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A Continuing Education Course (12 hrs)

"The Retirement Planning Process"

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SECTION I: 5 EXAM QUESTIONS

"OVERVIEW TO RETIREMENT PLANNING: CASH ACCUMULATION ALTERNATIVES"

There are **three basic alternatives** available to the individual when it comes to retirement planning and cash accumulation. An individual can accumulate cash via

1) social insurance,
2) pension plans at their place of employment or
3) individual initiative and effort.

As a preview to the entire retirement process, a brief analysis of these alternatives is required. Both social insurance and employer pension plans are highly dependent upon the efforts of others while individual initiative is the only option within the control and direction of the person involved.

In America today, all but a few percent of the population, upon attaining retirement age, are in a position of true financial independence. The vast majority of senior citizens in the United States have little more on their financial horizon than just getting by or living below the poverty level. The old adage that "these people didn't plan to fail they just failed to plan" rings true. It seems the reliance the Individual places upon others or outside conditions to make cash accumulation available is as positive a concept as it is negative. It is good because social insurance and employer pension plans are an integral part of the way in which Americans accumulate cash. However, it can also be considered a poor alternative because both methods are outside of the controlling influence of the individual involved. The only manner in which to accumulate cash, upon which an individual can rely, is when the individual takes the time and trouble to commit to the sacrifices necessary for a comfortable standard of living in the future.

Social Insurance

Everyone is familiar with the concept of social security. Social security was implemented in America in the 1930's during the sweeping reforms of the new deal era instituted by the Roosevelt administration. The great depression of the 1930's highlighted the tragedy that most senior citizens in America were destitute and poverty stricken after a lifetime of work. The concept of Social security was introduced not as the method by which a person's entire pension or retirement could be made available, but rather as a supplement to individual and employment-sponsored cash accumulation efforts.

The original actuarial basis upon which social security were based showed that very modest amounts of contribution over a worker's lifetime would assure a more comfortable retirement. As social security became an institution in America people began to rely on government social insurance. More and more benefits and, correspondingly, higher and higher contribution levels were placed upon both individuals and businesses.

The concept of social security, over the short period of time from the 1930's to the 1960's, began to incorporate such concepts as disability insurance, survivorship benefits and even health insurance benefits for the elderly through the Medicare system. By the early 1970's it became evident that all the benefits being provided by social insurance could not be maintained without massive increases in contributions. The first generation of Americans who had paid into the system was now collecting benefits, but the benefits they were collecting were in excess of the contributions they had actually made. Therefore the burden to pay for these programs was shifted to people currently working who someday themselves would also be collecting benefits. Today, the second and third generations paying into social security are responsible not only for contributing to their own retirement but also for helping to pay for the retirements of those who are currently drawing benefits.

In the early 1980’s the United States congress, after a major study and evaluation of social insurance, decided on a bold course of increased payroll taxation. Contribution levels were raised from a few percent to double digit contributions percentages. In 1970 a wage earner in the top bracket would be expected to contribute a maximum of about $370 into the social security system. By 1990 that amount of maximum contribution was already in excess of $4000 and must be matched by the individual's employer. Congressional efforts to raise taxes substantially since the early 1980's was based on the concept of building an enormous cash reserve that would take care of current needs while providing a cushion in the future for the massive influx of projected future retirees known as "baby boomers”.

A population trend shows that when the people born in the 1945 to the 1964 era begin to retire early in the 21st century, enormous amounts of money and services must be made available by social insurance to this group. The main issue involved is money. From where will the money come to pay for these benefits for such a large population group? The tax increases of the early 80's were instituted in order to provide the necessary benefits to this large population segment for the future.

Just recently a minority of congressional members has been publicizing the fact that all the money which has been collected since the early 1980's in excess of funds actually spent, also known as the "social security trust surplus", has been spent to reduce the mounting federal deficit. **The United States government has been using the surplus funds of social security in order to fund and pay for the day to day operations of running the United States government.** However other government leaders downplay this situation and assert there is no cause for concern because the United States treasury has been placing "IOUS’" into the treasury for the hundreds of billions of dollars that they have "borrowed" from the social security system.

