

The Mayfield Case

A RETIREMENT PLANNING MINI-CASE

Peter and Ann Mayfield, both age 52, recently sought your help in planning their financial future. Peter is the Anytown, Anystate, city manager. His wife is active in many civic organizations but not employed outside of the home. They live at 123 Maple Street, in Anytown. They have been married for slightly more than 25 years.

Their two children, Nick and Nedra, have both moved away from home and started their own families. In fact, Nick and his wife have two children, Lisa and Timmy, ages 3 and 2, respectively. Table VI.17 presents additional information about the Mayfields.

Additional Personal Information

Table VI.17 The Mayfields' Personal Information

Occupation—Peter	City Manager 123 Elm Street Anytown, Anystate 01010 26 years of employment
Occupation—Ann	Homemaker 26 years of employment

Global Assumptions (Valid unless otherwise Specified in Certain Instances)

- Inflation: 3%
- All income and expense figures are given in today's dollars.
- Federal marginal tax bracket: 25%

- State marginal tax bracket: 4.5%
- Any qualified plan or IRA contribution growth rates are assumed to stop at the federally mandated limit unless otherwise restricted.
- All nominal rates of return are pretax returns.
- They are currently qualified for Social Security benefits.

Income Issues

Peter currently earns \$90,000 per year and expects his salary to increase at 3% per year until retirement. As shown in Table VI.18, Peter contributes 10% of his salary to his employer-sponsored 403(b) plan. He receives a 33% match from the city. Ann and Peter are covered by an employer-sponsored health care plan, which has a premium of only \$50 per month and is paid for directly out of Peter's paycheck on a pretax basis. The Mayfields currently use interest earned from their municipal bond holdings to supplement their income.

Dedicated and Discretionary Expenses

Table VI.18 The Mayfields' Dedicated and Discretionary Expenses

Source of Expense	Amount	Frequency
Pretax medical premiums	\$600	Annually
403(b) contributions	\$750	Monthly
Social Security withholdings	\$6,839	Annually
Federal tax withholdings	\$10,000	Annually
State tax withholdings	\$3,400	Annually
Mortgage payment (P&I)	\$511.63	Monthly
Credit card payments	\$450	Annually
Auto insurance	\$550	Semi-Annually
Homeowner's insurance	\$50	Monthly
Life insurance (private policy)	\$780	Annually
Other insurance	Not calculated by client	
Umbrella policy	\$150	Annually
Peter's traditional IRA contribution	\$2,000	Annually
Ann's traditional IRA contribution	\$2,000	Annually
Unallocated savings	\$1,000	Quarterly
Subscriptions	\$50	Monthly
Telephone charges	\$1,560	Annually
Alarm system	\$40	Monthly
Internet and cable	\$90	Monthly
Hobbies	\$100	Monthly

Recreation	\$400	Monthly
Health club dues	\$90	Monthly
Groceries	\$3,900	Annually
Eating-out expenses	\$4,900	Annually
Real estate taxes	\$1,600	Annually
Household maintenance	\$90	Monthly
Utilities	\$2,160	Annually
Clothing	\$1,700	Annually
Dry cleaning	\$60	Monthly
Personal care	\$100	Monthly
Stereo equipment	\$800	Annually
Yard maintenance service	\$900	Annually
Eye glasses	\$725	Annually
Health insurance co-pays	\$500	Annually
Prescriptions	\$400	Annually
Other medical expenses	\$350	Annually
Gas and car maintenance	\$800	Semiannually
Car licenses (not tax deductible)	\$250	Annually
Parking in city	\$100	Annually
Trains and taxis in city	\$300	Annually
Personal property tax	\$750	Annually
Safe deposit fees	\$40	Monthly
Bank fees	\$4	Monthly
IRA fees	\$45	Annually
Tax preparation fees	\$450	Annually
Charitable contributions	\$300	Monthly
Business travel*	\$1,500	Annually
Vacations	\$1,000	Quarterly
Business expenses*	\$250	Annually
Alcohol expenses	\$250	Semiannually
Postage stamps	\$125	Annually
Gifts to children/grandchildren	\$1,300	Semiannually
Other misc. expenses	\$500	Annually

*Peter's employer does not reimburse these expenses.

Asset and Liability Information

Table VI.19 presents the Mayfields' asset and liability information.

