title of the regulation is Regulation 9 - Fiduciary Powers of National Banks and Collective Investment Funds. [Section 9.18](#) of the regulation, dealing with collective investment funds, applies to collective investment funds operated by state-chartered banks through Section 584 of the Internal Revenue Code, which requires compliance with Regulation 9.

**REIT** Real Estate Investment Trust. A trust which operates somewhat like a mutual fund. REITs invest in real estate loans and/or equity interests in real estate. Ninety-five percent of its income must be paid out to shareholders if the REIT is to qualify for a tax exemption.

**Remainder** A future estate or interest in property which will become an estate or interest in possession upon the termination of the prior estate or interest created at the same time and by the same instrument. For example, A conveys Blackacre to B for life and upon B's death to C in fee simple. C's interest is a remainder. The term remainder over is sometimes used in such phrases as "To A for life, with remainder over to B," calling attention to the fact that there is a prior estate or interest. To be distinguished from reversion.

**Remainderman** A person or entity entitled to a future interest in a trust or estate. The rights to the property in the trust or estate are typically transferred after the interests of the prior beneficiary (such as the [income beneficiary](#)) have terminated.

**REMIC** Acronym for a real estate mortgage investment conduit. This is a pass-through type of investment vehicle created by the Tax Reform Act of 1986 to issue multi-class mortgage-backed securities. REMIC's may be organized as corporations, partnerships or trusts. Those meeting certain qualifications are not subject to double taxation. Interests in REMIC's may be senior or junior, regular (debt instruments) or residual (equity interests). REMIC's generally provide the issuer with more flexibility than a collateralized mortgage obligation (CMO), as they permit mortgage pools to be separated not only into maturity classes but also into risk classes. While CMO's usually have AAA ratings, REMIC's represent a range of risk levels.

**Reportable Event** Serious situations involving a private defined benefit employee benefit plan which require a notice to be filed with the PBGC. Events covered include loss of tax qualification, 80% or more drop in participation from the previous year, full or partial plan termination, inability to pay benefits, merger with another plan, bankruptcy of the plan sponsor, etc.

**Representative** (1) A general term designating either an executor or an administrator. (2) The person who acts or speaks for another under his authority.

**Repurchase Agreement** As applicable to trust departments, means a "loan" by a trust account to a financial institution or securities dealer. Normally, these loans are secured by U. S. Government or agency securities, bear a fixed rate, are payable at a fixed maturity, and may be subject to other terms. The regulatory agencies have generally taken the position that repurchase agreements with the fiduciary bank are a conflict of interest and self-dealing unless specifically authorized. Also sometimes called reverse repurchase agreements, repo, asset repo, RP, and buy back.

**Reputation Risk** The possibility that negative publicity will expose the institution to costly litigation, financial loss, or effect its ability to establish new relationships, or to continue existing relationships.

**Residence** The place where one resides, whether temporarily or permanently. See also [Domicile](#).

**Residuary Trust** A trust which is composed of the property of the testator, remaining in the estate after the payment of all taxes, debts, expenses, charges, and the satisfaction of all other gifts under the will.

**Resulting Trust** A trust which results in law from the acts of the parties, regardless of whether they intend to create a trust, as when a person disposes of property under circumstances which raise an inference that he does not intend that the person taking or holding the property shall have the beneficial interest in it; to be distinguished from an express trust and a constructive trust.

**Revenue Anticipation Note** A debt obligation issued by a state or political subdivision to be repaid from the receipt of the anticipated revenue.

**Revenue Bond** A municipal bond payable, not from general tax collections, but from revenue generated by either the operation of a public facility or from a special source of revenue.

**Reverse Repurchase Agreement** An agreement in which Party A purchases an asset (financial instrument) from Party B and agrees to sell it back to Party B for a specified price at a specified date. See [Repurchase Agreement](#).

**Reverse Swap** A swap that has terms opposite those of another swap, therefore effectively canceling the former swap.

**Reversion** The interest in an estate remaining in the grantor after a particular interest, less than the whole estate, has been granted by the owner to another person; to be distinguished from remainder. The reversion remains in the grantor; the remainder goes to some grantee.



**Revocable Trust** A trust which may be terminated by the settlor or by another person; opposed to an irrevocable trust.

**RHO** The rate at which the price of an option changes in response to a given move in interest rates.

**Rights** A privilege granted to existing shareholders of a corporation to purchase new shares of common stock at a discount from its market price. Rights are offered under terms of a Rights Offering. The right must be exercised within a short (30-60 day) timespan. Sometimes, rights are issued under state law that requires existing shareholders be given an opportunity to maintain their proportionate share of ownership. See [Preemptive Rights](#).

**Rollover** The procedure of repeated investment of the proceeds of short-term securities upon maturity. See [Tax-Free Rollover](#).

**Roth IRA** was introduced in 1998. Except for some special rules which apply only to Roth IRAs, these individual retirement accounts are subject to many of the same IRS rules as are traditional IRAs. Unlike traditional IRAs, contributions are taxable, but distributions are not taxed. Also, no distributions from Roth IRAs are ever required, and IRA owners may continue to contribute to the IRA after the age of 70 ½.

**Routine** A Registered Transfer Agent term defined in SEC Rule 17Ad-1(i), as follows: An item is "routine" if it does not:

- (1) require requisitioning certificates of an issue for which the transfer agent, under the terms of its agency, does not maintain a supply of certificates;
- (2) include a certificate as to which the transfer agent has received notice of a stop order, adverse claim, or any other restriction on transfer;
- (3) require any additional certificates, documentation, instructions, assignments, guarantees, endorsements,

explanations, or opinions of counsel before transfer may be effected;

(4) require review of supporting documentation other than assignments, endorsements or stock powers, certified corporate resolutions, signature, or other common and ordinary guarantees, or appropriate tax, or tax waivers;

(5) involve a transfer in connection with a reorganization, tender offer, exchange, redemption, or liquidation,

(6) include a warrant, right, or convertible security presented for transfer of record ownership within five business days before any day upon which exercise or conversion privileges lapse or change;

(7) include a warrant, right, or convertible security presented for exercise or conversion; or

(8) include a security of an issue which within the previous 15 business days was offered to the public, pursuant to a registration statement effective under the Securities Act of 1933, in an offering not of a continuing nature.

**RPM Trust** - Remainder Purchase Marital Trust, is a special type of trust for the benefit of the grantor's spouse that is designed to qualify for the gift tax marital deduction, but will not be subject to estate tax at the spouse's death. As a result, the trust property passes to the grantor's children completely free of gift and estate tax. This can be a replacement for a GRIT or a GRAT without their inherent drawbacks. Both RPM Income and RPM Annuity Trusts provide benefits.

**Rule Against Perpetuities** A rule of common law that makes void any estate or interest in property so limited that it will not take effect or vest within a period measured by a life or lives in being at the time of the creation of the estate plus 21 years and the period of gestation. In many states the rule has been modified by statute. Sometimes it is known as the rule against remoteness of vesting.

**Safekeeping Account** An agency account concerning which the duties of the agent are to receipt for, keep safe, and deliver the property in the account on demand of the principal or his order; to be distinguished from a custody account and a managing agency account.

**Samurai Bond** A bond issued in the United States but denominated in Japanese Yen.

**SAR** Summary Annual Report for ERISA employee benefit plans.

**SARSEP** Acronym for Salary Reduction Simplified Employee Pension, a type of defined contribution employee benefit plan first authorized in 1986. Sometimes referred to as an *elective deferral arrangement*. SARSEPs are available to employers with 25 or less employees, and at least 50% of eligible employees must participate in the plan. Employees contribute a percentage of their salary, thus reducing current income. SARSEPs could be adopted by employers through 12-31-96. Beginning 1-1-97, SARSEPs were replaced by SIMPLE Retirement Plans, and no more new SARSEPs could be started. SARSEPs adopted prior to 1997 can be continued, however, with additional contributions made to them.

**Scalping** Trading for small gains over a short period of time, usually within a day. In some cases, this may involve taking advantage of very narrow spreads in volatile markets.

**Secular Trust** A form of employee benefit plan that operates differently from a rabbi trust. In contrast to a rabbi trust, contributions to a secular trust are taxable to the participant, but participants also have a vested interest in plan assets. While the trust is taxable, the employee is ensured of receiving the funds entrusted to the trust should the plan sponsor fail. See also [Rabbi Trust](#) and [Rabbicular Trust](#).

**Security-Based Derivative** These investment instruments are specially tailored from other securities, such as municipal, corporate, or U.S. Government agency bonds. While they offer enticing return potential, some carry high degrees of both market risk and income risk. They range from the highly predictable to the highly unpredictable. Examples of the highly unpredictable include inverse floaters, interest-only or principal-only STRIPS. Also called Synthetic Derivatives. See also [Derivatives](#).

**Securities Depository (Clearing Agency):** A physical location or organization where securities certificates are deposited and transferred by bookkeeping entry.

**Securities Lending** A practice where owners of securities, either directly or indirectly, lend their securities to (primarily) brokerage firms for a fee. The borrower pledges either cash, securities or a letter of credit to protect the lender. Securities are borrowed by cover fails of deliveries or short sales, provide proper denominations, and enable brokerage firms to engage in arbitrage trading activities.

**Sedol** A securities identification numbering system similar to CUSIP but used in some countries outside the United States.

**Self-Employed Retirement Plan** See [Keogh Plan](#).

**Self-Settled Trust** A trust which is funded from assets which came from the beneficiary.

**SEP** Simplified Employee Pension (plan). Basically, an IRA (SEP-IRA) established by an employer for the benefit of each covered employee. Both the employer and employees may contribute to the SEP-IRA. Employer contributions are excluded from an employee's income.

**Separate Line of Business** See [SLOB](#).

**SEPPAA** Single Employer Pension Plan Amendments Act of 1986.

**SERP** Supplemental Executive Retirement Plan. A non-tax-qualified pension plan that permits an employer to offer greater benefits to its highly paid employees.

**Settlement** (1) The winding up and distribution of an estate by an executor or an administrator; to be distinguished from the administration of an estate by a trustee or a guardian. (2) A property arrangement, as between a husband and wife or a parent and child, frequently involving a trust.

**Settlor** A person who creates a trust, such as a living trust, to become operative during his lifetime; also called donor, grantor, and trustor. Compare Testator.

**Short-Term Trust** Also known as a Clifford Trust. An irrevocable trust running for a period of ten years or longer, in which the income is payable to a person other than the settlor, and established under the provisions of the Revenue Act of 1954. The income from a trust of this kind is taxable to the income beneficiary and not to the settlor. The agreement may provide that on the date fixed for the termination of the trust, or on the prior death of the income beneficiary, the assets of the trust shall be returned to the settlor. The Tax Reform Act of 1986 eliminated the 10-year or Clifford trusts exception from grantor-trust taxation rules. Income from 10 year and other grantor trusts is taxed to the grantor, not the beneficiary if the trust property will revert to the grantor or the grantor's spouse. It applies to transfers in trusts after March 1, 1986.

**SICOVAM** A securities identification numbering system similar to CUSIP but used in some countries outside the United States.

**Simple** Acronym for Savings Incentive Match Plan for Employees, a type of defined contribution employee benefit plan passed by Congress in 1996 and effective beginning January 1, 1997. SIMPLE plans may be used by employers with 100 or less employees at any time during a year with no other employer-sponsored retirement plan. SIMPLE plans may take the form of an IRA or a 401(k) plan.

**Sinking Fund** An accumulation of amounts set aside periodically by municipalities or corporations, which will be sufficient to satisfy a debt, such as a bond issue, at maturity. See also [Amortization](#).

**SIPC** Securities Investor Protection Corporation. Congressionally-chartered corporation that protects investor funds at broker-dealers. In general, when a broker-dealer registers with the SEC, it automatically becomes a member of SIPC. SIPC covers an investor's account for an aggregate of \$500,000 in cash and securities, with a maximum of \$100,000 cash coverage.

**SLIC** A guaranteed investment contract issued by a savings and loan association or similar thrift institution. See also [GIC](#).

**SLOB** IRS term for a "separate line of business," as used in determining compliance with minimum coverage and participation requirements for employee benefit plans. The concept permits businesses that are part of a controlled group to ignore affiliates when testing for nondiscrimination in retirement and dependent care plans.

**Social Investing** Socially-sensitive investments which, when compared to normal fiduciary-quality investments, are considered to either (1) have a greater social or moral quality, or (2) create employment opportunities for plan participants. Social investing attempts to achieve the same investment quality and rate of return as other investments. Criteria for social investing may be expressed in positive and/or negative terms. Positive qualities might include firms which are seen to be pollution-free, union or employee-friendly, U.S. (or locally) based, providing housing or medical services, food production, or producing safe and high-quality consumer products, etc. Negative qualities might be heavy users of energy or polluters; firms moving jobs overseas; alcohol, tobacco or weapons manufacturers, etc. At one time, a "standard" negative quality was a firm doing business in South Africa. Under some criteria, fossil and/or nuclear energy firms can be viewed either positively or negatively. See also [ETIs](#).

**Soft Dollars** The purchase of research materials from brokerage firms and paid for by commissions (or part of the commissions) generated by securities transactions of trust accounts. Covered by Section 28(e)(1) of the Securities Exchange Act of 1934. Opposed to this is the purchase of materials by "hard dollars", which is when payment is made by the trust department itself, typically by issuing a check.

**SPD** Summary Plan Description for ERISA employee benefit plans.

**SPTDM** Statement of Principles of Trust Department Management.

**Specialist** A member of the New York Stock Exchange who has two functions: (1) Maintain an orderly market, insofar as possible, in the stocks for which he/she is registered as a specialist. This is done by buying or selling, for the specialist's own account, when there is a disparity between supply and demand. (2) Act as a broker's broker, to place "limit" orders that cannot be immediately executed by the broker. A limit order is one that says buy XYZ at \$50, but it is now selling at \$60; the specialist holds the broker's order until the price drops to \$50. There are about 350 NYSE specialists. See also [Market Maker](#).

**Spendthrift Clause** The provision in a will or trust instrument which limits the right of the beneficiary to dispose of his interest, as by assignment, and the right of his creditors to reach it, as by attachment.

**Spillover Trust** Type of trust which by its terms is merged with or added to another trust or estate upon the happening of a certain event. See [Pour-Over](#).

**SPIRA** Spousal IRA.

**Split** Stock term. Division of a company's stock into a greater number of shares. In the case of a four-for-one split, four new shares are issued for each old share. The opposite of a split is a *reverse split*, where a company shrinks its stock base by issuing fewer shares for each existing share.

**Sponsor** The party that establishes and maintains an employee benefit plan. This is normally the employer or an employee organization (union).

**Sprinkling Trusts** Trusts in which the income or principal is distributed among the members of a designated class in amounts and proportions as may be determined in the discretion of the trustee. Also called spray trusts.



**Step-up Swaps** A swap that contains periodic increases (or step-ups) in the fixed-rate side of the swap combined with an embedded option that gives the fixed-rate payer the right to extend the swap to a predetermined maximum maturity.

**STIF** Acronym for a Short Term Investment Fund, a money-market collective investment fund.

**Stock Bonus Plan** A defined contributions employee benefit plan similar to a profit sharing plan, except that employer contributions are not necessarily dependent upon profits and benefits are in the form of employer stock.

**Stock Option** Right to purchase stock of employer, generally at a fixed price for a fixed period of time.

**Stock Power** A form of assignment executed by the owner of stock which contains an irrevocable appointment of an attorney in fact to make the actual transfer on the books of the corporation.

**Stock Purchase Trust** A trust under which a surviving stockholder of a close corporation may purchase the stock of a deceased stockholder; usually, but not necessarily, an insurance trust.

**Stock Transfer Agent** The agent of a corporation appointed for the purpose of effecting transfers of stock from one stockholder to another by the actual cancellation of the surrendered certificates and the issuance of new certificates in the name of the new stockholder. See also [Transfer Agent](#).

**Stop Order** – An order to buy or sell a stock once it reaches a certain target price.

**Stop-Limit Order** – Instructs a broker to buy or sell once a stock hits the stop price but only at the limit price or better.

**Strategic Risk** The possibility that insufficient due diligence reviews or infrastructure preparations were made on the introduction of new products and services.

**Street Name** Shares of stock owned by a broker's customer but held in the name of the broker.

**Sub-Chapter S Corporation** An election available to a corporation to be treated as a partnership for income tax purposes. To be eligible to make the election, a corporation must meet certain requirements as to kind and number of shareholders, classes of stock, and sources of income.

**Subordinated Debenture** A debt obligation that has unsecured junior claims to interest and principal, which are subordinated to ordinary debentures or other debt of the issuing corporation.

**Subrogation** The substitution of one person for another with reference to a lawful claim or right and frequently referred to as the doctrine of substitution. It is a device adopted or invented by equity to compel the ultimate discharge of a debt or obligation by him who in good conscience should pay it.

**Successor Trustee** A trustee following the original or a prior trustee the appointment of whom is provided for in the trust instrument; to be distinguished from a substituted trustee.

**Surcharge** (Noun): An amount which the fiduciary is required by court decree to make good because of negligence or other failure of duty. The term is also used as a verb; as the court surcharged the trustee.

**Surety** An individual or a company that, at the request of another, usually called the principal, agrees to be responsible for the performance of some act in favor of a third person in the event that the principal fails to perform as agreed; as the surety on an administrator's or a guardian's bond.

**Swap** A forward-type contract in which two parties agree to exchange streams of payments over time according to a predetermined rule. In an **interest rate swap**, one party agrees to pay a fixed interest rate in exchange for receiving a floating interest rate from another party. An **equity index swap** may involve swapping the returns on two different stock market indices, or swapping the return on a stock index for a floating interest rate.

**Swaption** An option giving the holder the right, but not the obligation, to enter into or cancel a swap agreement at a future date.

**Synthetic Derivative** A type of security dependent on other securities. Includes inverse floaters and STRIPS. See [Security-Based Derivatives](#).

**Synthetic Forward** An agreement to either (1) purchase a call and write a put at the same strike price and expiration date, or (2) purchase a put and write a call at the same strike price and expiration date.

**Synthetic GIC** A Guaranteed Investment Contract issued by other than an insurance company. See "[GIC](#)", "[BIC](#)", "[SLIC](#)".

**TAB** U.S. Treasury Tax Anticipation Bill. These bills generally mature a week after the corporate income tax dates and are acceptable at par on the tax date. See also [Treasury Bills](#).

**TAC (Targeted Amortization Class)** A type of derivative that provides investors with a predefined payment schedule applicable to a single prepayment speed. Prepayments in excess of the predefined prepayment speed are allocated to companion, or support, classes and generally do not affect the TAC class. If prepayments fall below the predefined speed, however, the TAC will have slower principal repayment and its average life will extend.

**TAMRA** Technical and Miscellaneous Revenue Act of 1988.

**Target Plan** A type of employee benefit plan which combines elements of both defined contribution and defined benefit plans. Levels of contributions are established and a "target benefit" aimed for. An individual account is established for each participant. Actual benefits are based on the amount of the contributions, as affected by the individual's pro-rata share in the profits and losses of the investment portfolio.

**Tax Free Rollover** Provision whereby an individual receiving a lump sum distribution from a qualified pension or profit sharing plan can preserve the tax deferred status of these funds by a "rollover" into an IRA or another qualified plan if rolled over within sixty days of receipt.

**Tax Reduction Act of 1975** Provided special investment tax incentives for establishment of ESOP's (initially known as TRASOP's and changed to tax credit ESOP's by the Technical Corrections Act of 1979). The Tax Reform Act of 1986 repealed these credits.

**TEFRA** Tax Equity and Fiscal Responsibility Act of 1982. Among other things, this Act provides that (1) municipal bond issues had to be registered, rather than bearer, as to ownership information and (2) changed Section 72 of the Internal Revenue Code as to loans to participants of employee benefit plans.

**Tenancy By The Entirety** Tenancy by a husband and wife in such a manner that, except in concert with the other, neither husband nor wife has a disposable interest in the property during the lifetime of the other. Upon the death of either, the property goes to the survivor. To be distinguished from joint tenancy and tenancy in common.

**Tenancy In Common** The holding of property by two or more persons in such a manner that each has an undivided interest which, upon his death, passes as such to his heirs or devisees and not to the survivor or survivors; the same as an estate in common; to be distinguished from joint tenancy and tenancy by the entirety.

**Testamentary Trust** A trust established by the terms of a will.

**Testate** (Adjective): Having made and left a valid will; opposed to intestate.

**Testator** A man who has made and left a valid will at his death. Compare Settlor. See also [Trustor](#).

**Testatrix** A woman who has made and left a valid will at her death.

**Tickler** Any record established to serve as a reminder of action to be taken on a fixed future date. It is always arranged in the order dates on which such action is to be taken.

**Time Value** The difference between the total value of an option and the option's intrinsic value.

**Top Hat Plan** An unfunded plan maintained to provide deferred compensation for a select group of management or highly compensated employees.