Although many congressional leaders are upset with the fact that payroll taxes are being used to fund government, no one seems, at this time, to have a workable alternative to this borrowing because no one knows how to replace the massive amounts involved without raising revenues through other sources like the income tax.

The clear implication of current governmental policies toward America's social insurance system is that the future looks bleak for baby boomers. What happens when nearly 40 million Americans retire in the near future and there is not enough money in the system to pay the benefits which were originally promised? Will payroll taxes be increased to even higher levels? These are hard questions with no easy answers. The only fact which is a certainty is that either there will be little or no benefits for an entire generation of retiring Americans or massive amounts of additional taxation in the near future will be necessary. No other foreseeable alternatives for funding these Social programs have yet presented themselves.

Employer Pension Plans

Another common method upon which Americans have come to depend for cash accumulation is the employment qualified and/or unqualified pension plan. The differences between employment pensions plans are vast and the level to which money is available also incorporates a wide range of values. The choices that the individual has under employer pension plans can be quite limited or extremely flexible. The common denominator of all employer pension plans is that individuals covered by them normally do not understand much about them.

In the past, small medium and large corporations jumped on the band wagon of providing retirement plans of some sort to employees. Many major U.S. corporations instituted sweeping comprehensive cash accumulation programs for their employees. In the modern era there is a trend by large, medium and small corporations to place more and more of the cash accumulation burden onto the employee by leaving many plan decisions to the individual employee. Corporations have begun to look at past generosity in providing pension plans as a major cost of doing business they can no longer afford if they are to be competitive in the world economy.

The choices ranging from qualified too unqualified, funded and unfunded and all the other alternatives available make pension planning a program which can be confusing and relatively unproductive to the employees involved. In the previous generation, an individual worked for one company for most of their adult working life. Today the trend is for employees to not only hop from job to job, but to switch careers within relatively short periods of time. This means the potential for the individual to invest or qualify to receive benefits from a pension plan sponsored by a company is in greater doubt because of the lack of the longevity on the part of employees in staying employed with a company.

One thing has become quite clear with employer pension plans; it is less and less dependable in society for the individual to rely upon cash accumulation through the efforts of company for whom they work. Gone are the days when the employee stayed with the same company for 30 or 40 years, then received a decent monthly benefit upon which to live.

Individual Initiative

It has become increasingly obvious in modern American society that the only method upon which a person may rely for cash accumulation for future retirement purposes is through their own planning and effort. The problem is few people have realized or recognized the serious implications the future holds for America's elderly due to the instability of social insurance and general shifts in an employer sponsored pension programs. The individual today is more and more responsible for developing a strategy to supply funds for their own retirement.

However, the vast majority of Americans at this point in time have chosen to all but ignore this enormous responsibility. It seems that past reliance upon social and employer-sponsored programs has been instilled in the subconscious of American minds such that the individual does not feel a sense of urgency to take the responsibility involved for planning their own retirement. In an era when Americans save less than 5 percent of their disposable income while European and Asian counterparts save two, three and four times more money indicates the problem's severity.

Individual programs such as individual retirement accounts (IRA), non qualified plans such as annuity and life insurance are not particularly popular compared with the option of doing little or nothing. The individual American must become more aware of their personal role in the financial and retirement process before a stable financial retirement can become a certainty. Without individual initiative, the American senior citizen of the future will be poorer than ever.

It is the role of the financial services professional to instill a sense of urgency in individual Americans and to help motivate the population to recognize its awesome responsibility in actively saving more money for the future. Without taking such Individual initiative, the only alternative in the future would be for the government, and Individuals, to borrow heavily to finance retirement out of urgent necessity.

The above discussion on the interrelationship between social insurance, employer pension plans, and individual initiative in the cash accumulation process illustrates the importance of the topic of retirement planning. The material that follows represents a cross section of material designed to help the financial services representative gather a clear understanding of the alternatives involved in the retirement planning process as well as some of the technical knowledge required for the application of skills in this area.