Table VI.19 The Mayfields' Assets and Liabilities

Asset/Liability	Value	Notes
Checking account	\$13,000	No interest earned on asset
Municipal money market fund (general obligations)	\$240,000	2.50% federal annual tax-free yield
I-bonds*	\$42,000	Market value
Peter's 401(k)	\$975,000	Invested in equities
Peter's traditional IRA	\$52,000	Invested in equities
Ann's traditional IRA	\$35,000	Invested in equities
Primary residence	\$375,000	
Mazda	\$6,700	5 years old
Honda	\$5,200	6 years old
Household furnishings	\$30,000	
Yard equipment	\$7,500	
Other misc. assets	\$14,000	
Visa credit card	\$2,500	14.90% interest rate
MasterCard	\$4,000	9.90% interest rate
Discover card	\$1,000	18.90% interest rate
Macy's credit card	\$500	21.00% interest rate
First mortgage	\$25,685	Home purchased 25 years ago; \$75,000 financed at 7.25% for 30 years; 300 payments made to date

Note: All nonretirement assets are jointly owned.

*The I bonds have been owned for 4 years.

Tax Information

The Mayfields' marginal state tax rate is 4.5%. The state income tax is tied to the federal AGI figure. The Mayfields are eligible for two state exemptions in the amount of \$1,300 each and a state standard deduction of \$10,000. The Mayfields are also eligible for \$6,000 in state income tax adjustments. The municipal money market mutual fund is made up of general Anystate state obligations.

Insurance Information and Planning Issues

Life Insurance

Peter purchased a \$250,000 10-year term policy when he turned age 50. Peter is the owner and insured. Ann is the beneficiary. In addition, Peter's employer provides him with a group term policy in the amount of one times his salary. When estimating life insurance needs, the Mayfields would like to make the following assumptions:

- Life expectancy: age 95 each
- Final expense needs: \$12,000 each
- Estate administration needs: Peter: \$36,500; Ann: \$9,500
- Other immediate needs: \$12,000 each
- They would like to pay off all debts at the first death.
- Anticipated expense needs at first death: \$85,000 per year before and after retirement (in today's dollars).
- They believe they can earn 6% on any proceeds from insurance prior to retirement.
- They believe they can earn 5% on insurance proceeds after retirement.
- They anticipate being in a combined 25% federal and state marginal tax bracket after retirement.
- Projected inflation rate: 3%
- In the event of a spouse's death, Peter and Ann plan to stop working and collect early Social Security benefits at age 60. They will receive \$16,500 at that time.
- For conservative planning purposes, the Mayfields do not plan to use interest and/or dividends as an income source when planning insurance needs.
- Full retirement benefits, at age 66, are \$23,580.
- In addition to Peter's life insurance, they are willing to use all of their retirement, investments, and monetary assets to meet insurance needs.

Disability Insurance

Peter's employer provides both short- and long-term disability coverage. His short-term coverage pays 100% of his earned income for the first six months of disability. There is no wait period for this coverage. Peter's long-term coverage has a six-month

wait period and pays a benefit equal to 60% of earned income until age 65. All premiums, for both policies, are employer paid. If Peter were to become disabled, they would not continue to save for other goals. In case of disability:

- Total household expenses in the event of death or disability are \$85,000.
- When calculating life insurance needs, the Mayfields are willing to use all their combined retirement savings to offset insurance needs.
- The Mayfields assume that in the event of a possible disability neither will be eligible for Social Security disability benefits.
- For life insurance planning purposes only, they would like to replace \$85,000 per year, in today's dollars, for retirement.

Long-term Care Insurance

The Mayfields do not currently have long-term care insurance.

Retirement Information and Planning Issues

The following information should be used when evaluating the Mayfields' current retirement planning situation:

- Peter does not have a defined benefit plan at this time.
- Retirement age for reduced Social Security benefits is age 62; they plan to retire and take benefits at the earliest possible date.
- Retirement age for full Social Security benefits is age 66.
- Their individual life expectancies are 95 years of age.
- In the event of the death of one spouse, the surviving spouse is eligible to receive \$16,500 per year starting at age 60 from Social Security.
- At age 62, Peter's annual Social Security benefit will be \$17,950 in today's dollars; Ann is eligible to receive a survivor benefit equal to \$8,367.
- At age 66, Peter's annual Social Security benefit will be \$24,420 in today's dollars; Ann is eligible to receive one-half of this amount.
- At age 70, Peter's annual Social Security benefit will be \$32,900 in today's dollars; Ann is eligible to receive a survivor benefit.
- They would like to replace \$90,000 in yearly income, in today's pretax dollars, on their first day of retirement. (Note that this figure is different from the assumption they want to use for insurance planning purposes.)
- Ann is the beneficiary of Peter's qualified retirement plan assets.

- For retirement planning purposes only, they believe that they can earn a 7.6% rate of return prior to retirement and a 5% rate of return after retirement.
- Inflation before and after retirement is expected to be 3%.
- Peter's salary will increase at the rate of inflation.
- All annual retirement savings will increase by the rate of inflation (3%) prior to retirement.
- The Mayfields are willing to assume that they will remain in the same marginal tax bracket after they retire.
- All nonretirement assets are owned as JTWROS at this time.