**Top Heavy Plan** A plan that provides more than 60% of its aggregate accrued benefits or account balances to key employees. Such plans must meet certain additional qualification rules regarding vesting and contributions.

**"Totten" Trust** Trust created by deposit of one's own money in his own name as trustee for another. Title is vested in the record owner (trustee), who during his life holds it on a revocable trust for the named beneficiary. At the death of the depositor a presumption arises that an absolute trust was created as to the balance on hand at the death of the depositor.

**Tracking Error** For stock and bond index funds, the difference between index return and the actual return of the fund.

**Tranches** (1) Risk maturity or other classes into which a multi-class security, such as a collateralized mortgage obligation (CMO) or real estate mortgage investment conduit (REMIC) is split. (2) Subunits of a large (\$10 - \$30 million) Eurodollar certificate of deposit that are marketed to smaller investors in \$10,000 denominations. These are represented by separate certificates, and have the same issue date, interest rate and maturity as the original instrument.

**Transfer Agent** A corporate agency account whose duties are to transfer stock from one owner to another. A transfer agent maintains records of shareholders, and issues stock certificates. Transfer agents which transfer stock of companies with, generally, 500 stockholders and \$1 million in assets must register with either the SEC or its banking agency (as appropriate) under Section 17A of the Securities and Exchange Act of 1934. A transfer agent for bonds usually is known as a registrar. See also [Stock-Transfer Agent](#).

**TRASOP** An employee benefit account dealing with employee stock ownership plans which meet certain qualifications under the Tax Reduction Acts of 1975 and 1976. These Acts encouraged the use of TRASOP's by allowing a special investment credit as an incentive for establishing such a plan. The Technical Corrections Act of 1979 provided for further such incentives. The tax credits were repealed by the Tax Reform Act of 1986. See also [Employee Stock Ownership Plan](#).

**Treasury Bills** Short-term direct obligations of the U.S. Government. Often referred to as T-Bills. They are issued with maturities of three months, six months or one year, in denominations of \$10,000 and up in multiples of \$5,000. See also [TABs](#).

**Treasury Bonds** Long-term direct obligations of the U.S. Government issued with maturities of five to 30 years, paying interest semiannually.

**Treasury Notes** Short- to intermediate-term direct obligations of the U.S. Government issued with maturities of one to seven years, paying interest semiannually.

**TRESOP** Tax Reduction (Act) ESOP. See [TRASOP](#).

**Triple Witching** The last trading hour on the third Friday of March, June, September and December when options and futures on stock indexes expire concurrently. Massive trades in index futures, options and underlying stocks by hedge strategists and arbitragers cause abnormal activity and volatility. See also [Witching](#).

**Trust** A fiduciary relationship in which one person (the trustee) is the holder of the legal title to property (the trust property) subject to an equitable obligation (an obligation enforceable in a court of equity) to keep or use the property for the benefit of another person (the beneficiary).

**Trust Agreement** A written agreement between settlor and trustee setting forth the terms of a trust. See also [Deed of Trust](#).

**Trust Committee** A committee of directors or officers or both of a trust institution charged with general or specific duties relating to its trust business.

**Trustee** An individual or a trust institution which holds the legal title to property for the benefit of someone else.

**Trusteed Pension Plan** A pension plan in which the corporation's contributions to the plan are placed in a trust for investment and reinvestment, as distinguished from a plan in which the benefits are secured by life insurance.

**Trustor** A person who creates a trust; a broad term which includes settlor and testator.

**Trust Under Agreement** A trust evidenced by an agreement between the settlor and the trustee.

**Trust Under Deed** A trust evidenced by a deed of conveyance, as distinguished from an agreement; originally confined to real property but not frequently applied to personal property as well.

**Trust Under Will** A trust created by a valid will, to become operative only on the death of the testator; opposed to a living trust and the same as testamentary trust.

**Ultra Vires** Term applied to acts of a corporation which exceed its corporate powers.

**Undistributed Net Income (UNI)** The amount by which the distributable net income for the year exceeds the sum of any amount of income for the year required to be distributed currently, any other amounts properly paid, credited, or required to be distributed for such year, and the amount of taxes properly allocable to the undistributed portion of the distributable net income.

**Unfunded Insurance Trust** An insurance trust in which the premiums on the policies are to be paid by the insured or by some third person and not by the trustee; to be distinguished from a funded insurance trust.

**Unfunded Vested Pension Liability** In a defined benefit pension plan, the difference between the actuarially-determined value of the vested (nonforfeitable) benefits under the plan, and the market value of the plan's assets.

**Unfunded Prior Service Pension Liability** In a defined benefit pension plan, the difference between the actuarially-determined value of the projected future benefit costs (both vested and manifested) and administrative expenses, as well as the unamortized portion of prior benefit costs, under the plan, and the market value of the plan's assets.



**Unified Credit** A dollar amount allocated to each taxpayer which can be applied against the gift tax, the estate tax and, under certain circumstances, the generation-skipping tax.

**Uniform Gifts To Minors Act** An act adopted by most states providing for a means of transferring property to a minor, wherein the designated custodian of the property has the legal right to act on behalf of the minor without the necessity of a guardianship.

**Unit Investment Trust** An investment vehicle registered with the SEC under the Investment Company Act of 1940 that purchases a fixed portfolio of securities. Units in the trust are sold to investors, who receive a proportionate undivided interest in the principal and income of the portfolio. The portfolio of securities remains fixed until the securities mature or, unusually, are sold.

**Unmatched Swap** An interest rate swap that the counterparty has not paired with an asset or liability with interest payment terms similar to those of the swap.

**Unwinding a Swap** Terminating a swap agreement.

**VAR** Value at Risk. An alternative approach (supposedly more sophisticated and accurate) to stress tests for measuring the risk in certain securities activities, such as derivatives. A rudimentary probability analysis, VAR measures the potential for fluctuation in securities prices. VAR is designed to show probable risk, whereas stress tests show what is possible. In the U.S., VAR calculations are usually based on the daily RiskMetrics data issued by Morgan Guaranty Trust Company over Internet. The use of VAR to measure risk is endorsed by the Group of 30; the Basel Committee of international bank supervisors is leaning towards the use of VAR.

**Variable Amount Note** Note evidencing the amount the trust department lends to a borrower from cash held in various fiduciary accounts; the amount of the loan outstanding fluctuates depending on the amount of cash on hand.

**VEBA** Acronym for Voluntary Employees' Benefit Association. A tax exempt fund that pays death, health, accident or other benefits to plan participants, their dependents and/or beneficiaries. Generally covered under Section 501(c)(9) of the Internal Revenue Code.

**Vest** (Verb): To confer an immediate, fixed right of immediate or future possession and enjoyment of property.

**Vesting** As applied to pension and profit-sharing plans, vesting is a term that indicates the attainment by a participant of a benefit right, attributable to employer contributions, that is not contingent upon his continued employment. Vesting may be total and immediate, graduated over a period of years, or may occur on completion of stated service or participation requirements.

**Viatical Settlement** (From the Latin *viaticum*, for *provisions for a journey*.) The sale or transfer (settlement) of ownership rights to a life insurance policy prior to death by an insured individual with a terminal illness. The insured person receives a percentage of the life insurance policy's proceeds, with the amount paid is based on a number of factors, such as the life expectancy of the insured person, the amount payable on death, estimated future premiums, and any commissions or other costs. Purchasers may be brokers who sell interests in the life insurance policy's proceeds to investors, with the broker taking its own commission. Once the insurance policy is sold to a broker, the insured is not responsible for paying premiums on the policy. In a 6-8-95 letter to the Texas Department of Banking, the IRS stated that IRA accounts could not "lend" funds to a "viatical trust" for other than the IRA owner, as § 408(a)(3) of the Internal Revenue Code and § 1.408-2(b)(3) of IRS Regulations prohibit investment of IRA funds in insurance contracts. Beginning 1-1-97, funds received from viatical settlements are not taxable for federal income tax purposes if the insured has a life expectancy of less than 24 months or (under special conditions) is chronically ill. See also [Accelerated Death Benefit \(ADB\)](#).

**Volatility** The degree of price fluctuation for a given asset, rate, or index. Usually expressed as variance or standard deviation.

**Voting Authority** The power to vote a stock. A trustee may have sole, shared, or no authority to vote stock held in trust.

**Vulture Fund** A type of limited partnership that invests in depressed properties, usually real estate, aiming to make a profit when prices recover.

**Waiver** (1) The voluntary relinquishment of a right, privilege, or advantage. (2) The document by which the relinquishment is evidenced.

**Warrant** A securities certificate which carries the privilege of buying a certain number of shares of stock at a fixed price. They are sometimes attached to securities, at other times they are issued in connection with subscription privileges to holders of stock. See [Right](#).

**Wasting Assets** Assets which are exhausted through use or lose their value through the passage of time, such as oil wells, mining claims, and patents.

**Wearaway** a device which may be offered to employees with long company service when traditional defined benefit pension plans are converted to defined benefit cash balance plans. Wearaway provides employees the option of receiving the greater of their frozen benefit under the previous pension plan formula, or their total benefit under the new cash balance formula.

**Welfare Plans** A term defined by Section 3(1) of ERISA as employee benefit plans which provide the following types of benefits: medical, surgical, hospital care or benefits, sickness, accident, disability, death or unemployment, or vacation benefits. Also includes apprenticeship or other training programs, day care centers, scholarship funds, prepaid legal services, and similar types of benefits other than pensions.

**Will** A legally enforceable declaration of a person's wishes in writing regarding matters to be attended to after his death and inoperative until his death. A will usually, but not always, relates to the testator's property, is revocable (or amendable by means of a codicil) up to the time of his death, and is applicable to the situation which exists at the time of his death.

**Window** A term used with BIC's and GIC's for a contract where periodic deposits may be made over an agreed-upon period, usually three months to a year.

**Witching** The final trading hour, usually on the third Friday of months other than March, June, September and December, when index futures or options expire. This may lead to abnormally high levels of stock trading and volatility. See also [Triple Witching](#).

**When Issued (WI)** Short form of "when, as, and if issued." Refers to a transaction made conditionally because a security, while authorized, has not yet been issued. New issues of stocks and bonds, stocks that have split are traded on a when issued basis. Newspaper listings often indicate such issues by a "WI."

**Whoops** Nickname for the Washington Public Power Supply System. In the late 1970's and early 1980's, WHOOPS raised billions of dollars through municipal bonds to finance construction of five nuclear power plants. WHOOPS cancelled two of the plants and defaulted on the related bonds. It was the largest municipal bond default in history.

**WPPDA** Welfare and Pension Plans Disclosure Act, also known as the Landrum-Griffin Act. Pre-ERISA law now repealed and replaced by ERISA.

**WRAP** A wrap account is an account offered by a broker or investment dealer where the investor is charged an annual management fee for all services, usually based on the value of invested assets. Wrap fees are paid in lieu of commissions in such an account. Refer to [Section 7, Subsection N.2](#), of the Trust Manual for a discussion of wrap accounts offered by a trust department.

**Writer (short)** The seller of an option (financial instrument).

**Yankee Certificate of Deposit** A certificate of deposit issued by the U.S. branch of a foreign bank.

**Z Pac** A derivatives term. Similar to a Z Tranche, but holders also receive principal if prepayments fall within a specified range.

**Z Tranche** A derivatives term for a tranche with a stated interest, but where the interest is not paid until certain other classes have been paid.

**Legal Disclaimer:**

This manual the author or publishers do not hold ourself or ourselves out as providing any legal, financial, accounting, insurance, stocks, securities, or other advice. This book, content and information presented by Prof. George S. Mentz is purely for educational purposes and is intended to be part of the educational exception under the law. All contents herein may be outdated at any time due to changes in the law, regulations, or other. This book and the author also do not make any recommendation or sanction as to any investment, advisor or other service or product and we do not recommend or endorse any party, content, investment, advise or any material submitted created third parties or mentioned in this publication. In addition, this book and the author do not offer any advice regarding the nature, potential value or suitability of any particular investment, security, tactic, or investment strategy. The investment concepts, products and services mentioned on this manuscript may not be suitable for you. If you have any doubts you should contact an independent and licensed and regulated lawyer, government official, or licensed financial advisor. Additionally, some of the investments or strategies mentioned may not be regulated or regulated under the Financial Services Act 1986 or at all and the protection provided to you under this Act will not apply. The material in this book does not constitute advice and you should not rely on any material in this manuscript to make (or refrain from making) any decision or taking (or refraining from making) any action. This manuscript contains references to other groups, government agencies, and websites which are not under the control of and are not maintained by the author or the publishers. Anyone involved in the ownership, use, or publication of this book is not responsible for the content of any other parties. We do not make recommendations for buying or selling any securities or options. We educate readers with financial terminology or alternatives, and it is up to our readers to make their own decisions, or to consult with a licensed attorney, CPA, licensed individual, registered investment advisor, licensed insurance rep, licensed accountant, registered bank, broker dealer or insurance company when evaluating any information. 2006 All Rights Reserved. Any content from this manuscript has been created or edited by Prof. Mentz has been derived from "special public domain" sources.

## **Wealth Management Definition and Trends**

### Background on Wealth Management (WM) Business

What distinguishes WEALTH MANAGEMENT AND HIGH NET WORTH CLIENTS “HNW” from other asset management businesses is often the deep and direct relationship with the client and the types of products and services offered. The primary difference is that “True” wealth management offers planning, retirement, funds, stocks, bonds, treasuries, insurance, college planning, accounting, banking, business products, and the legal alliances to support their company and employee retirement needs. Moreover, trust services along with other super wealthy services are facilitated. Examples are: Hedge Funds, IPO allocations, Legal Advice, Special Exchange Funds, and even Forward Sales.

As the needs of wealthy individuals change or wealth base grows, HNW clients may move to a new provider that offers more broad capabilities, but they may also choose to remain with a firm with which a relationship has already been established. Thus, it is up to the individual bank, brokerage, RIA or Insurance company to satisfy their best customers.

### **Competition**

The HNW market is becoming increasingly competitive with small registered investment advisors, brokers, and accounting and tax firms entering as competitors. Certified Wealth Managers who are registered investment advisors are also emerging as competitors. Other more traditional competitors in this business are regional and national banks as well as other investment management firms. Scale and brand awareness are currently important and increasingly becoming more important in the marketplace. Of primary importance is the relationship between the client and provider; as a result, investment performance while important, is not always the relationship key. Pricing is also an important factor and can be very competitive. Pricing is typically a fee based on the amount of assets under management. A competitor may underprice services to win a deal and later adjust pricing.

The size of the HNW provider is not directly correlated with the asset size of the client. Those clients with a large amount of assets do not necessarily seek larger HNW providers. The best understanding of the competitive marketplace comes from clients. Boston Consulting Group has general information on trends in the industry, but does not publish information on specific providers. Other sources include VIP Forum, Phoenix, Young, and Merrill Lynch. There are both competitive advantages and disadvantages to being structured as a bank in the HNW business. A disadvantage is that a client may not like working with a bank as a client may view an investment advisor as more on the cutting edge. An advantage is the breadth of capabilities that a bank can provide.

### (3) Geographic Considerations

In this business there is typically a need for geographic closeness as the interaction with clients is face-to-face. There are some firms in this business with an international scope, but those would likely have offices internationally. Wealth Management focuses on Global clients in the High Net Worth - HNW business.

## **Taxation in the United States – History & Updates**

### History of the U.S. Tax System

The federal, state, and local tax systems in the United States have been marked by significant changes over the years in response to changing circumstances and changes in the role of government. The types of taxes collected, their relative proportions, and the magnitudes of the revenues collected are all far different than they were 50 or 100 years ago. Some of these changes are traceable to specific historical events, such as a war or the passage of the 16th Amendment to the Constitution that granted the Congress the power to levy a tax on personal income. Other changes were more gradual, responding to changes in society, in our economy, and in the roles and responsibilities that government has taken unto itself.

### Colonial Times

For most of our nation's history, individual taxpayers rarely had any significant contact with Federal tax authorities as most of the Federal government's tax revenues were derived from excise taxes, tariffs, and customs duties. Before the Revolutionary War, the colonial government had only a limited need for revenue, while each of the colonies had greater responsibilities and thus greater revenue needs, which they met with different types of taxes. For example, the southern colonies primarily taxed imports and exports, the middle colonies at times imposed a property tax and a "head" or poll tax levied on each adult male, and the New England colonies raised revenue primarily through general real estate taxes, excises taxes, and taxes based on occupation.



England's need for revenues to pay for its wars against France led it to impose a series of taxes on the American colonies. In 1765, the English Parliament passed the Stamp Act, which was the first tax imposed directly on the American colonies, and then Parliament imposed a tax on tea.

Even though colonists were forced to pay these taxes, they lacked representation in the English Parliament. This led to the rallying cry of the American Revolution that "taxation without representation is tyranny" and established a persistent wariness regarding taxation as part of the American culture.

### The Post Revolutionary Era

The Articles of Confederation, adopted in 1781, reflected the American fear of a strong central government and so retained much of the political power in the States. The national government had few responsibilities and no nationwide tax system, relying on donations from the States for its revenue. Under the Articles, each State was a sovereign entity and could levy tax as it pleased.

When the Constitution was adopted in 1789, the Founding Fathers recognized that no government could function if it relied entirely on other governments for its resources, thus the Federal Government was granted the authority to raise taxes. The Constitution endowed the Congress with the power to "...lay and collect taxes, duties, imposts, and excises, pay the Debts and provide for the common Defense and general Welfare of the United States." Ever on guard against the power of the central government to eclipse that of the states, the collection of the taxes was left as the responsibility of the State governments.

To pay the debts of the Revolutionary War, Congress levied excise taxes on distilled spirits, tobacco and snuff, refined sugar, carriages, property sold at auctions, and various legal documents. Even in the early days of the Republic, however, social purposes influenced what was taxed. For example, Pennsylvania imposed an excise tax on liquor sales partly "to restrain persons in low circumstances from an immoderate use thereof."

Additional support for such a targeted tax came from property owners, who hoped thereby to keep their property tax rates low, providing an early example of the political tensions often underlying tax policy decisions.

Though social policies sometimes governed the course of tax policy even in the early days of the Republic, the nature of these policies did not extend either to the collection of taxes so as to equalize incomes and wealth, or for the purpose of redistributing income or wealth. As Thomas Jefferson once wrote regarding the "general Welfare" clause:

To take from one, because it is thought his own industry and that of his father has acquired too much, in order to spare to others who (or whose fathers) have not exercised equal industry and skill, is to violate arbitrarily the first principle of association, "to guarantee to everyone a free exercise of his industry and the fruits acquired by it."

With the establishment of the new nation, the citizens of the various colonies now had proper democratic representation, yet many Americans still opposed and resisted taxes they deemed unfair or improper. In 1794, a group of farmers in southwestern Pennsylvania physically opposed the tax on whiskey, forcing President Washington to send Federal troops to suppress the Whiskey Rebellion, establishing the important precedent that the Federal government was determined to enforce its revenue laws. The Whiskey Rebellion also confirmed, however, that the resistance to unfair or high taxes that led to the Declaration of Independence did not evaporate with the forming of a new, representative government.

During the confrontation with France in the late 1790's, the Federal Government imposed the first direct taxes on the owners of houses, land, slaves, and estates. These taxes are called direct taxes because they are a recurring tax paid directly by the taxpayer to the government based on the value of the item that is the basis for the tax.

The issue of direct taxes as opposed to indirect taxes played a crucial role in the evolution of Federal tax policy in the following years. When Thomas Jefferson was elected President in 1802, direct taxes were abolished and for the next 10 years there were no internal revenue taxes other than excises.

To raise money for the War of 1812, Congress imposed additional excise taxes, raised certain customs duties, and raised money by issuing Treasury notes. In 1817 Congress repealed these taxes, and for the next 44 years the Federal Government collected no internal revenue. Instead, the Government received most of its revenue from high customs duties and through the sale of public land.

### The Civil War

When the Civil War erupted, the Congress passed the Revenue Act of 1861, which restored earlier excises taxes and imposed a tax on personal incomes. The income tax was levied at 3 percent on all incomes higher than \$800 a year. This tax on personal income was a new direction for a Federal tax system based mainly on excise taxes and customs duties. Certain inadequacies of the income tax were quickly acknowledged by Congress and thus none was collected until the following year.

By the spring of 1862 it was clear the war would not end quickly and with the Union's debt growing at the rate of \$2 million daily it was equally clear the Federal government would need additional revenues. On July 1, 1862 the Congress passed new excise taxes on such items as playing cards, gunpowder, feathers, telegrams, iron, leather, pianos, yachts, billiard tables, drugs, patent medicines, and whiskey. Many legal documents were also taxed and license fees were collected for almost all professions and trades.