SECTION II: 19 EXAM QUESTIONS

ASSESSING RETIREMENT PLANNING NEEDS

Establishing a Standard of Living

The basic approach a person takes in thinking about planning for retirement is based on two main factors. The first is that of current living standards because, to a large extent, they influence the expectations the individual has about the future type of retirement they would like to enjoy. The other main concept is the age or career point the Individual is currently experiencing.

People in the **earlier parts of their career** tend not to think too much about actual retirement needs. These individuals are usually raising families, paying mortgages and fully utilizing current income to meet current expenses without thinking too much about the future. It is a very real concern just to meet current monthly bills without the burden of worrying about points so distant (20, 30, 40 years) into the future. Many people at the beginning of their careers have an expectation that their retirement standard of living should be about the same or perhaps better than the current standard enjoyed by their own parents. It is at this stage of life individuals should be encouraged by planners to utilize the individual retirement account concept and to make voluntary contributions to employer plans, if they are available, or to non-qualified programs like tax deferred or tax-sheltered annuities.

People who are in the **middle part of careers** tend to think of retirement and the standard of living that they will enjoy in terms of being an enjoyable experience that they have not yet fully thought about. People in this group are more concerned with larger and larger incomes and a better lifestyle after having gone through the financial insecurity of youth.

Before looking to the future, this group seems to want to enjoy the present while still contemplating what will be. The planner can help this individual think about retirement in terms of taking current salary amounts and instituting an accounting for some sort of inflationary growth factor to make a guess at the individual's approximate salary upon retirement.

People in the **latter part of their careers** (closer to actual retirement) normally are enjoying the greatest income and highest standard of living of their entire lives. It is at this point that the individual becomes more and more aware and concerned of keeping this high and enjoyable standard of living. It is also at this point individuals are most willing to adjust a current lifestyle in an effort to plan for impending retirement. **However, for many people at this point, the actual saving process can be a case of too little too late.** It is quite ironic that those who recognize the importance and urgency of retirement planning are the same people who are now in a relatively poor and limited position to take meaningful steps in providing for comfortable and safe retirement.

The standard of living a person expects to enjoy in retirement really depends upon current age, income and career status. The closer the individual is to actual retirement, the more meaningful the experience of retirement planning is to that individual. This is compounded by the concept that perhaps that individual, upon finally realizing that it is time to create strategies and to take action, may in fact be too late to really do anything truly meaningful to help plan for the retirement experience.

Another factor involved in estimating the amount of money or income a person should plan for is called the replacement ratio. This concept seeks to provide a person in the late part of his career with the same standard of living or close to the same standard of living they may enjoy upon retirement. **The normal rule of thumb for income replacement would be to have available from 70 to 90 percent of the current income received as the amount necessary for financial independence during retirement.** The planner adds the last three to five years of income and takes an average and applies to that average 70 to 90 percent as the income figure which would keep most people comfortable upon entering retirement.

Incorporating Tax Deductions

Another critical factor in the retirement planning process in determining the future standard of living is incorporating the reduced taxes and tax deductions a retiree can apply. Normally a person who is retiring can **look forward to being in a lower tax bracket due to reduced income**. Additionally, previous taxes which had to be paid, such as social security taxes, are no longer applicable because they are only taken out of employment checks. Money received by retired people from pensions, IRA's and annuities are not considered income subject to payroll or FICA taxes. Another advantage a senior citizen at 65 years of age or older enjoys is **an additional exemption for federal and most state income tax computations**. In fact a 65-year-old taxpayer who is married to another 65 or older individual is eligible for two additional exemptions on their joint return. A taxpayer who is 65 or over also qualifies for an additional standard deduction for 1996, the amount is $1,000 if filing single and $850 if filing jointly.

Upon reaching retirement there is also a social security benefit exclusion. The married taxpayer can exclude all benefits from social security from income for tax purposes if

> Adjusted gross income (which includes earnings on state and local government Securities) plus one half of the social security benefit is not more than $32,500 ($25,000 for single taxpayers).