Estate Information and Planning Issues

- Final funeral, burial, and medical expenses for life insurance and estate planning purposes will be \$12,000 each.
- Estate administration costs are anticipated to be \$1,500, and executor fees will be approximately \$35,000 for Peter and \$8,000 for Ann.
- In the event of death, the Mayfields will need approximately \$12,000 to cover immediate needs.
- They would like to leave a legacy for their grandchildren by fully funding both children's college education costs should Peter or Ann die.
- Assumed investment return on assets in the event that one spouse dies is 6.00% annually.
- The value of the surviving spouse's net estate is expected to grow by 4.00% annually.

Additional Planning Assumptions

The Mayfields would like to maintain their monetary assets as an emergency fund if possible, and use interest earned as a "slush fund" while in retirement.

Goals and Objectives

The Mayfields are very much looking forward to retirement. They hope to spend more time with their growing grandchildren. Given this goal, they plan to retire when Peter turns age 62. They would like to know if they are currently on track to meet this goal.

Their second goal involves establishing an education funding plan to help their grandchildren pay for college expenses. They would like to fund one year of college tuition and room and board for each grandchild. Tuition plus expenses for colleges

they have looked at average \$18,000 per year. They believe that college costs will continue to rise at a 6% rate, but to offset some of this increase they are comfortable assuming an 8% rate of return in a tax-advantaged education savings account, which is roughly equivalent to a 5.5% after-tax rate of return.

Use the information provided in this narrative to answer the following case questions.

Case Questions

1. How much money market fund income did the Mayfields earn during the year?
 - a. \$0
 - b. \$6,000
 - c. \$6,325
 - d. \$7,200

2. Which of the following statements is true?
 - I. Peter must report \$110 in § 79 income for tax purposes.
 - II. Because Peter is over age 50, he does not need to report § 79 income.
 - III. § 79 income helps reduce a client's taxable income.
 - IV. § 79 income should be accounted for as a taxable expense on the income and expense statement.
 - a. II only
 - b. I and II only
 - c. I and IV only
 - d. II and III only
 - e. II, III, and IV only

3. How much of the Mayfields' gross income is considered total income for tax purposes on IRS Form 1040?
 - a. \$96,110
 - b. \$90,000
 - c. \$86,510
 - d. \$80,510

4. All of the following statements about the Mayfields' level of discretionary cash flow are incorrect except:¹
- After paying all dedicated and discretionary expenses, the Mayfields have a negative cash flow.
 - Total dedicated expenses are greater than discretionary expenses.
 - Savings expenses make up the largest dedicated/fixed expense item for the Mayfields.
 - The Mayfields' savings ratio, including employer matching contributions, exceeds 10%.
5. Which of the following are strengths related to the Mayfields' financial situation?
- Their savings rate, as measured by the savings ratio, is acceptable at this time.
 - Their debt as a percentage of net worth is low as measured by industry ratios.
 - They could easily pay off all of their debt using monetary assets.
 - All of the above.
6. Which of the following is true?
- The Mayfields should choose to itemize deductions on IRS Form Schedule A.
 - Given their age, they will receive enhanced personal exemptions for this year's taxes.
 - They can claim a tax credit for gifts made to their grandchild this year.
 - The Mayfields' standard deduction is greater than their itemized deduction.
 - Both a and b are correct.
7. During a benefits presentation for all city employees, the presenter talked about the need for those in attendance to think about long-term care needs. Peter was shocked to learn how much one year of nursing home care would cost. He is worried about depleting assets if he or his wife should need this type of care. He wants to know whether he and his wife should purchase long-term care insurance. Which of the following statements best represents the strategy that the Mayfields should consider?
- Purchase long-term care insurance because their net worth, exclusive of home value, is less than \$1.5 million.
 - They do not need long-term care insurance because they can afford to self-insure the costs of care.
 - They should expect to spend down assets to a point where they will become eligible for Medicaid, and as such, they do not need long-term care insurance.