The 1862 law also made important reforms to the Federal income tax that presaged important features of the current tax. For example, a two-tiered rate structure was enacted, with taxable incomes up to \$10,000 taxed at a 3 percent rate and higher incomes taxed at 5 percent. A standard deduction of \$600 was enacted and a variety of deductions were permitted for such things as rental housing, repairs, losses, and other taxes paid. In addition, to assure timely collection, taxes were "withheld at the source" by employers.

The need for Federal revenue declined sharply after the war and most taxes were repealed. By 1868, the main source of Government revenue derived from liquor and tobacco taxes. The income tax was abolished in 1872. From 1868 to 1913, almost 90 percent of all revenue was collected from the remaining excises.

#### The 16th Amendment

Under the Constitution, Congress could impose direct taxes only if they were levied in proportion to each State's population. Thus, when a flat rate Federal income tax was enacted in 1894, it was quickly challenged and in 1895 the U.S. Supreme Court ruled it unconstitutional because it was a direct tax not apportioned according to the population of each state.

Lacking the revenue from an income tax and with all other forms of internal taxes facing stiff resistance, from 1896 until 1910 the Federal government relied heavily on high tariffs for its revenues. The War Revenue Act of 1899 sought to raise funds for the Spanish-American War through the sale of bonds, taxes on recreational facilities used by workers, and doubled taxes on beer and tobacco. A tax was even imposed on chewing gum. The Act expired in 1902, so that Federal receipts fell from 1.7 percent of Gross Domestic Product to 1.3 percent.

While the War Revenue Act returned to traditional revenue sources following the Supreme Court's 1895 ruling on the income tax, debate on alternative revenue sources remained lively.

The nation was becoming increasingly aware that high tariffs and excise taxes were not sound economic policy and often fell disproportionately on the less affluent. Proposals to reinstate the income tax were introduced by Congressmen from agricultural areas whose constituents feared a Federal tax on property, especially on land, as a replacement for the excises.

Eventually, the income tax debate pitted southern and western Members of Congress representing more agricultural and rural areas against the industrial northeast. The debate resulted in an agreement calling for a tax, called an excise tax, to be imposed on business income, and a Constitutional amendment to allow the Federal government to impose tax on individuals' lawful incomes without regard to the population of each State.

By 1913, 36 States had ratified the 16th Amendment to the Constitution. In October, Congress passed a new income tax law with rates beginning at 1 percent and rising to 7 percent for taxpayers with income in excess of \$500,000. Less than 1 percent of the population paid income tax at the time. Form 1040 was introduced as the standard tax reporting form and, though changed in many ways over the years, remains in use today. One of the problems with the new income tax law was how to define "lawful" income. Congress addressed this problem by amending the law in 1916 by deleting the word "lawful" from the definition of income. As a result, all income became subject to tax, even if it was earned by illegal means. Several years later, the Supreme Court declared the Fifth Amendment could not be used by bootleggers and others who earned income through illegal activities to avoid paying taxes. Consequently, many who broke various laws associated with illegal activities and were able to escape justice for these crimes were incarcerated on tax evasion charges.

Prior to the enactment of the income tax, most citizens were able to pursue their private economic affairs without the direct knowledge of the government. Individuals earned their wages, businesses earned their profits, and wealth was accumulated and dispensed with little or no interaction with government entities.

The income tax fundamentally changed this relationship, giving the government the right and the need to know about all manner of an individual or business' economic life. Congress recognized the inherent invasiveness of the income tax into the taxpayer's personal affairs and so in 1916 it provided citizens with some degree of protection by requiring that information from tax returns be kept confidential.

#### World War I and the 1920's

The entry of the United States into World War I greatly increased the need for revenue and Congress responded by passing the 1916 Revenue Act. The 1916 Act raised the lowest tax rate from 1 percent to 2 percent and raised the top rate to 15 percent on taxpayers with incomes in excess of \$1.5 million. The 1916 Act also imposed taxes on estates and excess business profits.

Driven by the war and largely funded by the new income tax, by 1917 the Federal budget was almost equal to the total budget for all the years between 1791 and 1916. Needing still more tax revenue, the War Revenue Act of 1917 lowered exemptions and greatly increased tax rates. In 1916, a taxpayer needed \$1.5 million in taxable income to face a 15 percent rate. By 1917 a taxpayer with only \$40,000 faced a 16 percent rate and the individual with \$1.5 million faced a tax rate of 67 percent.

Another revenue act was passed in 1918, which hiked tax rates once again, this time raising the bottom rate to 6 percent and the top rate to 77 percent. These changes increased revenue from \$761 million in 1916 to \$3.6 billion in 1918, which represented about 25 percent of Gross Domestic Product (GDP). Even in 1918, however, only 5 percent of the population paid income taxes and yet the income tax funded one-third of the cost of the war.

The economy boomed during the 1920s and increasing revenues from the income tax followed. This allowed Congress to cut taxes five times, ultimately returning the bottom tax rate to 1 percent and the top rate down to 25 percent and reducing the Federal tax burden as a share of GDP to 13 percent. As tax rates and tax collections declined, the economy was strengthened further.

In October of 1929 the stock market crash marked the beginning of the Great Depression. As the economy shrank, government receipts also fell. In 1932, the Federal government collected only \$1.9 billion, compared to \$6.6 billion in 1920.

In the face of rising budget deficits which reached \$2.7 billion in 1931, Congress followed the prevailing economic wisdom at the time and passed the Tax Act of 1932 which dramatically increased tax rates once again. This was followed by another tax increase in 1936 that further improved the government's finances while further weakening the economy. By 1936 the lowest tax rate had reached 4 percent and the top rate was up to 79 percent. In 1939, Congress systematically codified the tax laws so that all subsequent tax legislation until 1954 amended this basic code. The combination of a shrunken economy and the repeated tax increases raised the Federal government's tax burden to 6.8 percent of GDP by 1940.

### The Social Security Tax

The state of the economy during the Great Depression led to passage of the Social Security Act in 1935. This law provided payments known as "unemployment compensation" to workers who lost their jobs. Other sections of the Act gave public aid to the aged, the needy, the handicapped, and to certain minors. These programs were financed by a 2 percent tax, one half of which was subtracted directly from an employee's paycheck and one half collected from employers on the employee's behalf. The tax was levied on the first \$3,000 of the employee's salary or wage.

## World War II

Even before the United States entered the Second World War, increasing defense spending and the need for monies to support the opponents of Axis aggression led to the passage in 1940 of two tax laws that increased individual and corporate taxes, which were followed by another tax hike in 1941. By the end of the war the nature of the income tax had been fundamentally altered.

Reductions in exemption levels meant that taxpayers with taxable incomes of only \$500 faced a bottom tax rate of 23 percent, while taxpayers with incomes over \$1 million faced a top rate of 94 percent. These tax changes increased federal receipts from \$8.7 billion in 1941 to \$45.2 billion in 1945.

Even with an economy stimulated by war-time production, federal taxes as a share of GDP grew from 7.6 percent in 1941 to 20.4 percent in 1945. Beyond the rates and revenues, however, another aspect about the income tax that changed was the increase in the number of income taxpayers from 4 million in 1939 to 43 million in 1945.

Another important feature of the income tax that changed was the return to income tax withholding as had been done during the Civil War. This greatly eased the collection of the tax for both the taxpayer and the Bureau of Internal Revenue. However, it also greatly reduced the taxpayer's awareness of the amount of tax being collected, i.e. it reduced the transparency of the tax, which made it easier to raise taxes in the future.

## Developments after World War II

Tax cuts following the war reduced the Federal tax burden as a share of GDP from its wartime high of 20.9 percent in 1944 to 14.4 percent in 1950. However, the Korean War created a need for additional revenues which, combined with the extension of Social Security coverage to self-employed persons, meant that by 1952 the tax burden had returned to 19.0 percent of GDP.



In 1953 the Bureau of Internal Revenue was renamed the Internal Revenue Service (IRS), following a reorganization of its function. The new name was chosen to stress the service aspect of its work. By 1959, the IRS had become the world's largest accounting, collection, and forms-processing organization. Computers were introduced to automate and streamline its work and to improve service to taxpayers. In 1961, Congress passed a law requiring individual taxpayers to use their Social Security number as a means of tax form identification. By 1967, all business and personal tax returns were handled by computer systems, and by the late 1960s, the IRS had developed a computerized method for selecting tax returns to be examined. This made the selection of returns for audit fairer to the taxpayer and allowed the IRS to focus its audit resources on those returns most likely to require an audit.

Throughout the 1950s tax policy was increasingly seen as a tool for raising revenue and for changing the incentives in the economy, but also as a tool for stabilizing macroeconomic activity. The economy remained subject to frequent boom and bust cycles and many policymakers readily accepted the new economic policy of raising or lowering taxes and spending to adjust aggregate demand and thereby smooth the business cycle. Even so, however, the maximum tax rate in 1954 remained at 87 percent of taxable income. While the income tax underwent some manner of revision or amendment almost every year since the major reorganization of 1954, certain years marked especially significant changes. For example, the Tax Reform Act of 1969 reduced income tax rates for individuals and private foundations.

Beginning in the late 1960s and continuing through the 1970s the United States experienced persistent and rising inflation rates, ultimately reaching 13.3 percent in 1979. Inflation has a deleterious effect on many aspects of an economy, but it also can play havoc with an income tax system unless appropriate precautions are taken.

Specifically, unless the tax system's parameters, i.e. its brackets and its fixed exemptions, deductions, and credits, are indexed for inflation, a rising price level will steadily shift taxpayers into ever higher tax brackets by reducing the value of those exemptions and deductions.

During this time, the income tax was not indexed for inflation and so, driven by a rising inflation, and despite repeated legislated tax cuts, the tax burden rose from 19.4 percent of GDP to 20.8 percent of GDP. Combined with high marginal tax rates, rising inflation, and a heavy regulatory burden, this high tax burden caused the economy to under-perform badly, all of which laid the groundwork for the Reagan tax cut, also known as the Economic Recovery Tax Act of 1981.

### The Reagan Tax Cut

The Economic Recovery Tax Act of 1981, which enjoyed strong bipartisan support in the Congress, represented a fundamental shift in the course of federal income tax policy. Championed in principle for many years by then-Congressman Jack Kemp (R-NY) and then-Senator Bill Roth (R- DE), it featured a 25 percent reduction in individual tax brackets, phased in over 3 years, and indexed for inflation thereafter. This brought the top tax bracket down to 50 percent.

The 1981 Act also featured a dramatic departure in the treatment of business outlays for plant and equipment, i.e. capital cost recovery, or tax depreciation. Heretofore, capital cost recovery had attempted roughly to follow a concept known as economic depreciation, which refers to the decline in the market value of a producing asset over a specified period of time. The 1981 Act explicitly displaced the notion of economic depreciation, instituting instead the Accelerated Cost Recovery System which greatly reduced the disincentive facing business investment and ultimately prepared the way for the subsequent boom in capital formation. In addition to accelerated cost recovery, the 1981 Act also instituted a 10 percent Investment Tax Credit to spur additional capital formation.

Prior to, and in many circles even after the 1981 tax cut, the prevailing view was that tax policy is most effective in modulating aggregate demand whenever demand and supply become mismatched, i.e. whenever the economy went in to recession or became "over-heated". The 1981 tax cut represented a new way of looking at tax policy, though it was in fact a return to a more traditional, or neoclassical, economic perspective. The essential idea was that taxes have their first and primary effect on the economic incentives facing individuals and businesses. Thus, the tax rate on the last dollar earned, i.e. the marginal dollar, is much more important to economic activity than the tax rate facing the first dollar earned or than the average tax rate. By reducing marginal tax rates it was believed the natural forces of economic growth would be less restrained.

The most productive individuals would then shift more of their energies to productive activities rather than leisure and businesses would take advantage of many more now profitable opportunities. It was also thought that reducing marginal tax rates would significantly expand the tax base as individuals shifted more of their income and activities into taxable forms and out of tax-exempt forms.

The 1981 tax cut actually represented two departures from previous tax policy philosophies, one explicit and intended and the second by implication. The first change was the new focus on marginal tax rates and incentives as the key factors in how the tax system affects economic activity. The second policy departure was the de facto shift away from income taxation and toward taxing consumption. Accelerated cost recovery was one manifestation of this shift on the business side, but the individual side also saw a significant shift in the enactment of various provisions to reduce the multiple taxation of individual saving. The Individual Retirement Account, for example, was enacted in 1981.

Simultaneously with the enactment of the tax cuts in 1981 the Federal Reserve Board, with the full support of the Reagan Administration, altered monetary policy so as to bring inflation under control. The Federal Reserve's actions brought inflation down faster and further than was anticipated at the time, and one consequence was that the economy fell into a deep recession in 1982. Another consequence of the collapse in inflation was that federal spending levels, which had been predicated on a higher level of expected inflation, were suddenly much higher in inflation-adjusted terms. The combination of the tax cuts, the recession, and the one-time increase in inflation-adjusted federal spending produced historically high budget deficits which, in turn, led to a tax increase in 1984 that pared back some of the tax cuts enacted in 1981, especially on the business side.

As inflation came down and as more and more of the tax cuts from the 1981 Act went into effect, the economic began a strong and sustained pattern of growth. Though the painful medicine of disinflation slowed and initially hid the process, the beneficial effects of marginal rate cuts and reductions in the disincentives to invest took hold as promised.

### The Evolution of Social Security and Medicare

The Social Security system remained essentially unchanged from its enactment until 1956. However, beginning in 1956 Social Security began an almost steady evolution as more and more benefits were added, beginning with the addition of Disability Insurance benefits. In 1958, benefits were extended to dependents of disabled workers. In 1967, disability benefits were extended to widows and widowers. The 1972 amendments provided for automatic cost-of-living benefits.

In 1965, Congress enacted the Medicare program, providing for the medical needs of persons aged 65 or older, regardless of income. The 1965 Social Security Amendments also created the Medicaid programs, which provides medical assistance for persons with low incomes and resources.

Of course, the expansions of Social Security and the creation of Medicare and Medicaid required additional tax revenues, and thus the basic payroll tax was repeatedly increased over the years. Between 1949 and 1962 the payroll tax rate climbed steadily from its initial rate of 2 percent to 6 percent. The expansions in 1965 led to further rate increases, with the combined payroll tax rate climbing to 12.3 percent in 1980. Thus, in 31 years the maximum Social Security tax burden rose from a mere \$60 in 1949 to \$3,175 in 1980. Despite the increased payroll tax burden, the benefit expansions Congress enacted in previous years led the Social Security program to an acute funding crises in the early 1980s. Eventually, Congress legislated some minor programmatic changes in Social Security benefits, along with an increase in the payroll tax rate to 15.3 percent by 1990. Between 1980 and 1990, the maximum Social Security payroll tax burden more than doubled to \$7,849.

#### The Tax Reform Act of 1986

Following the enactment of the 1981, 1982, and 1984 tax changes there was a growing sense that the income tax was in need of a more fundamental overhaul. The economic boom following the 1982 recession convinced many political leaders of both parties that lower marginal tax rates were essential to a strong economy, while the constant changing of the law instilled in policy makers an appreciation for the complexity of the tax system. Further, the debates during this period led to a general understanding of the distortions imposed on the economy, and the lost jobs and wages, arising from the many peculiarities in the definition of the tax base. A new and broadly held philosophy of tax policy developed that the income tax would be greatly improved by repealing these various special provisions and lowering tax rates further. Thus, in his 1984 State of the Union speech President Reagan called for a sweeping reform of the income tax so it would have a broader base and lower rates and would be fairer, simpler, and more consistent with economic efficiency.

The culmination of this effort was the Tax Reform Act of 1986, which brought the top statutory tax rate down from 50 percent to 28 percent while the corporate tax rate was reduced from 50 percent to 35 percent. The number of tax brackets was reduced and the personal exemption and standard deduction amounts were increased and indexed for inflation, thereby relieving millions of taxpayers of any Federal income tax burden. However, the Act also created new personal and corporate Alternative Minimum Taxes, which proved to be overly complicated, unnecessary, and economically harmful.

The 1986 Tax Reform Act was roughly revenue neutral, that is, it was not intended to raise or lower taxes, but it shifted some of the tax burden from individuals to businesses. Much of the increase in the tax on business was the result of an increase in the tax on business capital formation.

It achieved some simplifications for individuals through the elimination of such things as income averaging, the deduction for consumer interest, and the deduction for state and local sales taxes. But in many respects the Act greatly added to the complexity of business taxation, especially in the area of international taxation. Some of the over-reaching provisions of the Act also led to a downturn in the real estate markets which played a significant role in the subsequent collapse of the Savings and Loan industry.

Seen in a broader picture, the 1986 tax act represented the penultimate installment of an extraordinary process of tax rate reductions. Over the 22 year period from 1964 to 1986 the top individual tax rate was reduced from 91 to 28 percent. However, because upper-income taxpayers increasingly chose to receive their income in taxable form, and because of the broadening of the tax base, the progressivity of the tax system actually rose during this period.

The 1986 tax act also represented a temporary reversal in the evolution of the tax system. Though called an income tax, the

Federal tax system had for many years actually been a hybrid income and consumption tax, with the balance shifting toward or away from a consumption tax with many of the major tax acts. The 1986 tax act shifted the balance once again toward the income tax. Of greatest importance in this regard was the return to references to economic depreciation in the formulation of the capital cost recovery system and the significant new restrictions on the use of Individual Retirement Accounts.

Between 1986 and 1990 the Federal tax burden rose as a share of GDP from 17.5 to 18 percent. Despite this increase in the overall tax burden, persistent budget deficits due to even higher levels of government spending created near constant pressure to increase taxes.

Thus, in 1990 the Congress enacted a significant tax increase featuring an increase in the top tax rate to 31 percent. Shortly after his election, President Clinton insisted on and the Congress enacted a second major tax increase in 1993 in which the top tax rate was raised to 36 percent and a 10 percent surcharge was added, leaving the effective top tax rate at 39.6 percent. Clearly, the trend toward lower marginal tax rates had been reversed, but, as it turns out, only temporarily.

The Taxpayer Relief Act of 1997 made additional changes to the tax code providing a modest tax cut. The centerpiece of the 1997 Act was a significant new tax benefit to certain families with children through the Per Child Tax credit. The truly significant feature of this tax relief, however, was that the credit was refundable for many lower-income families. That is, in many cases the family paid a "negative" income tax, or received a credit in excess of their pre-credit tax liability. Though the tax system had provided for individual tax credits before, such as the Earned Income Tax credit, the Per Child Tax credit began a new trend in federal tax policy.

Previously tax relief was generally given in the form of lower tax rates or increased deductions or exemptions. The 1997 Act really launched the modern proliferation of individual tax credits and especially refundable credits that are in essence spending programs operating through the tax system.

The years immediately following the 1993 tax increase also saw another trend continue, which was to once again shift the balance of the hybrid income tax-consumption tax toward the consumption tax. The movement in this case was entirely on the individual side in the form of a proliferation of tax vehicles to promote purpose-specific saving. For example, Medical Savings Accounts were enacted to facilitate saving for medical expenses. An Education IRA and the Section 529 Qualified Tuition Program was enacted to help taxpayers pay for future education expenses. In addition, a new form of saving vehicle was enacted, called the Roth IRA, which differed from other retirement savings vehicles like the traditional IRA and employer-based 401(k) plans in that contributions were made in after-tax dollars and distributions were tax free.

Despite the higher tax rates, other economic fundamentals such as low inflation and low interest rates, an improved international picture with the collapse of the Soviet Union, and the advent of a qualitatively and quantitatively new information technologies led to a strong economic performance throughout the 1990s. This, in turn, led to an extraordinary increase in the aggregate tax burden, with Federal taxes as a share of GDP reaching a postwar high of 20.8 percent in 2000.

### The Bush Tax Cut

By 2001, the total tax take had produced a projected unified budget surplus of \$281 billion, with a cumulative 10 year projected surplus of \$5.6 trillion. Much of this surplus reflected a rising tax burden as a share of GDP due to the interaction of rising real incomes and a progressive tax rate structure.



Consequently, under President George W. Bush's leadership the Congress halted the projected future increases in the tax burden by passing the Economic Growth and Tax Relief and Reconciliation Act of 2001. The centerpiece of the 2001 tax cut was to regain some of the ground lost in the 1990s in terms of lower marginal tax rates. Though the rate reductions are to be phased in over many years, ultimately the top tax rate will fall from 39.6 percent to 33 percent.

The 2001 tax cut represented a resumption of a number of other trends in tax policy. For example, it expanded the Per Child Tax credit from \$500 to \$1000 per child. It also increased the Dependent Child Tax credit. The 2001 tax cut also continued the move toward a consumption tax by expanding a variety of savings incentives. Another feature of the 2001 tax cut that is particularly noteworthy is that it put the estate, gift, and generation-skipping taxes on course for eventual repeal, which is also another step toward a consumption tax. One novel feature of the 2001 tax cut compared to most large tax bills is that it was almost devoid of business tax provisions.