If this base amount is exceeded, in most cases one half of the social security benefits would be considered part of income for tax paying purposes, however, in some instances for very affluent retirees as much as 85 percent of social security benefits are included in determining taxable income.

Social security benefits are exempt from state income taxes in some states while other states do tax these benefits. Some states give income tax relief to the elderly through various credits, rebates and personal exemptions.

Another tax break senior citizens may be able to utilize is the deductible medical expense if the taxpayer itemizes deductions for federal tax purposes. The 7.5 percent threshold for deductibility of qualifying medical expenses is much easier for elderly people to achieve because of lower income and increased medical expenses which tend to take up a greater and greater percentage of income expenditures. Remember that the premiums paid for Medicaid and Supplemental Medicare Insurance may also be included in determining you itemized medical expense deduction. Premiums paid for Long Term Care insurance up to $2,000 per year (indexed from 1997) if over 60 and $2,500 per year (indexed from 1997) if over 70 are also deductible as an itemized medical deduction. Their is also a basic $175/day exclusion (indexed from 1997) for per diem benefits paid under such policies plus an exclusion for any additional amounts paid for actual long term care expenses incurred over that amount.

Decreased Expenses

Another factor to incorporate into the retirement benefit formula is the various living expenses which actually decline or reduce upon retirement. Work related expenses such as clothing, meals and commuting costs no longer exist once a person retires Therefore the amounts of expenditure associated with these items is no longer needed upon retirement.

Home ownership expenses should also be reduced at the point at which a person retires. Typically retirees no longer have mortgage debt. However, a future trend to be considered is when people retire they may not only still have a mortgage, but perhaps one of the greatest sized mortgages of their entire life. The reason for this potential for increased mortgage debt for senior citizens will be the fact that current tax law allows the deductibility of mortgage interest as one of the last remaining tax advantages open to Americans.

Americans are being encouraged today to extend mortgages, to take home equity loans and to generally increase the debt associated with home ownership in order to finance other expenditures such as automobile purchases, home improvement and tuition expenses. The future price senior citizens may pay for enormous home ownership borrowing today is yet to be witnessed, but the current reliance upon mortgage debt elimination at retirement may be challenged in the future.

At retirement, a retiree's children are normally grown and are no longer financially supported by the elderly parents. This situation will depend largely on the individual because many grown children are still quite economically dependent upon parents for financial support. When a retired person wishes to continue helping adult children this factor must also be accounted for in the retirement planning process.

Three other factors involved in reduced living expenses for senior citizens include special price discounts given to senior citizens, the need to no longer save for retirement and reduced life insurance costs. Many restaurants and retail establishments offer substantial discounts to people who are retired. Also, since a retired person is on retirement, they no longer need to save money for that purpose. Finally, since the need for life insurance is greatest when a person is young and has the greatest potential for loss, upon attaining retirement the need for life insurance should be diminished or eliminated all together.

One extra note, retired people generally have reduced need for personal automobiles. Instead of owning two or three cars and paying for repairs and auto insurance, one car is usually sufficient for an elderly couple to meet their transportation needs. Fewer places to go translate into less gas purchased, less repair bills and one auto insurance premium.

Increased Expenses

The most insidious threat a retired person, especially those living a fixed income, is inflation. Inflationary pressures in the cost of living have historically damaged the purchasing power of the dollar and this trend is expected to continue unabated for the foreseeable future. The inflationary threat means that not only do individuals have to presently put aside greater amounts of money for retirement but, upon attaining retirement, the burden of continued saving will also exist.

The main inflationary pressure which most directly affects senior citizens is the cost for medical and long term nursing care in the American economy. While current cost of living increases in America have ranged from three to 5 percent annually in recent years, the increase in the cost of medical services has been at a rate of approximately 8 to 10 percent per year within the past decade. Since expenditures for medical expenses constitute a significant portion of the expenditures of the senior citizen, higher inflation in this area hits home even harder than to younger members of the population.