1. It is recommended that the Financial Facilitator be used to answer this question.

- d. They do not need long-term care insurance because they can use a combination of assets, Medicare funding, and Medicaid reimbursement to fund care needs.
8. Peter was recently approached by a financial adviser who wanted Peter to consider investing in a variable annuity for retirement. A few days later the adviser called Peter again and said that a variable universal life (VUL) insurance policy could also be used to fund retirement needs. Which of the following statement(s) is (are) true in relation to annuities and VULs?
- I. Given their favorable tax treatment, variable annuities and VUL policies allow earnings to grow tax deferred until withdrawn.
 - II. Distributions from the annuity, after age 59½, will be taxed at the long-term capital gain rate if the annuity has been in existence for at least one year.
 - III. Distributions from the VUL policy, if made in the form of a loan, will be taxed at the Mayfields' marginal tax rate.
 - IV. Distributions in the form of a VUL loan need not be reported on IRS Form 1040 for tax purposes.
- a. I and II only
 - b. III and IV only
 - c. I and IV only
 - d. II, III, and IV only
9. Reducing a client's life expectancy assumption will have which of the following effects?
- a. Increase the amount of life insurance needed.
 - b. Decrease the amount of retirement assets needed.
 - c. Increase the amount of retirement assets needed.
 - d. Both a and c are correct.
10. Which of the following disability insurance statements is true?
- a. All of the benefits received by Peter from his disability coverage will be taxable because his employer paid the premium.
 - b. None of the benefits received by Peter from his disability coverage will be taxable because his employer paid the premium.
 - c. If Ann becomes disabled, she is eligible for coverage under her state's workers' compensation program.
 - d. Both a and c are correct.
 - e. Both b and c are correct.

11. Peter and Ann have been discussing the possibility of retiring as early as age 60. What do the Mayfields need to consider as factors that will impact the costs, risks, and benefits of this objective when conducting their planning?
 - a. Distributions from their qualified retirement plans at that time will be subject to a 10% early withdrawal penalty.
 - b. They can deal with the loss of health insurance by extending their current health insurance coverage using both COBRA and HIPAA benefits until age 65, at which time they will be eligible to enroll in Medicare.
 - c. The cost of Medicare will increase dramatically for each year that they postpone enrolling after age 60.
 - d. None of the above.
12. Which of the following strategies should the Mayfields consider to increase their level of discretionary cash flow?
 - a. Pay off credit card debt with monetary assets.
 - b. Open a home equity line of credit.
 - c. Increase contributions to Peter's 403(b).
 - d. Increase IRS W-4 withholdings on an annual basis.
 - e. A and b only.
13. If Peter and Ann want to pay off their credit card debt, which of the following assets should they use first?
 - a. Money market fund
 - b. Proceeds from a 403(b) loan
 - c. I-bonds
 - d. Home equity
14. Suppose that the Mayfields decide to retire at age 60. How much do they need in assets at that time to fund income needs from ages 60–62, assuming that they still want \$90,000 (in today's dollars) in annual income starting on their first day of retirement?
 - a. \$114,009
 - b. \$225,847
 - c. \$228,018
 - d. \$231,438

15. Peter and Ann are concerned about estate planning details. They have heard about income in respect of a decedent (IRD). They realize that their retirement plans could be subject to IRD taxation. Which of the following statements is true in relation to IRD property?
- I. IRD property will be included in the Mayfields' estates at fair market value.
 - II. IRD property does not receive a step-up in basis.
 - III. IRD property is subject to income taxation when the heir or estate collects income from the property.
 - IV. IRD property will be included in the Mayfields' estates at a step-up in basis value.
- a. I and III only
 - b. II and IV only
 - c. I, II, and III only
 - d. II, III, and IV only
16. Which of the following factors should help drive the Mayfields' decision to fund a capital preservation approach of retirement planning compared to a capital depletion method?
- a. Their desire to leave a legacy at the death of the second spouse.
 - b. Their willingness to dedicate additional cash flow today to fund the higher retirement asset need in the future.
 - c. Their willingness to decrease their income replacement ratio assumption.
 - d. All of the above.
17. Calculating the future value of regular savings using a geometrically varying annuity assumption will tend to
- a. reduce the future value of the asset.
 - b. reduce the tax liability of the asset.
 - c. increase the future value of the asset.
 - d. increase the interest rate used to calculate future value.

18. Peter and Ann would like to establish a gifting program for their grandchildren. They have two desires. First, they want to implement a strategy that does not allow the grandchildren to access principal prior to age 21, except to pay expenses for the welfare of the child. Second, they want to maintain the maximum flexibility in terms of the types of assets that they can gift. Which of the following alternatives meet(s) their desires?
- A Uniform Gifts to Minors Act account
 - A § 2503(b) trust
 - A § 2503(c) trust
 - All of the above
 - B or c only
19. What is (are) the advantage(s) associated with suggesting prepaying the Mayfields' mortgage at this time?
- The loss of the interest deduction will require them to claim the standard deduction.
 - Their annual level of discretionary cash flow will increase, which can be used to fund other financial goals and objectives.
 - They will have the satisfaction of knowing that they own their home outright.
 - All of the above.
 - B and c only.
20. The Mayfields should consider which of the following estate planning strategies to reduce the likelihood of owing federal estate taxes in the future?
- Maximizing use of the marital deduction.
 - Gifting strategies to reduce the value of Peter's gross estate.
 - Using a credit equivalency or bypass trust arrangement.
 - A and b only.
 - B and c only.

Discussion Question

Describe how the Mayfields' asset allocation approach may need to change as they get closer to their retirement goal.