The 2001 tax cut will provide additional strength to the economy in the coming years as more and more of its provisions are phased in, and indeed one argument for its enactment had always been as a form of insurance against an economic downturn. However, unbeknownst to the Bush Administration and the Congress, the economy was already in a downturn as the Act was being debated. Thankfully, the downturn was brief and shallow, but it is already clear that the tax cuts that were enacted and went into effect in 2001 played a significant role in supporting the economy, shortening the duration of the downturn, and preparing the economy for a robust recovery.

One lesson from the economic slowdown was the danger of ever taking a strong economy for granted. The strong growth of the 1990s led to talk of a "new" economy that many assumed was virtually recession proof. The popularity of this assumption was easy to understand when one considers that there had only been one very mild recession in the previous 18 years.

Taking this lesson to heart, and despite the increasing benefits of the 2001 tax cut and the early signs of a recovery, President Bush called for and the Congress eventually enacted an economic stimulus bill. The bill included an extension of unemployment benefits to assist those workers and families under financial stress due to the downturn. The bill also included a provision to providing a temporary but significant acceleration of depreciation allowances for business investment, thereby assuring that the recovery and expansion will be strong and balanced. Interestingly, the depreciation provision also means that the Federal tax on business has resumed its evolution toward a consumption tax, once again paralleling the trend in individual taxation.

## **Educational Planning and College Planning**

### **A NOTE TO PARENTS**

Education can be the fault line between those who will prosper in the new economy and those who will be left behind. Today's good jobs require skills and training beyond a high school education, and effective and accessible postsecondary education is critically important to individuals as well as our nation's economy and democracy. In fact, the Census Bureau estimates that a person with a bachelor's degree earns about \$600,000 more in today's dollars over the course of a lifetime than a person whose education ended with high school.

You and your family can take specific actions to prepare properly - both academically and financially - to put America's excellent colleges and universities within reach of your children.

First, your child will need to study hard at every level and take the courses in middle and high school that lay the foundation for success in college-level courses. This has to include taking challenging math courses throughout high school. Second, it is important for you and your child to try to put money aside for college and to be well informed about the many sources of student financial aid for college. College costs are not nearly as high as many families assume, and there are many financial aid programs like Pell Grants, federal work-study, loans, and Hope Scholarship and Lifetime Learning tax credits that make college more affordable.

This resource book is designed to help you and your child plan ahead for college. It describes the types of courses students should take and when to take them, how to work with teachers and school counselors to choose colleges that fit your student's needs, and how to plan financially for the costs of college.

The Congress and President in the 1990's has emphasized universal access to postsecondary education and lifelong learning as top priorities. In addition to tax credits, grants and other subsidized loans are still available. Moreover, there are many college savings plans and products that are now available.

---

### **Why attend college?**

A college degree can provide your child with many opportunities in life. A college education can mean:

- **Greater Knowledge**

A college education will increase your child's ability to understand developments in science and in society, to think abstractly and critically, to express thoughts clearly in speech and in writing, and to make wise decisions. These skills are useful both on and off the job.

- **More Money**

A person who attends college generally earns more than a person who does not. For example, in 1997, a person with a college degree from a four-year college earned approximately \$18,000 more in that year than a person who did not go to college. Someone with a twoyear associate's degree also tends to earn more than a high school graduate.

- **Greater Potential**

A college education can help increase your child's understanding of the community, the nation, and the world-as he or she explores interests, discovers new areas of knowledge, considers lifelong goals, and becomes a responsible citizen.

- **More Job Opportunities**

The world is changing rapidly. Many jobs rely on new technology and already require more brain power than muscle power. In your child's working life, more and more jobs will require education beyond high school. With a college education, your child will have more jobs from which to choose.

Some of these benefits of college may not be obvious to your child. Even though he or she has to make the final decision to attend college, you can help in the decision-making process by learning about all aspects of college yourself and sharing what you learn with your child.

### **How can I afford to send my child to college?**

Saving money in advance and obtaining financial aid are common ways for parents to make their child's education affordable. Other ways of making college affordable, such as attending college part time, will be discussed later in this handbook. (See [this section](#).)

### **Saving Money**

Saving money is the primary way to prepare for the costs of college. Setting aside a certain amount every month or each payday will help build up a fund for college. If you and your child begin saving early, the amount you have to set aside each month will be smaller.

In order to set up a savings schedule, you'll need to think about where your child might attend college, how much that type of college might cost, and how much you can afford to save. Keep in mind that colleges of the same type have a range of costs and your child may be able to attend one that is less expensive. You can also pay part of the costs from your earnings while your child is attending school. In addition, your child may also be able to meet some of the costs of college by working during the school year or during the summer. Finally, some federal, state, or other student financial aid may be available, including loans to you and to your child.

You will also want to think about what kind of savings instrument to use or what kind of investment to make. By putting your money in some kind of savings instrument or investment, you can set aside small amounts of money regularly and the money will earn interest or dividends. Interest refers to the amount that your money earns when it is kept in a savings instrument. Dividends are payments of part of a company's earnings to people who hold stock in the company.

A savings instrument has an "interest rate" associated with it; this refers to the rate at which the money in the instrument increases during a certain period of time. Principal refers to the face value or the amount of money you place in the savings instrument on which the interest is earned.

Every type of savings or investment has some risk that the return will be less than needed or expected. Federally insured savings accounts are safe and guaranteed up to \$100,000 by the U.S. Government. However, they may have lower interest rates, making it harder to save large amounts of money for college. Bonds and stocks often have higher returns than savings accounts or EE savings bonds but are riskier. You can reduce the risks of these kinds of investments by starting to save early. The earlier you begin the less money you will have to put aside each month and the more total savings you will accumulate. You should talk with your banker or other financial professional about different savings and investment choices. You might also talk with a friend or relative who understands these choices. You can also learn about them by reading some of the magazines that have articles on saving for college.

[Chart 7](#) shows how much you would need to save each month in order to have \$10,000 available when your child begins college.

The chart assumes that you are getting a return of 5 percent on your savings. If you are able to earn more than that, your total savings will be higher. As the chart shows, if you start saving when your child is born, you will have 18 years of accumulated savings by the time your child enters college. You would only have to save or invest about \$29 each month in an account earning 5 percent in order to have \$10,000 at the end of 18 years. If you wait until your child is 12, you will have to set aside \$119 a month. By waiting too long to begin saving, you may not be able to afford the amount of monthly savings needed to reach your goals.

| <b>CHART 7</b>   |                                  |                                    |                  |                        |                      |
|--|----------------------------------|------------------------------------|------------------|------------------------|----------------------|
| <b>Amount You Would Need to Save to Have \$10,000 Available When Your Child Begins College</b> |                                  |                                    |                  |                        |                      |
| <b>Amount Available When Child Begins College</b>  |                                  |                                    |                  |                        |                      |
| <b>If you start saving when your child is</b>  | <b>Number of years of saving</b> | <b>Approximate monthly savings</b> | <b>Principal</b> | <b>Interest earned</b> | <b>Total savings</b> |
| (Assuming a 5 percent interest rate.)  |                                  |                                    |                  |                        |                      |
| Newborn  | 18                               | \$29                               | \$6,197          | \$3,803                | \$10,000             |
| Age 4  | 14                               | 41                                 | 6,935            | 3,065                  | 10,000               |
| Age 8  | 10                               | 64                                 | 7,736            | 2,264                  | 10,000               |
| Age 12   | 6                                | 119                                | 8,601            | 1,399                  | 10,000               |
| Age 16   | 2                                | 397                                | 9,531            | 469                    | 10,000               |

When deciding which type of savings or investment is right for you and your family, you should consider four features:

- **Risk:** The danger that the money you set aside could be worth less in the future.
- **Return:** The amount of money you earn on the savings instrument or investment through interest or dividends.
- **Liquidity:** How quickly you can gain
- **Time Frame:** The number of years you will need to save or invest.

When you select one or more savings or investments, you should balance these factors by minimizing the risk while maximizing the return on your money. You will also want to be sure that you will be able to access the money at the time you need to pay for your child's education.

If you start early enough, you may feel confident about making some long-term investments. Some investments are riskier than others but can help you earn more money over time. [Chart 10](#) lists some of the major kinds of savings instruments and investments that you may want to use. You can get more information on these access to the money in the instrument or and other savings instruments at local banks and at your investment. neighborhood library.

Don't forget that you won't necessarily have to save for the entire cost of college. The following section tells about student financial aid for which you and your child might qualify and other ways to keep college costs down.

## Financial Aid

Financial aid can help many families meet college costs. Every year millions of students apply for and receive financial aid. In fact, almost one-half of all students who go on for more education after high school receive financial aid of some kind.



There are three main types of financial assistance available to qualified students at the college level:

- **Grants and Scholarships,**
- **Loans, and**
- **Work-Study.**

- **Grants and Scholarships**

Grants and scholarships provide aid that does not have to be repaid. However, some require that recipients maintain certain grade levels or take certain courses.

- **Loans**

Loans are another type of financial aid and are available to both students and parents. Like a car loan or a mortgage for a house, an education loan must eventually be repaid. Often, payments do not begin until the student finishes school, and the interest rate on education loans is commonly lower than for other types of loans. For students with no established credit record, it is usually easier to get student loans than other kinds of loans. There are many different kinds of education loans. Before taking out any loan, be sure to ask the following kinds of questions:

- **What are the exact provisions of the loan?**
- **What is the interest rate?**
- **Exactly how much has to be paid in interest?**
- **What will the monthly payments be?**
- **When will the monthly payments begin?**
- **How long will the monthly payments last?**
- **What happens if you miss one of the monthly payments?**
- **Is there a grace period for paying back the loan?**

In all cases, a loan taken to pay for a college education must be repaid, whether or not a student finishes school or gets a job after graduation. Failure to repay a student loan can ruin a student or parent's credit rating. This is an important reason to consider a college's graduation and job placement rates when you help your child choose a school.

- **Work-Study Programs**

Many students work during the summer or parttime during the school year to help pay for college. Although many obtain jobs on their own, many colleges also offer work-study programs to their students. A work-study job is often part of a student's financial aid package. The jobs are usually on campus and the money earned is used to pay for tuition or other college charges.

The types of financial aid discussed above can be merit-based, need-based, or a combination of merit-based and need-based.

- **Merit-Based Financial Aid**

Merit-based assistance, usually in the form of scholarships or grants, is given to students who meet requirements not related to financial needs. For example, a merit scholarship may be given to a student who has done well in high school or one who displays artistic or athletic talent. Most merit-based aid is awarded on the basis of academic performance or potential.

- **Need-Based Financial Aid**

Need-based aid means that the amount of aid a student can receive depends on the cost of the college and on his or her family's ability to pay these costs. Most financial aid is need-based and is available to qualified students.

## What are the most common sources of financial aid?

Student financial aid is available from a number of sources, including the federal government, state governments, colleges and universities, and other organizations. Students can receive aid from more than one source.

- **Federal Financial Assistance**

The federal government supplies the largest amount of all student aid, about 75 percent or \$35 billion annually. The largest and most popular federal student aid programs are:

- **Federal Pell Grants**

These are need-based grants that were given to just under 3.8 million students for school year 1998-99. In school year 1998-99, the maximum Pell Grant was \$3,000.

- **Federal Direct and FFEL Stafford Loans**

Direct and FFEL Stafford Loans are the federal government's major form of self-help aid. Direct Stafford Loans are available through the William D. Ford Direct Loan (Direct Loan) Program and FFEL Stafford Loans are available through the Federal Family Education Loan (FFEL) Program. In 1998-99, approximately 5.4 million students received FFEL Stafford Loans and about 3 million received Direct Stafford Loans.

The terms and conditions of a Direct Stafford or a FFEL Stafford are similar. The major differences between the two are the source of the loan funds, some aspects of the application process, and the available repayment plans. Under the Direct Loan Program, the funds for your loan are lent to you directly by the U.S. government. If your school does not participate in the Direct Loan Program, the funds for your loan are lent to you from a bank, credit union, or other lender that participates in the FFEL program.

## **- Federal Campus-Based Programs**

The federal government provides money to colleges to give to needy students through three federal campus-based programs. These three programs include (1) a grant program (Federal Supplemental Educational Opportunity Grants, or SEOGs), (2) a loan program (Federal Perkins Loans), and (3) the Federal Work-Study Program.

- **More Information on Federal Aid**

Students can get aid from more than one federal program. *For the most up-to-date information about student aid supplied by the federal government, call the Federal Student Financial Aid Information Center toll free at the U.S. Department of Education at 1-800-4FED-AID. You can also obtain a guide to federal financial aid for students, called The Student Guide, which provides an extensive and annually updated discussion of all federal student aid programs. You can obtain the Guide by writing to the following address:*

**Federal Student Aid Information Center  
P.O. Box 84  
Washington, DC 20044**

**Or call: 1-800-4FED-AID.**

- **State Financial Assistance**

States generally give financial support to public colleges and universities. This support lowers tuition for all students attending these schools. Some states also offer financial assistance directly to individual students, which can be need-based or merit-based. To find out about state aid

- **College or University Assistance**

Colleges themselves provide aid to many of their students. Most of this institutional aid is in the form of scholarships or grants. Some is need-based and some is merit-based.

When your child wants financial aid information about specific schools, he or she should contact the financial aid offices of these schools and request information.

- **Other Types of Assistance**

Other organizations, such as corporations, labor unions, professional associations, religious organizations, and credit unions, sometimes award financial aid. You can find out about the availability of such scholarships by contacting someone from the organization or by contacting its headquarters.

In addition, some organizations, particularly foundations, offer scholarships to minorities, women, and disabled students. To learn more about such scholarships, go to the nearest public library with a good reference section and look for directories that list such scholarships. (The names of a few books that list scholarships appear in the last section of this guide.) College admissions offices and high school guidance counselors should also be able to provide more information about scholarships.

- **Help in Getting More Information**

The guidance counselors at your child's high school should be able to provide information on when and how to apply for federal, state, and other types of aid. If they cannot give you this information, try a local college. Even if your child doesn't plan to attend that particular institution, financial aid officers there should have information on federal financial aid. Many colleges can also tell you about state aid and their own institutional aid.

## **Tax credits, deductions, and deferrals**

In addition to any student aid awarded to a student, families may be eligible for tax credits, tax deductions, or tax breaks on savings plans. These are not the same as student aid but may make college education more affordable by reducing the amount of taxes that would otherwise be owed.

Tax credits directly reduce the amount of taxes owed to the federal government. There are two types of tax credit programs. The first is called the Hope Scholarship and can provide up to \$1,500 for a child's first and second years of college. The second is called the Lifetime Learning tax credit and can provide as much as \$1,000 a year after the first two years of college. The actual amount of the credit depends on the amount of college expenses and on parent or student income. Parents can take the tax credit if they claim the student as an exemption on their return. The student can take the tax credit if he files a separate return and claims himself as an exemption.

When deciding about student loans, students should also remember that some of the annual interest payments may be deductible on their tax returns during the first five years of loan repayment.

The federal government also encourages families to save in advance for their education by allowing taxes to be deferred or forgiven on accumulated earnings. One provision is the Education IRA or individual retirement account. This allows total contributions of not more than \$500 a year to the account of a child under 18. These contributions cannot be deducted from taxes. However, the taxes on the earnings in the account are deferred. If the withdrawals from the account are used for qualified higher education expenses, the student will not owe any tax on the accumulated earnings.

Certain states and agencies also have programs that allow people to buy credits or certificates or make contributions to accounts that can be used to pay higher education expenses. These programs are usually referred to as state tuition programs or pre-paid tuition programs. The contributions are not tax deductible but the earnings from the accounts are not taxed when used for higher education expenses.

Many families have used EE savings bonds as a way to accumulate funds for college. The interest on these bonds, if they were issued after 1989 and used to pay qualified college expenses, can be excluded from gross income on your tax return. This exclusion depends on the family's income and other financial aid and tax benefits that the student or parents may have received.

Eligibility for tax credits, deductions, and deferrals involves complex rules and calculations. You should seek the advice of someone who has experience with these provisions. *You can also read IRS Publication 970, Tax Benefits for Higher Education.*

### **Are there other ways to keep the cost of college down?**

#### **Serve in AmeriCorps**

AmeriCorps is a domestic service organization in which thousands of young men and women are working in community service projects around the country in exchange for a living allowance averaging \$7,500 per year; health care; child care when needed; and an education award of \$4,725 per year for paying back a student loan or for financing post secondary education. Under some circumstances a person can serve parttime and receive an education award of \$2,362 per year.

AmeriCorps projects serve communities throughout the country. All meet at least one of four national priorities: (1) education, (2) public safety, (3) human needs, and (4) the environment. For example, AmeriCorps members teach state-of-the-art computer skills to teenagers, tutor grade-school children in basic reading, or organize innovative after-school programs in some of the education projects.

AmeriCorps members in environmental projects clean up urban streams and inland waterways, monitor dangerous trends in air quality, or test-start city-wide recycling programs.

There are many different points in a person's educational career when participation in AmeriCorps is an option: right after high school; during or after college; and during or after graduate school or occupational training. AmeriCorps members are recruited locally and nationally. *To find out more about AmeriCorps, call the AmeriCorps Hotline free of charge at 1-800-94ACORPS (1-800-942-2677) or TDD 1-800-833-3722. You may also visit the AmeriCorps web site at: [www.americorps.org](http://www.americorps.org).*

### **Take Advanced Placement (AP) Courses and Exams in High School**

As discussed in an earlier section of this guide, many high schools offer Advanced Placement (AP) courses and exams. AP courses are college-level courses that help students prepare for college-level work. After taking AP courses, students can take AP exams offered in the same subjects as the AP courses. If students score a grade of 3 or higher on an AP exam, they can often receive college credit. Students with high grades on AP exams in many different subjects are sometimes granted a full year of course credit at the colleges where they enroll. The receipt of course credit can result in savings in college costs. These savings can be quite large if it means that a student is able to enter into a college as a second-year student; such a student might save the cost of tuition, room, board, and fees for a whole year of college.

However, not all colleges and universities give college credit for a grade of 3 or higher on an AP exam. Contact your child's high school to find out if AP courses and exams are offered. Write to the admissions office of the colleges that are of interest to your child to find out if they give credit for an AP exam grade of 3 or higher.



## **Participate in a Career-Focused Educational Program such as "Tech-Prep" or "School-to-Career"**

As [discussed earlier](#) in this guide, some high schools offer career-focused educational programs that provide students with a set of high school courses that are formally linked to courses offered at local community or technical colleges. These "tech-prep" or "school-to-career" programs, as they are often called, offer students the opportunity to go through a sequence of career-focused courses in high school that prepares them for an apprenticeship program or for a specialized sequence of college courses in a particular occupational field. Thus, students who master certain technical and occupational skills and knowledge in high school do not need to repeat the same courses when they enter college or an apprenticeship.

In some of these programs, students who take the specialized sequence of courses in high school can sometimes be awarded college credit or advanced standing in the occupational program at the college level. This can save students time and money. It also means that students can gain access to more advanced college courses much earlier in their college careers. To find out if such career-focused programs exist in your community, ask your child's guidance counselor or teacher, or staff at a local college. To learn more about career-focused programs like tech-prep and school-to-career programs, [contact the organizations](#) listed in this guide.

## **Enroll in a Two-Year College; Then Transfer to a Four-Year College**

Local community colleges are usually the least expensive. In addition to charging low tuition, usually it is possible to save money by having the student live at home and commute to campus.

After completing an associate's degree or certificate in a two-year college, students often can transfer to a four-year college and work toward a bachelor's degree.

If your child chooses this route, he or she needs to take courses in the two-year college that will count toward a bachelor's degree. Certain community college courses may not be transferable to a four-year institution. Community college admissions officers can explain transfer terms and opportunities.

### **Work Part Time**

Some students choose to work part-time and attend college part-time. If your child wishes to do this, he or she should make sure that work, classes, and time for studying do not conflict. Some institutions offer programs that enable students to combine work and classes. Although going to school part-time is a good option for many students, it usually takes longer for part-time students to earn their degrees.

### **Take Advantage of Armed Forces Education Programs**

All of the ways to get postsecondary educational training through the armed forces are shown in [Chart 9](#) below. The armed forces offer educational programs during or after active duty. If your child prefers to work toward a college degree immediately after high school, attending one of the military academies or attending a civilian school and enrolling in the Reserve Officers Training Corps (ROTC) program are options. If your child wants to join the armed forces before attending college full-time, he or she can attend college after military service by taking advantage of the Montgomery GI Bill or by obtaining college credit for some of the military training he or she will receive.

- **Military Academies**

Each branch of the military, with the exception of the Marine Corps, has its own academy—a four-year college that offers a bachelor's degree and a commission in the military upon graduation. The military academies are highly competitive and are tuition-free to students who are admitted. The three main military academies are:

- (1) U.S. Military Academy, located in West Point, N.Y.,
- (2) U.S. Naval Academy, located in Annapolis, Md., and
- (3) U.S. Air Force Academy, located in Colorado Springs, Colo.