Other higher living expenses by senior citizens tend to come from increased travel, vacations and lifestyle changes. A healthy and financially comfortable senior citizen usually uses this period of life to enjoy some of the things they were not able, or did not have time to for, when they were younger. Experiences like taking extended vacations and engaging in travel are costly, but enjoyable. It is somewhat ironic that when a person has the most time to enjoy leisure activities it also tends to be a time when many people cannot afford to indulge in this type of activity. Again the potential to enjoy future retirement depends on the care and sacrifice given to these concepts when the individual is younger.

Due to the uncertainty of increased living expenses it should be paramount that the individual thinks about increasing income over the retirement years. This is necessary from two points of view. First, the typical retired person's income remains relatively fixed while prices continue to increase, therefore reducing the purchasing power of available cash to the senior citizen. This translates into a lifestyle which deteriorates each and every year.

The second factor is that Americans are living longer and longer and this increase in age means the typical individual will have to draw upon income and cash reserves for longer and longer periods of time. The fastest growing population segment in the United States is currently for people 85 years of age and older. Now that medical science and technology can keep people alive to ages never before thought possible, society's problem seems to be structuring a payment plan to support these people once as they attain these generous life spans.

Time Value of Money and its Impact on Future Living Standards

In planning for future retirement and incorporating inflationary trends of the future, what type of inflationary forecasting should the planner recommend? There are two ways to look at this concept. One is to get a feel from the client as to what future expectations of inflation and to make certain to incorporate that expectation in any long range planning figures. Another view in forecasting inflation is to take a long term average of compound increases of prices experienced in the past. For instance, for the previous 40 year periods, the average annual inflation rate was approximately 4.2 percent. Whether or not this percentage is valid for the next 20 to 30 years is of course questionable, especially in light of the recent trend toward higher and higher average amounts of inflation. Although no one has a crystal ball which can predict accurately the actual amount of future inflation, some measure or yardstick must be incorporated into the retirement planning process.

Social Insurance (Medicare)

Social insurance, under the social security system, has grown into a broad and comprehensive plan which provides old age, disability, survivorship and health insurance to citizens of the United States. In order to qualify for old age insurance under social security an individual covered receives credit based on a specific amount of work and number of quarters in which a person is employed under the system. Retirement benefits can be paid to an insured worker under social security as early as age 62 but full benefits are not paid until an individual reaches the age of 65 and then decides to retire.

Under old age benefits, the amount of insurance provided to an individual is based on that worker's average indexed monthly earning or the actual amount of social security taxes which were paid by that individual. Estimating social security benefits requires making a request of the employee's actual data from the social security administration. To request this information from the Social Security Administration you simply go to or call your local center and obtain A Request for

Earnings and Benefit Estimate Statement Form SSA-7004 PC-OPl (also available from your local SSA office or by calling 1-800-234-5772). After you complete this form and send it to the Social Security Administration P.O. Box 57, Baltimore, MD 21203 they will send you a comprehensive analysis and report of earnings in about six to eight weeks. It's a good idea to check your status at least once every three years.

The actual amount of benefit received by a retiree under social security increases each year based on the cost of living adjustment index. The consumer price index of the previous one year period, ending in the third quarter, is used to determine increases in the social security benefit. However, this adjustment due to the consumer price index increase may not be used if there is a drop in the social security trust funds which are below specific levels. In this case the wage base would be used.

Individuals who are not covered by social security include civilian employees of the federal government who are employed by the government before 1984, individuals covered by the Railroad Retirement Act (railroad workers), employees of specific state and local government covered under state or local pension systems, Ministers electing out of coverage due to religious principles and some American citizens working outside of the country for foreign affiliates of U.S. employers.

Medicare

Medical insurance serving the needs of people in America who are age 65 or older is called Medicare. Medicare consists of two parts, part A and part B. In part A refers to costs associated with hospitalization and hospital stays while part B refers to physician and doctor services. Eligibility under part A is granted at no cost to people age 65 or older as long as that person was entitled to retirement benefits under either social security or railroad retirement. Civilian employees of the federal government age 65 or older and those who are age 65 and older and do not meet other eligibility requirements can voluntarily enroll in Medicare and pay a monthly premium.