- **Other Academies**

Two other academies operate on the same model as the military academies, with subsidized tuition in return for service. They are: (1) U.S. Coast Guard Academy, located in New London, Conn., and (2) U.S. Merchant Marine Academy, located in Kings Point, N.Y.

- **ROTC**

In the ROTC scholarship program, the military covers most of the cost of tuition, fees, and textbooks and also provides a monthly allowance. Scholarship recipients participate in summer training while in college and fulfill a service commitment after college.

- **The Montgomery GI Bill**

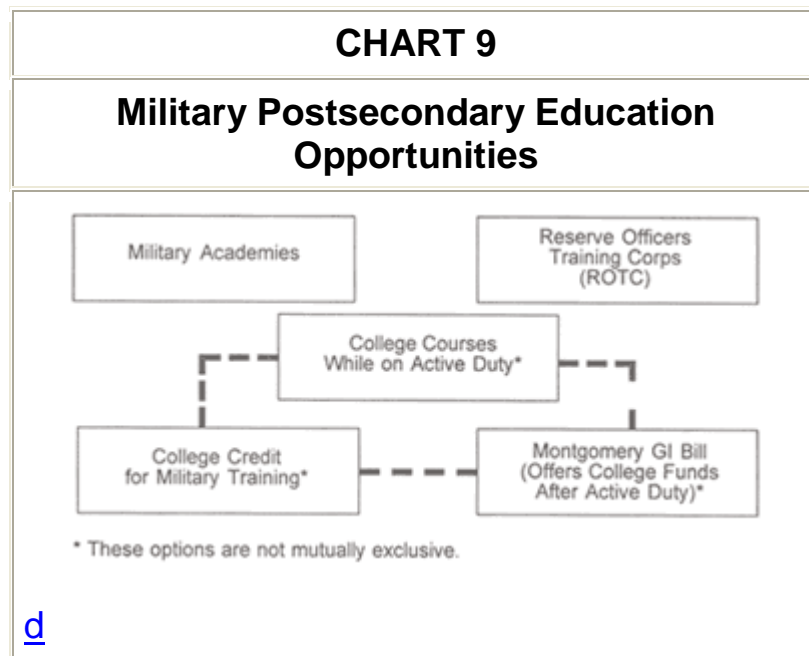
This bill provides financial support for people who wish to pursue a college education after serving in the military.

- **Other Ways to Get a College Education in the Armed Forces**

Most branches of the military offer some kind of tuition assistance program that enables members to take college courses at civilian colleges during their off-duty hours while on active duty. In addition, military training while on active duty can sometimes count toward college credit. All branches of the military offer training in various technical and vocational areas, and military enrollees can often obtain college credit for some of this training.

The National Guard and the Armed Forces Reserves offer the same kind of educational benefits as those available to people on Active Duty.

Local armed forces recruiting offices can provide detailed information about education opportunities through the military.



### How do I set up a long-range plan?

Step by step, you can help your child make informed decisions about his or her education, do well academically, learn about colleges, and find the best possible opportunities for a college education.

Following are two checklists that are designed to help you and your child, year by year, progress toward preparing for college-both academically and financially. The first list speaks directly to your child, although he or she may need your help. The second list speaks directly to you.

## CHECKLIST

### College Preparation Checklist for Students

#### **Pre-High School:**

Take challenging classes in English, mathematics, science, history, geography, the arts, and a foreign language.

Develop strong study skills.

Start thinking about which high school classes will best prepare you for college.

If you have an opportunity to choose among high schools or among different programs within one high school, investigate the options and determine which ones will help you

-further your academic and career interests and

-open doors to many future options.

Start saving for college if you haven't already.

Investigate different ways to save money-buying a U.S. Savings Bond or opening a savings account in a bank, investing in mutual funds, etc.

Find a mentor who will support your positive goals and help you with questions about plans for your future.

**High School:**

**9TH GRADE**

Take challenging classes in English mathematics, science, history, geography, a foreign language, civics, economics, and the arts.

Get to know your career counselor or guidance counselor, and other college resources available in your school.

Talk to adults in a variety of professions to determine what they like and dislike about their jobs and what kind of education is needed for each kind of job.

Continue to save for college.

**10TH GRADE**

Take challenging classes in English, mathematics, science, history, geography, a foreign language, government, civics, economics, and the arts.

Continue to talk to adults in a variety of professions to determine what they like and dislike about their jobs, and what kind of education is needed for each kind of job.

Become involved in school- or communitybased extracurricular (before or after school) activities that interest you and enable you to explore career interests.

Meet with your career counselor or guidance counselor to discuss colleges and their requirements.

Take the Preliminary Scholastic Assessment Test/National Merit Scholarship Qualifying Test (PSAT/NMSQT). You must register early. If you have difficulty paying the registration fee, see your guidance counselor about getting a fee waiver.

Take advantage of opportunities to visit colleges and talk to students.

Continue to save for college.

### **11TH GRADE**

Take challenging classes in English, mathematics, science, history, geography, a foreign language, government, civics, economics, and the arts.

Meet with your career counselor or guidance counselor to discuss colleges and their requirements.

Continue involvement in school- or community-based extracurricular activities.

Decide which colleges most interest you. Write these schools to request information and an application for admission. Be sure to ask about special admissions requirements, financial aid, and deadlines.

Talk to college representatives at college fairs.

Take advantage of opportunities to visit colleges and talk to students.

Consider people to ask for recommendations-teachers, counselors, employers, etc.

Investigate the availability of financial aid from federal, state, local, and private sources. Call the Student Aid Hotline at the U.S. Department of Education (1-8004FED-AID) for a student guide to Federal financial aid. Talk to your guidance counselor for more information.

If you are interested, learn more about AmeriCorps by calling 1-800-942-2677 or TDD 1-800-833-3722. Via the Internet, go to [www.americorps.org](http://www.americorps.org).

Investigate the availability of scholarships provided by organizations such as corporations, labor unions, professional associations, religious organizations, and credit unions.

If applicable, go to the library and look for directories of scholarships for women, minorities, and disabled students.

Register for and take the Scholastic Assessment Test (SAT), the ACT, SAT Subject Tests, or any other exams required for admission to the colleges you might want to attend. If you have difficulty paying the registration fee, see your guidance counselor about getting a fee waiver.

Continue to save for college.

## **12TH GRADE**

Take challenging classes in English, mathematics, science, history, geography, a foreign language, government, civics, economics, the arts, and advanced technologies.

Meet with your counselor early in the year to discuss your plans.

Complete all necessary financial aid forms. Make sure that you fill out at least one form that can be used for Federal aid.

Write colleges to request information and applications for admission. Be sure to ask about financial aid, admissions



requirements, and deadlines.

If possible, visit the colleges that most interest you.

Register for and take the Scholastic Assessment Test (SAT), American College Test (ACT), SAT Subject Tests, or any other exams required for admission to the colleges to which you are applying. If you have difficulty paying the registration fee, see your guidance counselor about getting a fee waiver.

Prepare your application carefully. Follow the instructions, and **PAY CLOSE ATTENTION TO DEADLINES!** Be sure to ask your counselor and teachers at least two weeks before your application deadlines to submit the necessary documents to colleges (your transcript, letters of recommendation, etc.).

## CHECKLIST

### Financial Preparation Checklist for Parents

#### PRE-HIGH SCHOOL:

Start saving money for your child's college education. Investigate different ways to save money-buying U.S. Savings Bonds or opening a savings account in a bank, etc.

#### HIGH SCHOOL:

**9TH GRADE** Continue to save for college.

**10TH GRADE** Continue to save for college.

#### 11TH GRADE

Help your child investigate the availability of financial aid from federal, state, local, and private sources. Call the Student Aid Hotline at the U.S.

Department of Education (1-800-4FED-AID) for a student guide to federal financial aid. Have your child talk to his or her guidance counselor for more information.

Help your child investigate the availability of scholarships provided by organizations such as corporations, labor unions, professional associations, religious organizations, and credit unions. If applicable, go to the library with your son or daughter and look for directories on scholarships for women, minorities, and disabled students.

## **12TH GRADE**

Make sure your child completes all necessary financial aid forms, including the Free Application for Federal Student Aid (FAFSA) from the U.S. Department of Education. Call 1-800-4FED-AID; TDD 1-800-730-8913 or visit the FAFSA web site at: [www.fafsa.ed.gov](http://www.fafsa.ed.gov).

Continue to save for college.

## **Common Features of Prepaid Tuition and College Savings Plans**

### **Federal Tax Advantages**

One of the biggest advantages of 529 plans over other college savings options are the tax advantages they offer. Earnings grow tax-free and withdrawals also are tax-free for qualified education expenses.<sup>3</sup>

**Caution!** The law exempting qualified withdrawals from federal income tax expires on December 31, 2010. Unless Congress and the President take action to extend the provisions of this law, withdrawals from 529 plans will not be tax-free beginning in 2011. Keep this mind if you have younger children who will be in college after 2010.

Although the IRS typically allows you to give no more than \$11,000 a year to another person without a federal gift tax, you can contribute up to \$55,000 to a 529 plan in one year. A special tax law allows you to aggregate five years of the allowable \$11,000 annual gift-tax exclusion to jumpstart a 529 plan. While you will be precluded from making any further gifts for five years, compounding will make your earnings grow faster than if you invested \$11,000 in each of the five years. Use our [College Savings Calculator](#) to see the difference in savings of using a lump sum to jump-start a 529 plan.

Also, anyone can contribute to a 529 plan. Unlike education savings accounts (ESAs) and saving bonds, which are discussed later, there are no income limitations. For most wealthy families, 529 plans are one of the few available tax-advantaged college savings options.

### **State Tax Advantages**

State tax treatment of 529 plans varies from state to state. In over 20 states, contributions are tax deductible if you're a resident of the state sponsoring the 529 plan. For example, in Missouri, up to \$8,000 in contributions to the state's 529 plan can be deducted from Missouri state taxable income per taxpayer per year. Many states also don't tax earnings or qualified withdrawals from 529 plans. To get this tax exemption, you may have to live in that state and choose its 529 plan. These tax benefits may net you more investing in your state plan than if you invest in another state's plan that earns more.

### **Control**

Unlike Custodial Accounts and ESAs, 529 plans allow the account owner to maintain control over the assets in a 529 plan for the life of the account. You also can change beneficiaries to another "family member" of the original beneficiary. Thus, if your child gets a scholarship or decides not to go to college, you can name another beneficiary, even yourself. Some 529 plans, especially prepaid tuition plans, may limit or restrict your ability to change beneficiaries, so check the plan offering document.

## **Transfers**

The assets of one 529 plan can be transferred tax-free to another 529 plan of another beneficiary, as long as the new beneficiary is a "family member" of the beneficiary of the 529 plan from which the transfer was made. "Family members" include, among others, the beneficiary's spouse, son, daughter, grandchild, niece, nephew and first cousin.

The assets of one 529 plan also can be transferred tax-free to another 529 plan for the same beneficiary. However, only one transfer of this type is allowed within any 12-month period. There also may be state tax implications when you transfer from one 529 plan to another. You may want to consult with your tax advisor before you make a transfer.

## **Withdrawals for Non-College Related Expenses**

If your child decides not to go to college or you over-fund a 529 plan, you may pay a penalty in addition to any taxes you owe on any earnings. If you withdraw money from a 529 plan that is not used for qualified education expenses, you are generally required to pay income tax and an additional 10% penalty on earnings.

There are a number of exceptions to this penalty. The penalty may be waived if your child gets a scholarship or is disabled. You also can avoid the taxes and penalties by transferring the 529 plan to another beneficiary that will use the funds for qualified education expenses. Furthermore, you can use our [College Savings Calculator](#) to estimate the amount you need to save so that you don't over-fund a 529 plan.

<sup>3</sup> Until 2004, withdrawals from school-sponsored 529 plans are taxable.

## Educational Glossary of Terms

### What terms do I need to understand?

Below is a glossary of some terms that you may want to remember:

**A.A.:** This stands for an "associate of arts" degree, which can be earned at most two-year colleges.

**A.A.S.:** This refers to an "associate of applied science" degree, which can be earned at some two-year colleges.

**ACT:** This is a test published by American College Testing, which is located in Iowa City, Iowa. The ACT measures a student's aptitude in English, mathematics, reading, and science reasoning. Many colleges in the South and Midwest require students to take this test and submit their test scores when they apply for admission. Some colleges accept this test or the SAT. (See below for explanation of SAT.) Most students take the ACT or the SAT during their junior or senior year of high school.

**B.A. or B.S. degree:** B.A. stands for "bachelor of arts," and B.S. stands for "bachelor of science." Both degrees can be earned at four-year colleges.

**Certificates of Deposit:** [See chart.](#)

**Default Rate:** The default rate is the percentage of students who took out federal student loans to help pay their expenses but did not repay them properly.

**Dividends:** Dividends are payments of part of a company's earnings to people who hold stock in the company.

**Expected Family Contribution (EFC):** An amount, determined by a formula that is specified by law, that indicates how much of a family's financial resources should be available to help pay for school. Factors such as taxable and non-taxable income, assets (such as savings and checking accounts), and benefits (for example, unemployment or Social Security) are all considered in this calculation. The EFC is used in determining eligibility for Federal need-based aid.

**Fees:** These are charges that cover costs not associated with the student's course load, such as costs of some athletic activities, clubs, and special events.

**Financial Aid:** Financial aid in this handbook refers to money available from various sources to help students pay for college.

**Financial Aid Package:** The total amount of financial aid a student receives. Federal and non-federal aid such as grants, loans, or work-study are combined in a "package" to help meet the student's need. Using available resources to give each student the best possible package of aid is one of the major responsibilities of a school's financial aid administrator.

**Financial Need:** In the context of student financial aid, financial need is equal to the cost of education (estimated costs for college attendance and basic living expenses) minus the expected family contribution (the amount a student's family is expected to pay, which varies according to the family's financial resources).

**General Educational Development (GED) Diploma:** The certificate students receive if they have passed a high school equivalency test. Students who don't have a high school diploma but who have a GED will still qualify for federal student aid.

**Grant:** A grant is a sum of money given to a student for the purposes of paying at least part of the cost of college. A grant does not have to be repaid.

**Individual Corporate Bonds or Stocks:** [See chart.](#)

**Interest:** This refers to the amount that your money earns when it is kept in a savings instrument.

**Investment:** In this guide, an investment refers to using your money to invest in something that will enable you to earn interest or dividends over time.

**Liquidity:** A term that refers to how quickly you can gain access to money that you invest or deposit in some kind of savings instrument.

**Loan:** A loan is a type of financial aid that is available to students and to the parents of students. An education loan must be repaid. In many cases, however, payments do not begin until the student finishes school.

**Merit-based Financial Aid:** This kind of financial aid is given to students who meet requirements not related to financial needs. Most merit-based aid is awarded on the basis of academic performance or potential and is given in the form of scholarships or grants.

**Money Market Accounts/Money Market Mutual Funds:** [See chart.](#)

**Mutual Funds:** [See chart.](#)

**Need-based Financial Aid:** This kind of financial aid is given to students who are determined to be in financial need of assistance based on their income and assets and their families' income and assets, as well as some other factors.

**Open Admissions:** This term means that a college admits most or all students who apply to the school. At some colleges it means that anyone who has a high school diploma or a GED can enroll. At other schools it means that anyone 18 years of age or older can enroll. "Open admissions," therefore, can mean slightly different things at different schools.

**Pell Grants:** These are federal need-based grants that were given to just under 4 million students for school year 1998-99. In school year 1998-99, the maximum Pell Grant was \$3,100.

**Perkins Loans:** This is a federal financial aid program that consists of low-interest loans for undergraduates and graduate students with exceptional financial need. Loans are awarded by the school.

**PLUS Loans:** These federal loans allow parents to borrow money for their children's college education.

**Postsecondary:** This term means "after high school" and refers to all programs for high school graduates, including programs at two- and four-year colleges and vocational and technical schools.

**Principal:** This refers to the face value or the amount of money you place in a savings instrument on which interest is earned.

**Proprietary:** This is a term used to describe postsecondary schools that are private and are legally permitted to make a profit. Most proprietary schools offer technical and vocational courses.

**PSAT/NMSQT:** This stands for the Preliminary Scholastic Assessment Test/National Merit Scholarship Qualifying Test, a practice test that helps students prepare for the Scholastic Assessment Test (SAT). The PSAT is usually administered to tenth or eleventh grade students. Although colleges do not see a student's PSAT/NMSQT score, a student who does well on this test and who meets many other academic performance criteria may qualify for the National Merit Scholarship Program.



**Return:** Return refers to the amount of money you earn through a financial investment or savings instrument. You earn money on investments and savings instruments through interest earnings or dividends.

**Risk:** In reference to saving or investing, risk refers to the danger of losing money you set aside in some kind of savings plan.

**ROTC:** This stands for Reserve Officers Training Corps program, which is a scholarship program wherein the military covers the cost of tuition, fees, and textbooks and also provides a monthly allowance. Scholarship recipients participate in summer training while in college and fulfill a service commitment after college.

**SAT:** This stands for the Scholastic Assessment Test, published by the College Board, a non-profit organization with headquarters in New York City. The SAT is a test that measures a student's mathematical and verbal reasoning abilities. Many colleges in the East and West require students to take the SAT and to submit their test scores when they apply for admission. Some colleges accept this test or the ACT. (See above for an explanation of the ACT.) Most students take the SAT or the ACT during their junior or senior year of high school.

**SAT Subject Test:** SAT subject tests (also known as SAT II tests) are offered in many areas of study including English, mathematics, many sciences, history, and foreign languages. Some colleges require students to take one or more SAT subject tests when they apply for admission. [Write to this address](#) for more information about such tests.

**Savings Accounts:** [See chart.](#)

**Savings Instrument:** In this document, savings instrument refers to any kind of savings plan or mechanism you can use to save money over time. Examples of savings instruments discussed in this handbook are savings accounts, certificates of deposit (CDs), and money market accounts.

**Scholarship:** A scholarship is a sum of money given to a student for the purposes of paying at least part of the cost of college. Scholarships can be awarded to students based on students' academic achievements or on many other factors.

**SEOG (Supplemental Educational Opportunity Grant):** This is a federal award that helps undergraduates with exceptional financial need and is awarded by the school. The SEOG does not have to be paid back.

**Stafford Loans:** These are student loans offered by the federal government. There are two types of Stafford Loans—one need-based and another non-need based. Under the Stafford Loan programs, students can borrow money to attend school and the federal government will guarantee the loan in case of default. Under the Stafford Loan programs, the combined loan limits are \$2,625 for the first year, \$3,500 for the second year, \$5,500 for the third or more years. An undergraduate cannot borrow more than a total of \$23,000.

**Transcript:** This is a list of all the courses a student has taken with the grades that the student earned in each course. A college will often require a student to submit his or her high school transcript when the student applies for admission to the college.

**Tuition:** This is the amount of money that colleges charge for classroom and other instruction and use of some facilities such as libraries. Tuition can range from a few hundred dollars per year to 40, 000 dollars or more per year plus room and board.

**William D. Ford Federal Direct Loans:** Under this new program, students may obtain federal loans directly from their college or university with funds provided by the U.S. Department of Education instead of a bank or other lender.

**Work-Study Programs:** These programs are offered by many colleges. They allow students to work part time during the school year as part of their financial aid package. The jobs are usually on campus and the money earned is used to pay for tuition or other college charges.

### **Where can I get more information on the topics discussed in this handbook?**

In this section you will find phone numbers, mailing addresses, Internet addresses, and books that you can use to get more information about planning for college both financially and academically. You should be able to find most of these books and others like them at your local library.

The following publications, organizations, and Internet addresses represent a partial list of such sources of information. Their placement on this list does not constitute an endorsement by the U.S. Department of Education.

### **Books and Other Resources on Occupations and Careers**

- (1) *The Occupational Outlook Handbook*, 1998-99 Edition. U.S. Department of Labor, Bureau of Labor Statistics, 1998.
- (2) *Careers for the '90s: Everything You Need To Know to Find the Right Career*. Research and Education Association, 1994.
- (3) *The College Board Guide to Jobs and Career Planning*, Second Edition, Joyce Slaton Mitchell. The College Board, 1994.
- (4) *What Color Is Your Parachute?* Richard Nelson Bolles. Ten Speed Press, annual.

(5) ACT (American College Testing) and the National Career Development Association have developed a career exploration and guidance kit called *Realizing the Dream*. Many schools around the country are using this kit to help students identify careers of interest. Ask your child's guidance counselor if *Realizing the Dream* is being used in your child's school or district. To find out more about the kit, you can call 319-337-1000 or write to the following address:

(6) *Internet Guide for College-Bound Students*, Kenneth E. Hartman. The College Board, 1998.

Program Coordinator  
ACT  
2201 North Dodge Street  
P.O. Box 168  
Iowa City, IA 52243-0168  
<http://www.act.org/>  
e-mail: [cps@act.org](mailto:cps@act.org)

### **Books about Choosing a College**

(1) *The College Guide for Parents*, Third Edition, Charles Shields. The College Board, 1994.

(2) *The College Handbook, 1999*. The College Board, 1998.

(3) *Peterson's Guide to Four-Year Colleges*, 1998, Twenty-Eighth Edition. Peterson's Guides, 1997.

(4) *Barron's Profiles of American Colleges*, Twenty-Third Edition. Barron's Educational Series, Inc., 1998.

(5) *Rugg's Recommendations on the Colleges*, Sixteenth Edition. Rugg's Recommendations, 1999.

(6) *The Multicultural Student's Guide to Colleges*, Robert Mitchell. Noonday Press, 1996.

## **Books about Private Sources of Financial Aid**

(1) *Foundation Grants to Individuals*, 11th Edition, L. Victoria Hall (ed.). The Foundation Center, 1999.

(2) *The A's and B's of Academic Scholarships*, 20th Edition, Ann Schimke (ed.) and Anna Leider. Octameron Associates, 1998.

(3) *The Scholarship Book*, 1998/1999 Edition, Daniel Cassidy and Tom Powea. Prentice Hall, Inc., 1998.

(4) *The Complete Grants Sourcebook for Higher Education*, Third Edition, David Bauer and David Bower. Oryx Press, 1996.

### **The U.S. Department of Education:**

The U.S. Department of Education and its Office of Postsecondary Education have information that may be of use to you. The *Student Guide* is available over the Internet from the Education Department.

U.S. Department of Education (ED)

**Address:** <http://www.ed.gov>

ED's Office of Postsecondary Education

**Address:** <http://www.ed.gov/offices/OPE/index.html>

The Student Guide

**Address:** [http://www.ed.gov/prog\\_info/SFA/StudentGuide](http://www.ed.gov/prog_info/SFA/StudentGuide)

Think College Early

**Address:** <http://www.ed.gov/thinkcollege>

### **8) The Consumer Information Center in Pueblo, Colo.:**

This volume, *Preparing Your Child for College*, is available through the Internet from the electronic arm of the Government Document Distribution Center in Pueblo, Colorado.

Address: <http://www.pueblo.gsa.gov/prepare.htm>

## Types of Retirement Plans

### IRA Individual Retirement Accounts

#### **Can an individual contribute to a traditional IRA if he or she has other retirement plans?**

Yes, individuals can contribute to a traditional IRA whether or not they are covered by another retirement plan. However, they may not be able to deduct all of their contributions if they or their spouses are covered by an employer-sponsored retirement plan. [Note that contributions to a Roth IRA are not deductible and income limits apply.] See [Publication 590](#) for further information.

---

#### **How can an individual convert a traditional IRA to a Roth IRA?**

A traditional IRA can be converted to a Roth IRA by:

**Rollover** - A distribution from a traditional IRA can be contributed to a Roth IRA within 60 days after distribution.

**Trustee-to-trustee transfer** - The financial institution holding the traditional IRA assets will provide directions on how to transfer those assets to a Roth IRA with another financial institution.

**Same trustee transfer** - As with the trustee-to-trustee transfer, the financial institution holding the traditional IRA assets will provide directions on how to transfer those assets to a Roth IRA. In this case, things should be simpler because the transfer occurs within the same financial institution.

A conversion results in taxation of any untaxed amounts in the traditional IRA. Also, the conversion is reported on [Form 8606](#), *Nondeductible IRAs*.

**Can an IRA be rolled over into a qualified retirement plan (e.g., 401(k), profit-sharing, etc.)?**

An IRA can be rolled over into a qualified retirement plan, assuming the qualified retirement plan has language permitting such rollovers.

---

**Can an IRA accept rollovers from a qualified retirement plans?**

Provided the IRA document permits rollovers, almost any type of plan distribution can be rolled over into it.

---

**Are in-service distributions allowed from an IRA-based plan (e.g., SEP, SARSEP or SIMPLE IRA plan)?**

There are no prohibitions on distributions from IRA-based plans. A participant can take distributions at any time. However, in addition to the distribution being taxable, it may be subject to a 10% additional tax if the participant has not reached age 59 1/2. If the distribution is taken in the first 2 years of participation in a SIMPLE IRA plan, the additional tax is increased to 25%.

---

**Are hardship distributions allowed from an IRA-based plan?**

As in-service distributions are allowed, so are "hardship" distributions, subject to the same conditions.

---

**Must distributions be made to IRA-based plan participants who are over age 70 1/2, if they are still working? What about to the owner of the company?**

Both the owner and any employees over age 70 1/2 must take required minimum distributions. Unlike qualified plans (e.g., 401(k), profit-sharing, etc.), there is no exception for non-owners who have not retired.

---

**How much must be taken out of an individual's IRA at age 70 1/2?**

Required minimum distributions apply each year beginning with the year the account owner turns age 70 1/2. The required minimum distribution for each year is calculated by dividing the IRA account balance as of December 31 of the prior year by the applicable distribution period or life expectancy. An account owner can determine his or her applicable distribution period or life expectancy by using the Tables in Appendix C of [Publication 590](#). Table I is used by beneficiaries. Table II is for use by owners who have spouses who are both the IRA's sole beneficiary and who are more than 10 years younger than the owner.

---

**If an IRA is cashed in before age 59 1/2, what forms need to be filled out?**

Regardless of age, the IRA owner will need to file a Form 1040 and show the amount of withdrawal from the IRA. Since the withdrawal was taken before reaching age 59 1/2, unless certain exceptions listed in [Publication 590](#) *Individual Retirement Arrangements (IRAs)* are met, the IRA owner will need to pay an additional 10 percent tax on early distributions from qualified retirement plans that is reported on Form 1040. A [Form 5329](#) *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, may need to be completed and attached to the tax return.



**Can the 10% additional tax for an early withdrawal from an IRA be deducted in the Adjusted Gross Income section of Form 1040 as a penalty on early withdrawal of savings?**

No, the additional 10% tax on early distributions from qualified retirement plans does not qualify as a penalty for withdrawal of savings.

**Does the participant request the distribution check directly from the employer or from the financial institution where the IRA-based plan is invested?**

The participant will need to contact the financial institution holding the IRA assets. After the employer sends the IRA plan contributions to the financial institution, that institution will have control over the funds.

**Can the outstanding loan balance from a retirement plan be rolled over into an IRA and the loan payments made to the IRA instead of the other plan?**

IRAs (including SEP-IRAs) do not permit loans. Therefore, repaying a loan balance from one plan by transferring the loan balance and making loan payments to an IRA is not allowed. If this transaction was attempted, the loan would be treated as a distribution at the time of the attempted rollover.

---

**The bank refuses to give a loan from an IRA-based plan - isn't it required to allow loans?**

IRAs are the investment vehicles for IRA-based plans. As discussed in the above Q&A, IRAs do not permit loans. So banks aren't allowed to give loans from an IRA.

**Are there any restrictions on the things an IRA can be invested in?**

The law does not permit IRA funds to be invested in collectibles.

If an IRA invests in collectibles, the amount invested is considered distributed in the year invested. The account owner may have to pay a 10% additional tax on early distributions.

Here are some examples of collectibles:

- Artwork,
- Rugs,
- Antiques,
- Metals - there are exceptions for certain kinds of bullion,
- Gems,
- Stamps,
- Coins - there are exceptions for certain coins minted by the U.S. Treasury,
- Alcoholic beverages, and
- Certain other tangible personal property.

Check [Publication 590](#), *Individual Retirement Arrangements (IRAs)*, for more information on collectibles.

Finally, IRA trustees are permitted to impose additional restrictions on investments. For example, because of administrative burdens, many IRA trustees do not permit IRA owners to invest IRA funds in real estate. IRA law does not prohibit investing in real estate but trustees are not required to offer real estate as an option.

---

### **Are the basic investment rules different for SEPs and SIMPLE IRA plans?**

The basic investment vehicle for each of these plans is an IRA, and the investment restrictions apply equally to all types of IRAs.

---

### **Can losses in an IRA be deducted on a participant's income tax return?**

No - Neither IRA losses nor IRA gains are taken into account on a participant's tax return while the IRA is on-going.

## **ROTH IRA Plans**

### **What is a Roth 401(k) or Roth 403(b)? Is it a new type of plan?**

No, it is not a new type of plan. Designated Roth contributions are a new type of contribution that can be accepted by new or existing 401(k) or 403(b) plans. This feature is permitted under a Code section added by the **Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)**, effective for years beginning on or after January 1, 2006. If a plan adopts this feature, employees can designate some or all of their elective contributions as designated Roth contributions, (which are included in gross income) rather than traditional, pre-tax elective contributions. So, starting in 2006, elective contributions come in two types: traditional, pre-tax elective contributions (elective contributions are also referred to as elective deferrals) and designated Roth contributions.

---

### **Can my employer start making designated Roth contributions to my designated Roth account as of January 1, 2006?**

Legislation permits designated Roth contributions to be made under 401(k) or 403(b) plans after December 31, 2005; HOWEVER, these plans must be properly amended for this feature by the end of the plan year in which the Roth contributions are first effective.

### **What is a designated Roth contribution?**

A designated Roth contribution is an elective deferral to a section 401(k) or 403(b) plan that has been designated irrevocably by an employee as not excludable from the employee's gross income and to be deposited into a designated Roth account under the plan. Thus, the contribution is treated by the employer as includible in the employee's gross income at the time the employee would have received the amount in cash if the employee had not made the election (hence subject to all applicable wage withholding requirements). Designated Roth contributions are allowed in 401(k) plans and 403(b) plans but not in SARSEPs or SIMPLE IRA plans.

---

### **Can I make both pre-tax elective and designated Roth contributions in the same year?**

Yes, you can make contributions to both a designated Roth account and a traditional, pre-tax account in the same year in any proportion you choose. However, the combined amount contributed in any one year is limited by the 402(g) limit - \$15,000 for 2006 (plus an additional \$5,000 in catch-up contributions if age 50 or older).

---

**Are there any limits as to how much I may contribute to my designated Roth account?**

Yes, the combined amount contributed to all designated Roth accounts and traditional, pre-tax accounts in any one year for any individual is limited by the 402(g) limit - \$15,000 for 2006 (plus an additional \$5,000 in catch-up contributions if age 50 or older).

---

**Can my age-50 catch-up contributions be made as a designated Roth contribution to my designated Roth account?**

Yes.

---

**Must I make the election to make designated Roth contributions at the beginning of the year?**

The rules regarding frequency of elections apply in the same manner to both pre-tax elective contributions and designated Roth contributions and must be specified under the plan. Thus, an employee must have an effective opportunity to make (or change) an election to make designated Roth contributions at least once during each plan year. A Roth election must be in place before any money can be placed in a designated Roth account.

---

**Do the same income restrictions that apply to Roth IRAs apply to designated Roth contributions?**

No, there are no limits on income in determining if designated Roth contributions can be made. Of course, you have to have salary from which to make any 401(k) or 403(b) deferrals.

---

**Can my employer make matching contributions on my designated Roth contributions? Can the matching contributions be allocated to my designated Roth account?**

The employer can make matching contributions on designated Roth contributions. However, only an employee's designated Roth contributions can be allocated to designated Roth accounts. The matching contributions made on account of designated Roth contributions must be allocated to a pre-tax account, just as matching contributions on traditional, pre-tax elective contributions are.

---

**Can plan forfeitures be placed into my designated Roth account?**

No amounts other than designated Roth contributions and rollover contributions (and earnings on such contributions) are permitted to be allocated to a designated Roth account. Therefore, forfeitures, matching or any other employer contributions may not be allocated to the designated Roth account.

---

**If I start making designated Roth contributions at the beginning of the year and later change my mind and want them treated as pre-tax elective contributions, can they be re-characterized and transferred from the designated Roth account to the traditional, pre-tax account?**

No, the election to make designated Roth contributions is irrevocable. Once they are designated as Roth contributions, they cannot later be changed to pre-tax elective contributions.

---

**Can my plan offer only designated Roth contributions?**

No, in order to provide for designated Roth contributions, a 401(k) or 403(b) plan must also offer pre-tax elective contributions.

---

**Can my plan automatically enroll me into making designated Roth contributions if I fail to affirmatively decline participation?**

Yes, a plan that provides for a cash or deferred election can stipulate that contributions will be made in the absence of an affirmative election by you declining participation. If such plan has both pre-tax elective contributions and designated Roth contributions, the plan must set forth the extent to which those default contributions are pre-tax elective contributions or designated Roth contributions. An employee who has not made an affirmative election is deemed to have irrevocably designated the contributions as designated Roth contributions.

---

**If designated Roth contributions are offered to one participant under a 403(b) Tax-Sheltered Annuity plan, must they be offered to all participants under that TSA plan?**

The proposed regulations provide that the universal availability requirement of section 403(b)(12) includes the right to make designated Roth contributions. Thus, if any employee is given the opportunity to designate section 403(b) elective deferrals as designated Roth contributions, then all employees must be given that right.

### **What is a designated Roth account?**

A designated Roth account is a separate account under a section 401(k) plan or section 403(b) plan to which designated Roth contributions are made, and for which separate accounting of contributions, gains, and losses is maintained. This separate accounting requirement applies at the time the designated Roth contribution is contributed to the plan and must continue to apply until the designated Roth account is completely distributed.

---

### **Does a new account need to be established under my 401(k) or 403(b) plan to receive my designated Roth contributions?**

Yes, designated Roth contributions must be kept completely separate from previous and current 401(k) or 403(b) pre-tax elective contributions. A separate account must be established for each participant making designated Roth contributions.

### **What is a qualified distribution from a designated Roth account?**

A qualified distribution is generally a distribution that is made after a 5-taxable-year period of participation and that either:

1. is made on or after the date the employee attains age 59½ ,
2. is made after the employee's death, or
3. is attributable to the employee's being disabled.

A qualified distribution from a designated Roth account is not includible in the employee's gross income.

---



### **What is a 5-taxable-year period of participation and how is it calculated?**

The proposed regulations state that the 5-taxable-year period of participation begins on the first day of the employee's taxable year for which the employee first had designated Roth contributions made to the plan and ends when 5 consecutive taxable years have passed. If a direct rollover is made from a designated Roth account under another plan, the 5-taxable-year period for the employee under the recipient plan begins on the first day of the employee's taxable year for which the employee first had designated Roth contributions made to the other plan, if earlier.

---

### **Are there any distributions that cannot be qualified distributions and includible in income?**

Yes, distributions of the following amounts are not treated as qualified distributions, are not eligible rollover distributions and are includible in income:

- Corrective distributions of elective deferrals contributed to a designated Roth account in excess of the section 415 limits (lesser of \$44,000 or 100% of earnings for 2006)
  - Corrective distributions of excess deferrals under section 402(g) (\$15,000 in 2006, \$20,000 if 50 or older)
  - Corrective distributions of excess contributions or excess aggregate contributions
  - Deemed distributions under section 72(p) (participant loan defaults).
-

### **What happens if I take a distribution from my designated Roth account before the end of the 5-taxable-year period?**

Under the proposed regulations, a nonqualified distribution is included in the distributee's gross income to the extent allocable to income on the contract and excluded from gross income to the extent allocable to investment in the contract (basis). The amount of a distribution allocated to investment in the contract is determined by applying to the distribution the ratio of the investment in the contract to the designated Roth account balance. For example, if a nonqualified distribution of \$5,000 is made from an employee's designated Roth account when the account consists of \$9,400 of designated Roth contributions and \$600 of earnings, the distribution consists of \$4,700 of designated Roth contributions (that are not includible in the employee's gross income) and \$300 of earnings (that are includible in the employee's gross income).

See Q&As regarding Rollovers of Designated Roth Contributions for additional provisions for rolling over both qualified and nonqualified designated Roth account distributions.

---

### **Since designated Roth contributions are made after-tax, can I withdraw from my designated Roth account at any time and without taxes?**

No, the plan's restrictions on withdrawals that apply to pre-tax elective contributions also apply to designated Roth contributions. So if your plan permits distributions from your 401(k) or 403(b) accounts on account of hardship, you may choose to receive a hardship distribution from your designated Roth account. But such a distribution will consist of a pro-rata share of earnings and basis and the earnings will be included in gross income unless you have had the designated Roth account for 5 years and are either disabled or over age 59 ½.

**Can distributions from a designated Roth account be rolled over to a designated Roth account of another employer or into a Roth IRA?**

The proposed regulations provide that if the portion of a distribution from a designated Roth account under a plan qualified under section 401(a) that is not includible in income is to be rolled over into a designated Roth account under another plan, the rollover of the distribution must be accomplished through a direct rollover (i.e., a rollover to another designated Roth account is not available for the portion of the distribution not includible in gross income if the distribution is made directly to the employee) and can only be made to a plan qualified under section 401(a) which agrees to separately account for the amount not includible in income (i.e., it cannot be rolled over into a section 403(b) plan).

If a distribution from a designated Roth account is made to the employee, the employee would still be able to roll over the entire amount (or any portion thereof) into a Roth IRA within 60 days of receipt. Under section 402(c)(2), if only a portion of the distribution is rolled over, the portion that is rolled over is treated as consisting first of the amount of the distribution that is includible in gross income. Alternatively, the employee is permitted to roll over the taxable portion of the distribution to a designated Roth account under either a section 401(a) or 403(b) plan within 60 days of receipt. In addition, the employee's period of participation under the distributing plan is not carried over to the recipient plan for purposes of determining whether the employee satisfies the 5-taxable-year requirement under the recipient plan.

---

**How is the 5-taxable-year period calculated in the case of a rollover of a distribution from a designated Roth account maintained under a section 401(k) or 403(b) plan to a Roth IRA?**

The proposed regulations provide that in the case of a rollover of a distribution from a designated Roth account maintained under a section 401(k) or 403(b) plan to a Roth IRA, the period that the rolled-over funds were in the designated Roth account does not count towards the 5-taxable-year period for determining qualified distributions from the Roth IRA. However, if an individual had established a Roth IRA in a prior year, the 5-year period for determining qualified distributions from a Roth IRA that began as a result of that earlier Roth IRA contribution applies to any distributions from the Roth IRA (including a distribution of an amount attributable to a rollover contribution from a designated Roth account).

---

**Are there any examples to help explain the rollover rules?**

Yes, the forthcoming examples from the proposed regulations under Section 402A illustrate the rollover rules.

1. Employee B receives a \$14,000 eligible rollover distribution that is not a qualified distribution from B's designated Roth account, consisting of \$11,000 of investment in the contract and \$3,000 of income. Within 60 days of receipt, Employee B rolls over \$7,000 of the distribution into a Roth IRA. The \$7,000 is deemed to consist of \$3,000 of income and \$4,000 of investment in the contract. Because the only portion of the distribution that could be includible in gross income (the income) is rolled over, none of the distribution is includible in Employee B's gross income.

2. Employee C receives a \$12,000 distribution, which is a qualified distribution that is attributable to the employee being disabled, from C's designated Roth account. Immediately prior to the distribution, the account consisted of \$21,850 of investment in the contract (i.e., designated Roth contributions) and \$1,150 of income. For purposes of determining recovery of investment in the contract, the distribution is deemed to consist of \$11,400 of investment in the contract [ $\$12,000 \times 21,850 / (1,150 + 21,850)$ ], and \$600 of income [ $\$12,000 \times 1,150 / (1,150 + 21,850)$ ]. Immediately after the distribution, C's designated Roth account consists of \$10,450 of investment in the contract and \$550 of income. This determination of the remaining investment in the contract will be needed if C subsequently is no longer disabled and takes a nonqualified distribution from the designated Roth account.

**Who is responsible for keeping track of the designated Roth contributions and 5-taxable-year period?**

Under the proposed regulations, the plan administrator or other responsible party with respect to a plan with a designated Roth account is responsible for keeping track of the 5-taxable-year period for each employee and the amount of designated Roth contributions made on behalf of such employee. In addition, the plan administrator or other responsible party of a plan directly rolling over a distribution would be required to provide the plan administrator of the recipient plan (i.e., the plan accepting the eligible rollover distribution) with a statement indicating either the first year of the 5-taxable-year period for the employee and the portion of such distribution attributable to basis or that the distribution is a qualified distribution.

---

**Since a qualified distribution from a designated Roth account is not subject to taxation, must the distribution be reported?**

Yes, if the distribution is not a direct rollover to a designated Roth account under another eligible plan, the plan administrator or responsible party must provide to the employee, upon request, the portion of such distribution attributable to basis or that the distribution is a qualified distribution. The statement would be required to be provided within a reasonable period following the rollover (or employee request), but in no event later than 30 days following the rollover (or employee request), and the plan administrator or other responsible party for the recipient plan would be permitted to rely on these statements. In order to give plans sufficient time to develop systems to comply with these reporting requirements, these reporting and record keeping requirements are proposed to be effective beginning with the 2007 taxable year.