All individuals eligible under part A are also eligible under part B as long as they pay a monthly premium. This monthly premium represents only a small fraction of the actual costs of the benefits provided and therefore it is highly recommended that the retired individual accept the benefits under part B and pay the premium.

Under part A, specific benefits include: a) hospital expenses for stays in the hospital up to 90 days during a benefit period.

b) skilled nursing facilities if a physician certifies that skilled nursing or therapeutic care
is a necessary condition which was treated in a hospital within the last 30 days.

c) hospices for the terminally ill who have life expectancy of six months or less.

d) home health care benefits when a patient needs further care at home for a condition treated in a hospital or skilled nursing facility.

Part A also requires that covered individuals pay an inpatient deductible pegged at nearly $800 in 1997. This deductible represents the first dollars of any claim and must be paid by the insured.

Part B of Medicare, the supplemental medical insurance portion of Medicare, provides benefits for medical expenses not covered under part A, including:

a) physician and surgeon fees resulting from house calls, services provided in a hospital and office visits.

b) tests which are diagnostic in nature provided in a hospital or at a physician's office.

c) radiation therapy.

d) physical therapy in a physician's office or as an outpatient of a hospital, skilled nursing facility or approved clinic.

e) drugs and biological products which cannot be self-administered.

f) medical equipment rental.

g) medical supplies.

h) ambulance service.

i) Prosthetic devices.

j) home health services described under part A when prior hospitalization was not in effect.

k) pneumococcal vaccine and administration.

Part B carries with it a $75 annual deductible after which Medicare pays 80 percent of approved charges under covered medical expenses. The 80% coinsurance factor paid for by Medicare is only based on reasonable necessary and customary cost factors charged by physicians in a particular geographic area. This means that if a patient's doctor charges more than Medicare is willing to allow, then Medicare will only share costs upon allowable amounts and the balance of the charges would be up to the insured to pay.

Excluded under part B are the following: a) routine foot care, b) immunizations, c) drugs which can be self administered, d) dental care, e) cosmetic surgery, f) eyeglasses, hearing aids and orthopedic shoes, g) custodial care, h) routine physical, eye and hearing examinations. Also excluded from coverage are benefits provided to people who are eligible under workers compensation claims or who are treated in government hospitals (i.e., veterans of foreign wars).

Medicare supplements

Based upon the previous discussion of medical insurance provided by the Medicare system to senior citizens, it should have become obvious that the system is not designed to pay for all costs associated with health care for senior citizens. The somewhat hefty inpatient deductible under part A and deductibles and coinsurance requirements under part B make it clearly necessary for the senior citizen to consider an additional form of coverage, especially for long term illnesses or long term hospital stays.

The consideration of a "Medicare supplement" is a necessary requirement for most senior citizens. Medicare supplements are marketed from state to state under the direction of minimum standards imposed by the various state laws. Virtually every state requires that a Medicare supplement, in order to be marketed, must meet varying specific minimum conditions such as paying for all deductibles and coinsurance under part A and B based on Medicare's reasonable and necessary charge structure. Also prerequisite is the fact that only one Medicare supplement should be necessary to provide the required minimum coverage and the supplement should not duplicate coverage already offered under Medicare.

Medicare supplements are usually allowed to exclude from coverage the same things that the Medicare system itself excludes from coverage, otherwise, a supplement is supposed to be designed to pick up the reasonable and customary charges under the Medicare system which would otherwise be payable the insured.

The social problem created by Medicare supplements is that people living on the lowest incomes are not able to afford adequate supplementary coverage. Those middle income retirees who can afford Medicare supplements witness a larger and larger percentage of their income going toward health care and insurance premiums for health care. The wealthiest and most financially secure senior citizens naturally tend to have the best coverage available in society through the use of comprehensive Medicare supplements. For people who are retired and who cannot afford any supplement, the options become quite limited. Those very poor and indigent people who cannot even afford the deductibles and coinsurance amounts may be eligible for a system called Medicaid. Those who are not eligible are financially responsible for any amounts not covered by Medicare.