Furthermore, a distribution from a designated Roth account must be reported on Form 1099–R, “Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRA, Insurance Contracts,” in accordance with the instructions thereto.

---

**Since designated Roth contributions are already included as part of wages, tips & other compensation on the Form W-2, must the amount contributed as designated Roth contributions be identified on the Form W-2 as well?**

Yes, contributions to a designated Roth account must also be separately reported on Form W–2, “Wage and Tax Statement,” in accordance with the instructions thereto.

---

**Do employees have any recordkeeping or reporting obligations?**

An employee has no reporting obligation with respect to designated Roth contributions under a section 401(k) or 403(b) plan. However, an employee rolling over a distribution from a designated Roth account to a Roth IRA should keep track of the amount rolled over in accordance with the instructions to Form 8606, “Nondeductible IRAs.”

**Are my designated Roth contributions excluded from the 401(k) plan annual nondiscrimination testing?**

No, designated Roth contributions are treated the same as pre-tax elective contributions when performing annual nondiscrimination testing.

---

**If I am required to take a corrective distribution under my 401(k) plan due to failure of the ADP nondiscrimination testing, can I take some or all of it from my designated Roth account?**

Yes, a plan can provide that the highly compensated employee (HCE), as defined in section 414(q), with elective contributions for a year that include both pre-tax elective contributions and designated Roth contributions may elect whether excess contributions are to be attributed to pre-tax elective contributions or designated Roth contributions. There is no requirement that the plan provide this option, and a plan may provide for correction without permitting an HCE to make such an election.

A distribution of excess contributions is not includible in gross income to the extent it represents a distribution of designated Roth contributions. However, the income allocable to a corrective distribution of excess contributions that are designated Roth contributions is includible in gross income in the same manner as income allocable to a corrective distribution of excess contributions that are pre-tax elective contributions.

The final Roth 401(k) regulations also provide a similar rule under the correction methods that may be used when a plan fails to satisfy the actual contribution percentage (ACP) test.

## **SARSEP**

### **What is a SARSEP?**

A SARSEP is a simplified employee pension (SEP) plan set up before 1997 that includes a salary reduction arrangement. Under a SARSEP, employees can choose to have the employer contribute part of their pay to their Individual Retirement Account or Annuity (IRA) set up under the SARSEP. **A SARSEP may not be established after 1996.** However, for SARSEPs set up before 1997, eligible employees hired after 1996 must be allowed to participate. See [IRS Publication 560](#), *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)* and the "Instructions for the Employer" and "Instructions for the Employee" in [Form 5305A-SEP](#), *Salary Reduction Simplified Employee Pension - Individual Retirement Accounts Contribution Agreement*, for detailed information.

Note: The IRS has a system of correction programs for sponsors of retirement plans, including SEPs and SARSEPs, which are intended to satisfy Internal Revenue Code requirements but have not met the requirements for a period of time. This system, the Employee Plans Compliance Resolution System (EPCRS), permits employers to correct plan failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis. See [Correcting Plan Errors](#) for information on EPCRS.

---



## **What were the requirements to set up a SARSEP?**

Establishing a SARSEP required two types of documents. The SARSEP plan itself and a SEP-IRA account for each employee participating in the SARSEP.

Generally, a SARSEP plan was established using either [IRS Form 5305A-SEP](#) or a prototype SARSEP that has been approved by the IRS. SEP-IRAs for each employee are set up with banks, insurance companies, or other qualified financial institutions using either [IRS Form 5305](#), [Form 5305-A](#), or a prototype IRA approved by the IRS.

Although no new SARSEPs may be established, previously established SARSEPs may need to be amended for current law in order to maintain their tax advantaged status.

---

## **How do I amend my SARSEP for EGTRRA?**

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) changed many of the Internal Revenue Code's requirements and limits for qualified plans and IRAs. If you have a model SARSEP, to take advantage of new law changes, you must adopt the current version of the model [Form 5305A-SEP](#).

---

## **Could any employer establish a SARSEP?**

No, SARSEPs could not be established by a state or local government, any of its political subdivisions, agencies, or instrumentalities or a tax-exempt organization. Also, only employers with 25 or fewer eligible participants may continue to operate a SARSEP plan.

---

## **What are the requirements to maintain a SARSEP?**

A SARSEP set up before 1997 must meet the following requirements each year:

- 25 or fewer employees were eligible to participate in the SARSEP in the preceding year;
  - at least 50% of the eligible employees choose to make salary reduction contributions this year; and
  - the elective deferrals of highly compensated employees meet the SARSEP deferral percentage limitation.
- 

### **If I have more than 25 eligible employees this year, but had less than 25 employees in the preceding year, may salary reduction contributions be made this year?**

Yes, the 25-employee rule is a look-back rule. It is a year-by-year rule. For example, if you had 23 eligible employees in 2004, but 27 eligible employees in 2005, salary reduction contributions may be made to the SEP-IRAs of the 27 employees for 2005. However, in 2006 no salary reduction contributions may be made for you and your employees.

---

### **What happens if less than 50% of my eligible employees make elective deferrals under the SARSEP?**

If less than 50% of your eligible employees choose to make elective deferrals to the SARSEP for a year, all elective deferral contributions made by other eligible employees for that year are disallowed and must be withdrawn from the employees' SEP-IRAs.

You must notify each affected employee within 2½ months following the end of the plan year to which the disallowed deferrals relate (by March 15th of the following year for all model and other calendar year SARSEPs), telling them (a) the amount of the disallowed deferrals to their SEP-IRA for the preceding calendar year, (b) the calendar year in which the disallowed deferrals and earnings are includible in gross income, (c) information stating that the employee must withdraw the excess contributions (and earnings), and (d) an explanation of the tax consequences if the employee does not withdraw such amounts. See the Instructions for [Form 5305A-SEP](#) for a detailed description of correcting disallowed deferrals. This is a year-by-year rule. Each year the 50% rule is met elective deferral contributions for that year can remain in the employees' SEP-IRAs.

---

### **Are there any required notices to be given to employees/participants?**

You must give an employee the following information within a reasonable time after the date the employee becomes employed:

- Notice that the SARSEP is maintained,
- Requirements an employee must meet to receive an employer contribution, and
- The basis upon which the employer's contributions will be allocated.

This notification requirement can be satisfied by providing your employees with a copy of the SARSEP agreement ([Form 5305A-SEP](#)), its instructions and the other information listed in the Form 5305A-SEP instructions if a model SARSEP has been adopted. If you use a prototype or individually designed SARSEP, similar information must be provided.

Failure to furnish the above information within a reasonable time subjects you to a \$50 penalty per failure, unless the failure is due to reasonable cause.

In addition, each year you must furnish an annual statement to each employee participating in the SARSEP that shows the amount contributed to his or her SEP-IRA for that year. This annual reporting must be provided to the employee no later than the January 31 following the calendar year for which the report relates. Note: Often [Form 5498](#), *IRA Contribution Information*, is used for this purpose.

Failure to furnish an annual statement showing the amount contributed subjects you to a \$50 penalty per failure, unless the failure is due to reasonable cause.

---

### **What forms must be filed under a SARSEP?**

**Form 5500:** The [Form 5500](#), *Annual Return/Report of Employee Benefit Plan*, that is required to be filed by most qualified retirement plans is **generally not required** for SARSEPs. SARSEPs are exempt from the Department of Labor's reporting and disclosure requirements provided the employer satisfies certain employee notice requirements and does not impose investment restrictions on monies contributed to employees' SEP-IRAs.

**Reporting on Form W-2:** Do not include employee elective deferrals in the "Wages, tips, other compensation" box of [Form W-2](#). You must however, include them in the "Social security wages" and "Medicare wages and tips" boxes. You must also include them in box 12. Mark the "Retirement plan" checkbox in box 13. For more information, see the Form W-2 instructions.

**General Reporting Requirements:** In addition to the employee notification requirements above, the bank, insurance company or other trustee or issuer of the SEP-IRAs must comply with the following general reporting requirements:

- [Form 5498](#), *IRA Contribution Information*, must be submitted to the IRS by the trustee or issuer of a SEP-IRA to report contributions to the SEP-IRA. A separate Form 5498 must be submitted for each SARSEP participant. This form or other statement of fair market value and account activity must also be given to participants.
- [Form 1099-R](#), *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, is used to report distributions from a SEP-IRA. Distributions from a SEP-IRA are subject to the same withholding rules that apply to distributions from traditional IRAs. See [Publication 590](#), *Individual Retirement Arrangements (IRAs)*, for details on IRA distribution rules.

### **What is a SEP?**

A SEP is a simplified employee pension plan. A SEP plan provides employers with a simplified method to make contributions toward their employees' retirement and, if self-employed, their own retirement. Contributions are made directly to an Individual Retirement Account or Annuity (IRA) set up for each employee (a SEP-IRA). See [Publication 560](#) for detailed SEP information for employers and employees.

Note: The IRS has a system of correction programs for sponsors of retirement plans, including SEPs, which are intended to satisfy Internal Revenue Code requirements but have not met the requirements for a period of time. This system, the Employee Plans Compliance Resolution System ([EPCRS](#)), permits employers to correct plan failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis.

## How is a SEP established?

A SEP is established by adopting a SEP agreement and having eligible employees establish SEP-IRAs. There are three basic steps in setting up a SEP, all of which must be satisfied.

- A formal written agreement must be executed. This written agreement may be satisfied by adopting an Internal Revenue Service (IRS) model SEP using [Form 5305-SEP](#), *Simplified Employee Pension - Individual Retirement Accounts Contribution Agreement*. A prototype SEP that was approved by the IRS may also be used. Approved prototype SEPs are offered by banks, insurance companies, and other qualified financial institutions. Finally, an individually designed SEP may be adopted.
- Each eligible employee must be given certain information about the SEP. If the SEP was established using the Form 5305-SEP, the information must include a copy of the Form 5305-SEP, its instructions, and the other information listed in the Form 5305-SEP instructions. If a prototype SEP or individually designed SEP was used, similar information must be provided.
- A SEP-IRA must be set up for each eligible employee. SEP-IRAs can be set up with banks, insurance companies, or other qualified financial institutions. The SEP-IRA is owned and controlled by the employee and the employer sends the SEP contributions to the financial institution where the SEP-IRA is maintained.

---

## What types of employers can establish a SEP?

Any employer can establish a SEP.

---

**If an employer has a SEP, can it also have other retirement plans?**

An employer can maintain both a SEP and another plan. However, unless the other plan is also a SEP, the employer cannot use Form 5305-SEP; the employer must adopt either a prototype SEP or an individually designed SEP.

---

**If an employee participates in his or her employer's retirement plan, can he or she set up a SEP for self-employment income?**

Yes. A SEP can be set up for a person's business even if he or she participates in another employer's retirement plan.

---

**Is there a deadline to set up a SEP?**

A SEP can be set up for a year as late as the due date (including extensions) of the business's income tax return for that year.

---

**How is a SEP plan amended for EGTRRA?**

If a prototype plan was used, the employer should have received an amended plan from the financial institution that provided it with the plan. If for some reason the employer didn't receive a new plan document, the financial institution should be contacted.

While the financial institution provides many administrative services for the plan, it is the responsibility of the employer - the plan sponsor - to ensure that the plan is kept up-to-date with current law.

If a model plan was used, an updated model plan should have been adopted by the end of 2002. See [Form 5305-SEP](#)..

## **Simple IRA and Distributions**

### **What is a SIMPLE IRA plan?**

A SIMPLE IRA plan is an IRA-based plan that gives small employers a simplified method to make contributions toward their employees' retirement and their own retirement. Under a SIMPLE IRA plan, employees may choose to make salary reduction contributions and the employer makes matching or nonelective contributions. All contributions are made directly to an Individual Retirement Account or Individual Retirement Annuity (IRA) set up for each employee (a SIMPLE IRA). SIMPLE IRA plans are maintained on a calendar-year basis. See [IRS Publication 560](#), [IRS Publication 590](#) and [IRS Notice 98-4](#) for detailed information on SIMPLE IRA plans.

---

### **Can any employer establish a SIMPLE IRA plan?**

SIMPLE IRA plans may be established only by employers that had no more than 100 employees who earned \$5,000 or more in compensation during the preceding calendar year (the "100-employee limitation"). For purposes of the 100-employee limitation, all employees employed at any time during the calendar year are taken into account, regardless of whether they are eligible to participate in the SIMPLE IRA plan. Thus, employees who are excludable under the rules of Internal Revenue Code section 410(b)(3) or who have not met the plan's minimum eligibility requirements must be taken into account. Employees also include self-employed individuals described in section 401(c)(1) who received earned income from the employer during the year.



## **Are tax-exempt employers and governmental entities permitted to maintain SIMPLE IRA plans?**

Yes. Excludable contributions may be made to the SIMPLE IRA of employees of tax-exempt employers and governmental entities on the same basis as contributions may be made to employees of other eligible employers.

## **How do I establish a SIMPLE IRA plan?**

You establish a SIMPLE IRA plan by visiting a financial institution, adopting a SIMPLE IRA plan document, and setting up SIMPLE IRAs for your eligible employees. There are three basic steps in setting up a SIMPLE IRA plan, **all** of which must be satisfied.

1. You may establish a SIMPLE IRA plan by adopting an IRS model SIMPLE IRA plan using either [Form 5305-SIMPLE](#) (if you require all contributions to be deposited initially at a designated financial institution) or [Form 5304-SIMPLE](#) (if you permit each employee to choose the financial institution for receiving contributions). You may also use a prototype SIMPLE IRA plan that has been approved by the IRS. Approved prototype SIMPLE IRA plans are offered by banks, insurance companies, and other qualified financial institutions.
2. You must provide each eligible employee with certain information about the SIMPLE IRA plan and the SIMPLE IRA where contributions for that employee will be deposited. The information must be provided each year prior to the employees' election period. Generally, the election period is 60 days prior to January 1 of a calendar year.
3. A SIMPLE IRA must be set up for each eligible employee. You may use either IRS model [Form 5305-S](#) (a trust account) or [Form 5305-SA](#) (a custodial account). SIMPLE IRAs can be set up with banks, insurance companies, or other qualified financial institutions. The SIMPLE IRA is owned and controlled by the employee and you send the SIMPLE IRA plan contributions to the financial institution where the SIMPLE IRA is maintained.

See [IRS Publication 560](#), the Instructions to [Form 5305-SIMPLE](#) and [Form 5304-SIMPLE](#), and [IRS Notice 98-4](#) for information on establishing a SIMPLE IRA plan.

---

**Is there a deadline to set up a SIMPLE IRA plan?**

You can set up a SIMPLE IRA plan effective on any date between January 1 and October 1, provided you did not previously maintain a SIMPLE IRA plan. If you previously maintained a SIMPLE IRA plan, you may set up a SIMPLE IRA plan effective only on January 1.

---

**Can a SIMPLE IRA plan be maintained on a fiscal-year basis?**

A SIMPLE IRA plan may only be maintained on a calendar-year basis.

---

**Is there a grace period that can be used by an employer that ceases to satisfy the 100-employee limitation?**

An employer that previously maintained a SIMPLE IRA plan is treated as satisfying the 100-employee limitation for the 2 calendar years immediately following the calendar year for which it last satisfied the 100-employee limitation. However, if the failure to satisfy the 100-employee limitation is due to an acquisition, disposition or similar transaction involving the employer, then the 2-year grace period will apply only in accordance with rules similar to the rules of section 410(b)(6)(C)(i).

---

**Can an employer make contributions under a SIMPLE IRA plan for a calendar year if it maintains another qualified plan?**

Generally, an employer cannot make contributions under a SIMPLE IRA plan for a calendar year if the employer, or a predecessor employer, maintains a qualified plan (other than the SIMPLE IRA plan) under which any of its employees receives an allocation of contributions in a defined contribution plan or receives an accrual in a defined benefit plan for any plan year beginning or ending within that calendar year. In applying these rules, transfers, rollovers or forfeitures are disregarded, except to the extent forfeitures replace otherwise required contributions. "Qualified plan" means a plan, contract, pension or trust described in section 219(g)(5) and includes a plan qualified under section 401(a), a qualified annuity plan described in section 403(a), an annuity contract described in section 403(b), a plan established for employees of a State, a political subdivision or by an agency or instrumentality of any State or political subdivision (other than an eligible deferred compensation plan described in section 457(b)), a simplified employee pension ("SEP") described in section 408(k), a trust described in section 501(c)(18), and a SIMPLE IRA plan described in section 408(p). This "no-other-plan limitation" applies on a year-by-year basis. Thus, an employer cannot establish a SIMPLE IRA plan for a calendar year if the employer has another plan that is active during any plan year of the other plan that overlaps with the calendar year.

However, an employer can make contributions under a SIMPLE IRA plan for a calendar year even though it maintains another qualified plan if either:

1. The other qualified plan maintained by the employer covers only employees covered under a collective bargaining agreement for which retirement benefits were the subject of good faith bargaining and the SIMPLE IRA plan excludes these employees.
2. The other qualified plan is maintained by the employer during the calendar year in which an acquisition, disposition or similar transaction occurs (or the following calendar year); the requirements of this question would have been satisfied if the transaction had not occurred (and thus the employer maintaining the SIMPLE IRA plan had remained a separate

employer); and only individuals who would have been employees of that "separate" employer are eligible to participate in the SIMPLE IRA plan.

---

### **Must an employer establish a SIMPLE IRA plan on January 1?**

An existing employer may establish a SIMPLE IRA plan effective on any date between January 1 and October 1 of a year, provided that the employer (or any predecessor employer) did not previously maintain a SIMPLE IRA plan. This requirement does not apply to a new employer that comes into existence after October 1 of the year the SIMPLE IRA plan is established if the employer establishes the SIMPLE IRA plan as soon as administratively feasible after the employer comes into existence. If an employer (or predecessor employer) previously maintained a SIMPLE IRA plan, the employer may establish a SIMPLE IRA plan effective only on January 1 of a year.

---

### **When must a SIMPLE IRA be established for an employee?**

A SIMPLE IRA is required to be established for an employee prior to the first date by which a contribution is required to be deposited into the employee's SIMPLE IRA.

---

### **What if an eligible employee entitled to a contribution is unwilling or unable to set up a SIMPLE IRA?**

If an eligible employee who is entitled to a contribution under a SIMPLE IRA plan is unwilling or unable to set up a SIMPLE IRA with any financial institution prior to the date on which the contribution is required to be made to the SIMPLE IRA of the employee, an employer must execute the necessary documents to establish a SIMPLE IRA on the employee's behalf with a financial institution selected by the employer.

**Are there any "pre-approved" documents an employer may use to establish a SIMPLE IRA plan?**

Yes. The Service has issued two model forms: [Form 5305-SIMPLE](#) (for use with a Designated Financial Institution (DFI)), which is a form that may be used by an employer establishing a SIMPLE IRA plan with a financial institution that is a DFI; and [Form 5304-SIMPLE](#) (not subject to the Designated Financial Institution rules), which is the model form that may be used by an employer to establish a SIMPLE IRA plan that does not use a DFI. Alternatively, an employer can use an approved "prototype" plan, offered by many banks and mutual funds. Prototype plans are plans that are sponsored by financial institutions or firms that specialize in retirement plans and that have been reviewed by the Service to ensure that the language in the documents meets the requirements for SIMPLE IRA plans. Periodically, employers must adopt amended documents, either prototype or model form, to reflect law changes. The financial institution where the SIMPLE IRAs are maintained usually takes care of amending the documents and sending them to employers for adoption. Rev. Proc. 2002-10, 2002-1 C.B. 401, required that all prototype and model SIMPLE IRAs and SIMPLE IRA plans be updated for EGTRRA, generally, by the end of 2002.

---

**How do I amend my SIMPLE IRA plan for EGTRRA?**

If you're using a prototype plan, you should have received an amended plan from the financial institution that provided you with the plan. If for some reason you didn't receive a new plan document, contact your financial institution.

While the financial institution provides many administrative services for your plan, it is your responsibility as plan sponsor to ensure that the plan is kept up-to-date with current law.

Employee Plans has found that many employers have failed to update their SIMPLE IRA plans for EGTRRA. Employee Plans is offering employers with SIMPLE IRA plans an extended time to update their plans for the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

Employers that previously failed to amend their SIMPLE IRA plans for EGTRRA will have until December 31, 2006, to either adopt the latest version of the IRS model SIMPLE IRA plan (revised August 2005) or adopt the SIMPLE IRA plan document that their financial institution updated for EGTRRA. See [SIMPLE IRA Plan Document Compliance and Relief](#).

**May amounts held in a SIMPLE IRA be withdrawn at any time?**

Yes. An employer may not require an employee to retain any portion of the contributions in his or her SIMPLE IRA or otherwise impose any withdrawal restrictions.

---

**What are the tax consequences when amounts are distributed from a SIMPLE IRA?**

Generally, the same tax results apply to distributions from a SIMPLE IRA as to distributions from a regular IRA (i.e., an IRA described in section 408(a) or (b)). However, a special rule applies to a payment or distribution received from a SIMPLE IRA during the 2-year period beginning on the date on which the individual first participated in any SIMPLE IRA plan maintained by the individual's employer (the "2-year period").

Under this special rule, if the additional income tax on early distributions under section 72(t) applies to a distribution within this 2-year period, section 72(t)(6) provides that the rate of additional tax under this special rule is increased from 10 percent to 25 percent. If one of the exceptions to application of the tax under section 72(t) applies (e.g., for amounts paid after age 59 1/2, after death, or as part of a series of substantially equal payments), the exception also applies to distributions within the 2-year period and the 25-percent additional tax does not apply.

---

**When does the "2-year period" described in the previous question begin?**

The 2-year period described in the previous question begins on the first day on which contributions made by the individual's employer are deposited in the individual's SIMPLE IRA.

**Are there any special rollover rules that apply to a distribution from a SIMPLE IRA?**

Section 408(d)(3)(G) provides that the rollover provisions of section 408(d)(3) apply to a distribution from a SIMPLE IRA during the 2-year period (described in Q&A 2 under the Distribution section above) only if the distribution is paid into another SIMPLE IRA. Thus, a distribution from a SIMPLE IRA during that 2-year period qualifies as a rollover contribution (and thus is not includable in gross income) only if the distribution is paid into another SIMPLE IRA and satisfies the other requirements of section 408(d)(3) for treatment as a rollover contribution.

---

**Can an amount be transferred from a SIMPLE IRA to another IRA in a tax-free trustee-to-trustee transfer?**

During the 2-year period (described in Q&A 2 under the Distribution section above), an amount in a SIMPLE IRA may be transferred to another SIMPLE IRA in a tax-free trustee-to-trustee transfer. If, during this 2-year period, an amount is paid from a SIMPLE IRA directly to the trustee of an IRA that is not a SIMPLE IRA, the payment is neither a tax-free trustee-to-trustee transfer nor a rollover contribution; the payment is a distribution from the SIMPLE IRA and a contribution to the other IRA that does not qualify as a rollover contribution. After the expiration of the 2-year period, an amount in a SIMPLE IRA may be transferred in a tax-free trustee-to-trustee transfer to an IRA that is not a SIMPLE IRA.



## Sources and References

Securities and Exchange Commission – Retirement and Financial Planning

<http://www.sec.gov/investor/pubs/roadmap.htm>

Dallas Federal Reserve

<http://www.dallasfed.org/ca/wealth/glossary.html> Glossary

Chicago Federal Reserve

[http://www.chicagofed.org/consumer\\_information/index.cfm](http://www.chicagofed.org/consumer_information/index.cfm)

FDIC Federal Deposit Insurance Corporation

<http://www.pueblo.gsa.gov/results.tpl?id1=18&startat=1&--woSECTIONSdatarg=18&--SECTIONSword=ww>

FCIC College Planning

[http://www.pueblo.gsa.gov/cic\\_text/family/prepare4college/prep.htm#types](http://www.pueblo.gsa.gov/cic_text/family/prepare4college/prep.htm#types)

THE UNITED STATES ECONOMY AND ECONOMIC SYSTEMS

<http://usinfo.state.gov/products/pubs/oecon/chap12.htm>

RETIREMENT PLANNING

<http://www.fdic.gov/consumers/consumer/news/cnfall05/index.html>

FINANCIAL STATEMENTS

<http://www.sec.gov/investor/pubs/begfinstmtguide.htm>

INVESTING

<http://www.sec.gov/investor/pubs/begininvest.htm>

INVESTMENTS, STOCKS, BONDS, TREASURIES & ANNUITIES

<http://www.sec.gov/investor/pubs/investop.htm>

INSURANCE TOPICS

[http://www.mass.gov/doi/Consumer/css\\_life\\_BuyLifeInsPartSeven.html#beneficiary](http://www.mass.gov/doi/Consumer/css_life_BuyLifeInsPartSeven.html#beneficiary)

TREASURIES

<http://www.treasurydirect.gov/>

ESTATE PLANNING & WEALTH TRANSFER

[http://www.pueblo.gsa.gov/cic\\_text/money/estate/estate.htm](http://www.pueblo.gsa.gov/cic_text/money/estate/estate.htm)

MUTUAL FUNDS, RISK, FEES AND BENEFITS

<http://www.sec.gov/investor/pubs/inwsmf.htm>

VARIABLE ANNUITY INFORMATION

<http://www.sec.gov/investor/pubs/varannty.htm#wvar>

RISK TOLERANCE AND DIVERSIFICATION

<http://www.sec.gov/investor/pubs/roadmap/risk.htm#Diverse>

THE GLOBAL AND INTERNATIONAL ECONOMY – NEW YORK  
FED

[http://www.newyorkfed.org/research/global\\_economy/](http://www.newyorkfed.org/research/global_economy/)

FINANCIAL PLANNING & DEFINING YOUR GOALS

<http://www.sec.gov/investor/pubs.shtml>

INSIDER TRADING

<http://www.sec.gov/divisions/enforce/insider.htm>

CWM CHARTERED WEALTH MANAGER CERTIFICATION

[http://apps.nasd.com/investor\\_Information/resources/designations/AllDesigByAcronym.asp#CWM](http://apps.nasd.com/investor_Information/resources/designations/AllDesigByAcronym.asp#CWM)

WEALTH MANAGEMENT AND TRENDS

[www.federalreserve.gov/SECRS/2004/October/20041028/R-1154/R-1154\\_160\\_1.pdf](http://www.federalreserve.gov/SECRS/2004/October/20041028/R-1154/R-1154_160_1.pdf)

UNITED STATES TAXATION AND HISTORY

<http://www.ustreas.gov/education/fact-sheets/taxes/ustax.html>

## Economic Terms and Glossary

**Agribusiness:** A term that reflects the large, corporate nature of many farm enterprises in the modern U.S. economy.

**American Stock Exchange:** One of the key stock exchanges in the United States, it consists mainly of stocks and bonds of companies that are small to medium-sized, compared with the shares of large corporations traded on the New York Stock Exchange.

**Antitrust law:** A policy or action that seeks to curtail monopolistic powers within a market.

**Asset:** A possession of value, usually measured in terms of money.

**Balance of payments:** An accounting statement of the money value of international transactions between one nation and the rest of the world over a specific period of time. The statement shows the sum of transactions of individuals, businesses, and government agencies located in one nation, against those of all other nations.

**Balance of trade:** That part of a nation's balance of payments dealing with imports and exports -- that is, trade in goods and services -- over a given period. If exports of goods exceed imports, the trade balance is said to be "favorable"; if imports exceed exports, the trade balance is said to be "unfavorable."

**Bear market:** A market in which, in a time of falling prices, shareholders may rush to sell their stock shares, adding to the downward momentum.

**Bond:** A certificate reflecting a firm's promise to pay the holder a periodic interest payment until the date of maturity and a fixed sum of money on the designated maturing date.

**Budget deficit:** The amount each year by which government spending is greater than government income.

**Budget surplus:** The amount each year by which government income exceeds government spending.

**Bull market:** A market in which there is a continuous rise in stock prices.

**Capital:** The physical equipment (buildings, equipment, human skills) used in the production of goods and services. Also used to refer to corporate equity, debt securities, and cash.

**Capitalism:** An economic system in which the means of production are privately owned and controlled and which is characterized by competition and the profit motive.

**Capital market:** The market in which corporate equity and longer-term debt securities (those maturing in more than one year) are issued and traded.

**Central bank:** A country's principal monetary authority, responsible for such key functions as issuing currency and regulating the supply of credit in the economy.

**Commercial bank:** A bank that offers a broad range of deposit accounts, including checking, savings, and time deposits, and extends loans to individuals and businesses -- in contrast to investment banking firms such as brokerage firms, which generally are involved in arranging for the sale of corporate or municipal securities.

**Common market:** A group of nations that have eliminated tariffs and sometimes other barriers that impede trade with each other while maintaining a common external tariff on goods imported from outside the union.

**Common stock:** A share in the ownership of a corporation.

**Consumer price index:** A measure of the U.S. cost of living as tabulated by the U.S. Bureau of Labor Statistics based on the actual retail prices of a variety of consumer goods and services at a given time and compared to a base period that is changed from time to time.

**Consumption tax:** A tax on expenditures, rather than on earnings.

**Deficiency payment:** A government payment to compensate farmers for all or part of the difference between producer prices actually paid for a specific commodity and higher guaranteed target prices.

**Demand:** The total quantity of goods and services consumers are willing and able to buy at all possible prices during some time period.

**Depression:** A severe decline in general economic activity in terms of magnitude and/or length.

**Deposit insurance:** U.S. government backing of bank deposits up to a certain amount -- currently, \$100,000.

**Deregulation:** Lifting of government controls over an industry.

**Discount rate:** The interest rate paid by commercial banks to borrow funds from Federal Reserve Banks.

**Dividend:** Money earned on stock holdings; usually, it represents a share of profits paid in proportion to the share of ownership.

**Dow Jones Industrial Average:** A stock price index, based on 30 prominent stocks, that is a commonly used indicator of general trends in the prices of stocks and bonds in the United States.

**Dumping:** Under U.S. law, sales or merchandise exported to the United States at "less than fair market value," when such sales materially injure or threaten material injury to producers of like merchandise in the United States.

**Economic growth:** An increase in a nation's capacity to produce goods and services.

**Electronic commerce:** Business conducted via the World Wide Web.

**Exchange rate:** The rate, or price, at which one country's currency is exchanged for the currency of another country.

**Exports:** Goods and services that are produced domestically and sold to buyers in another country.

**Export subsidy:** A lump sum given by the government for the purpose of promoting an enterprise considered beneficial to the public welfare.

**Fast track:** Procedures enacted by the U.S. Congress under which it votes within a fixed period on legislation submitted by the president to approve and implement U.S. international trade agreements.

**Federal Reserve Bank:** One of the 12 operating arms of the Federal Reserve System, located throughout the United States, that together with their 25 branches carry out various functions of the U.S. central bank system.

**Federal Reserve System:** The principal monetary authority (central bank) of the United States, which issues currency and regulates the supply of credit in the economy. It is made up of a seven-member Board of Governors in Washington, D.C., 12 regional Federal Reserve Banks, and their 25 branches.

**Fiscal policy:** The federal government's decisions about the amount of money it spends and collects in taxes to achieve full employment and non-inflationary economy.

**Fixed exchange rate system:** A system in which exchange rates between currencies are set at a predetermined level and do not move in response to changes in supply and demand.

**Floating exchange rate system:** A flexible system in which the exchange rate is determined by market forces of supply and demand, without intervention.

**Food for Peace:** A program that provides for the disposition of U.S. farm products outside the United States.

**Free enterprise system:** An economic system characterized by private ownership of property and productive resources, the profit motive to stimulate production, competition to ensure efficiency, and the forces of supply and demand to direct the production and distribution of goods and services.

**Free trade:** The absence of tariffs and regulations designed to curtail or prevent trade among nations.

**Fringe benefit:** An indirect, non-cash benefit provided to employees by employers in addition to regular wage or salary compensation, such as health insurance, life insurance, profit-sharing, and the like.

**Futures:** Contracts that require delivery of a commodity of specified quality and quantity, at a specified price, on a specified future date.

**Gold standard:** A monetary system in which currencies are defined in terms of a given weight of gold.

**Gross domestic product:** The total value of a nation's output, income, or expenditure produced within its physical boundaries.

**Human capital:** The health, strength, education, training, and skills that people bring to their jobs.

**Imports:** Goods or service that are produced in another country and sold domestically.

**Income tax:** An assessment levied by government on the net income of individuals and businesses.



**Industrial Revolution:** The emergence of the factory system of production, in which workers were brought together in one plant and supplied with tools, machines, and materials with which they worked in return for wages. The Industrial Revolution was spearheaded by rapid changes in the manufacture of textiles, particularly in England about 1770 and 1830. More broadly, the term applies to continuing structural economic change in the world economy.

**Inflation:** A rate of increase in the general price level of all goods and services. (This should not be confused with increases in the prices of specific goods relative to the prices of other goods.)

**Intellectual property:** Ownership, as evidenced by patents, trademarks, and copyrights, conferring the right to possess, use, or dispose of products created by human ingenuity.

**Investment:** The purchase of a security, such as a stock or bond.

**Labor force:** As measured in the United States, the total number of people employed or looking for work.

**Laissez-faire:** French phrase meaning "leave alone." In economics and politics, a doctrine that the economic system functions best when there is no interference by government.

**Managed float regime:** An exchange rate system in which rates for most currencies float, but central banks still intervene to prevent sharp changes.

**Market:** A setting in which buyers and sellers establish prices for identical or very similar products, and exchange goods or services.

**Market economy:** The national economy of a country that relies on market forces to determine levels of production, consumption, investment, and savings without government intervention.

**Mixed economy:** An economic system in which both the government and private enterprise play important roles with regard to production, consumption, investment, and savings.

**Monetary policy:** Federal Reserve System actions to influence the availability and cost of money and credit as a means of helping to promote high employment, economic growth, price stability, and a sustainable pattern of international transactions.

**Money supply:** The amount of money (coins, paper currency, and checking accounts) that is in circulation in the economy.

**Monopoly:** The sole seller of a good or service in a market.

**Mutual fund:** An investment company that continually offers new shares and buys existing shares back on demand and uses its capital to invest in diversified securities of other companies. Money is collected from individuals and invested on their behalf in varied portfolios of stocks.

**National Association of Securities Dealers Automated Quotation system (Nasdaq):** An automated information network that provides brokers and dealers with price quotations on the approximately 5,000 most active securities traded over the counter.

**New Deal:** U.S. economic reform programs of the 1930s established to help lift the United States out of the Great Depression.

**New York Stock Exchange:** The world's largest exchange for trading stocks and bonds.

**Nontariff barrier:** Government measures, such as import monitoring systems and variable levies, other than tariffs that restrict imports or that have the potential for restricting international trade.

**Open trading system:** A trading system in which countries allow fair and nondiscriminatory access to each other's markets.

**Over-the-counter:** Figurative term for the means of trading securities that are not listed on an organized stock exchange such as the New York Stock Exchange. Over-the-counter trading is done by broker-dealers who communicate by telephone and computer networks.

**Panic:** A series of unexpected cash withdrawals from a bank caused by a sudden decline in depositor confidence or fear that the bank will be closed by the chartering agency, i.e. many depositors withdraw cash almost simultaneously. Since the cash reserve a bank keeps on hand is only a small fraction of its deposits, a large number of withdrawals in a short period of time can deplete available cash and force the bank to close and possibly go out of business.

**Price discrimination:** Actions that give certain buyers advantages over others.

**Price fixing:** Actions, generally by a several large corporations that dominate in a single market, to escape market discipline by setting prices for goods or services at an agreed-on level.

**Price supports:** Federal assistance provided to farmers to help them deal with such unfavorable factors as bad weather and overproduction.

**Privatization:** The act of turning previously government-provided services over to private sector enterprises.

**Productivity:** The ratio of output (goods and services) produced per unit of input (productive resources) over some period of time.

**Protectionism:** The deliberate use or encouragement of restrictions on imports to enable relatively inefficient domestic producers to compete successfully with foreign producers.

**Recession:** A significant decline in general economic activity extending over a period of time.

**Regulation:** The formulation and issuance by authorized agencies of specific rules or regulations, under governing law, for the conduct and structure of a certain industry or activity.

**Revenue:** Payments received by businesses from selling goods and services.

**Securities:** Paper certificates (definitive securities) or electronic records (book-entry securities) evidencing ownership of equity (stocks) or debt obligations (bonds).

**Securities and Exchange Commission:** An independent, non-partisan, quasi-judicial regulatory agency with responsibility for administering the federal securities laws. The purpose of these laws is to protect investors and to ensure that they have access to disclosure of all material information concerning publicly traded securities. The commission also regulates firms engaged in the purchase or sale of securities, people who provide investment advice, and investment companies.

**Services:** Economic activities -- such as transportation, banking, insurance, tourism, telecommunications, advertising, entertainment, data processing, and consulting -- that normally are consumed as they are produced, as contrasted with economic goods, which are more tangible.

**Socialism:** An economic system in which the basic means of production are primarily owned and controlled collectively, usually by government under some system of central planning.

**Social regulation:** Government-imposed restrictions designed to discourage or prohibit harmful corporate behavior (such as polluting the environment or putting workers in dangerous work situations) or to encourage behavior deemed socially desirable.

**Social Security:** A U.S. government pension program that provides benefits to retirees based on their own and their employers' contributions to the program while they were working.

**Standard of living:** A minimum of necessities, comforts, or luxuries considered essential to maintaining a person or group in customary or proper status or circumstances.

**Stagflation:** An economic condition of both continuing inflation and stagnant business activity.

**Stock:** Ownership shares in the assets of a corporation.

**Stock exchange:** An organized market for the buying and selling of stocks and bonds.

**Subsidy:** An economic benefit, direct or indirect, granted by a government to domestic producers of goods or services, often to strengthen their competitive position against foreign companies.

**Supply:** A schedule of how much producers are willing and able to sell at all possible prices during some time period.

**Tariff:** A duty levied on goods transported from one customs area to another either for protective or revenue purposes.

**Trade deficit:** The amount by which a country's merchandise exports exceed its merchandise imports.

**Trade surplus:** The amount by which a country's merchandise exports exceed its imports.

**Venture capital:** Investment in a new, generally possibly risky, enterprise.

*This glossary is based principally on-line glossaries developed by the Federal Reserve Bank of San Francisco, the Federal Reserve Bank of Minneapolis, the Virtual Trade Mission, and the Wisconsin Economic Education Council.*

**Prof. Dr. George S. Mentz, JD, MBA, DSS, CWM™, CAM™, CPM,™, MFP™ CFC™ (Licensed Attorney LA EDLA)**

- The first person in the United States to achieve "Quad Designation" Status as a Juris Doctorate Holder, MBA, licensed financial planner & wealth manager, and Certified Financial Consultant.
- Featured and quoted in the Wall Street Journal™, The Hindu National, The Financial Times Asia, Arab Times, and El Norte Latin America.
- The first person in the world to be approved as a Certified Wealth Manager Certified Trainer for AAFM Global.
- Faculty Appointments and Executive Training Appointments for law schools, business schools, and Training companies around the world.
- Prof. Mentz has representative offices in over 10 countries including: Singapore, Hong Kong, Cairo, Beijing, USA, Bahamas, Switzerland, Taiwan and more.
- Prof. Mentz has financed a Global Scholarship program that has helped qualified candidates from Africa, The Middle East, India, Europe, Russia, China, Indonesia, Malaysia, Australia, The USA, Mexico, Latin America and other countries as well.
- Past Senior Wealth Management Advisor for a Wall Street Firm
- Editor and Chief for the Original Tax and Estate Planning Law Review at Loyola University (A Loyola University Chartered Organization).
- Advisory Board of the Global Finance Forum, The Indian Academy, The China Wealth Council, The Latin American Financial Academy Capitulo and the World E-Commerce Forum.
- Author of Several books on Wealth Management, Human Potential & Project Management.
- Licensed Attorney and member of various legal and bar associations.
- Recipient of the International Legal Studies Certificate Diploma from an ABA Law School. And Recipient of several other honorary doctorates for research and publications.
- Author of over 200 Books, Articles and Essays.
- Advisor to Fortune 500 companies in several countries.
- Winner of multiple awards for teaching and charitable service.
- Holds a government license USA LA EDLA to counsel on the law and provide legal advice..

This book is US Financial Planning and Wealth Management reference. No decision should be made before talking to a licensed attorney, licensed CPA or Licensed Investment Advisor. This book is not a substitute for professional advice. Laws change on a daily basis. Thus, each investment, legal and monetary decision should be based on your objectives, investment horizon and risk tolerance. Please consult with a lawyer in your jurisdiction before making any Retirement or Estate Planning or Wealth Management Decision. All Rights Reserved to Content Modified, Created, Enhanced, or Revised. 2006,7,8,9

## **Formal Reference Guide for Executive Notes for Wealth Management Board Certification**

AAFM Board Certified Wealth Manager



[WWW.AAFM.US](http://WWW.AAFM.US)

[WWW.AAFMGLOBAL.COM](http://WWW.AAFMGLOBAL.COM)

[WWW.AAFM.ME](http://WWW.AAFM.ME)

[WWW.AAFMINDIA.COM](http://WWW.AAFMINDIA.COM)

[WWW.AAFMLA.ORG](http://WWW.AAFMLA.ORG)

[WWW.AAFMCHINA.COM](http://WWW.AAFMCHINA.COM)

[WWW.AAFMASIA.COM](http://WWW.AAFMASIA.COM)