Medicaid is a federally funded and state administered program to provide money to those poor and indigent senior citizens (and other people) who cannot afford even the most basic deductible and coinsurance costs. Although the federal government makes the money available to states, it is the state that establishes participation requirements. These requirements can be anywhere from generous, allowing a senior citizen to retain substantial amounts of net worth, down to the requirement that a senior citizen be totally insolvent prior to being eligible.

Long Term Care Considerations & Social Insurance (Medicaid)

Since whether or not a person qualifies for Medicaid can vary from state to state and is truly designed only for the poorest and most financially destitute senior citizens, everyone else is essentially left to their own devices in providing for their long term care. Long term care consideration is that of requiring long term and substantial medical attention above and beyond normal and customary hospital stays. People who require constant and long term nursing care have very limited options in our society. Hospitals are not designed to provide services to elderly people for substantial periods of time. When long term and routine care becomes necessary for a Senior citizen, they must leave the hospital and either be placed in a nursing home facility or be cared for at home by relatives or friends.

The major issue involved with long term care consideration is: "How will the bills be paid?" If a senior citizen has a relatively strong heart yet requires constant but limited medical attention, and there are no other members of the family who are willing or able to care for this individual, then that person is normally placed in either a state run or a private nursing home. Nursing home costs can run from $30 to $300 per day for care (or even greater cost in the case of those requiring long term and dedicated care).

It is common for senior citizens to completely liquidate all assets that they own in paying the costs associated with long term nursing care. Once all assets have been liquidated, the senior citizen is eligible for Medicaid.

Since the requirement for long term and costly health care is unpredictable at best when applied to an individual, preparing for this possible contingency becomes a necessity. There is probably no greater threat to the financial security of an elderly Married couple then if one of them becomes ill and requires long term care, lingering year after year while clinging to life. Money must be made available to care for this individual. All assets may be liquidated to the extent that the healthy spouse in the relationship is financially destitute by the time the federal government will take over payments. A greater and greater social implication of long term health care in America will be dealing with the surviving and healthy partner, in this relationship, who becomes financially destitute.

Long Term Care Policies

Enter the concept that private insurance can transfer the risk of long term costly health care to senior citizens from the individual to an insurance company. The "nursing home policies" as they have been called, are a relatively new phenomenon in the insurance marketplace. These policies recognize an increased need in our society for a vehicle by which senior citizens can transfer the risk of financial calamity regarding the cost of long term care from them to an insurance company.

A major drawback to these long term care policies is the fact that, since it is a relatively new concept, it is far from being an exact science. The few bold companies who, within the last 10 years, came out with basic long term care policies are pioneering a field which has an end result not known by the major insurance companies offering these policies. The actuarial assumptions being used to calculate premiums at this time may or may not be valid for the long term and actual financial considerations remain to be seen. Companies marketing long term care policies have incorporated premium structures which are quite conservative in view of the unknown factors involved.

Another problem concerning long term care policies is abuse by some people marketing these policies selling them to the senior markets. Like Medicare supplement marketing before them, long term policies can be a very positive thing or a costly alternative in which the senior citizen is not getting an adequate exchange or value for money.

These policies carry the enormous social benefit of allowing senior citizens to plan for the possible contingency that one or both of them may become long term disabled and financially dependent upon others. The policies allow the senior citizen to keep estate value intact either for a surviving spouse or to children or other descendants to whom they want these proceeds or monies to go.

A final point of discussion concerns the attitude by some that taxes should be used to pay for long term care. Opponents of this concept make the point that taxpayers should not be burdened with allowing senior citizens to retain assets to pass to children and grandchildren when those assets can be used to pay for their long term care costs.

LONG-TERM CARE PLANNING

"Long-term Care" (LTC) is a phrase which is used to describe a variety of services in the area of health, personal care and social needs of persons who are chronically ill or infirm.

1. <u>What are the chances that you will need Long-term Care?</u>

Recent studies, based on nursing home admissions, indicate that 40% of all persons age 65 and over will enter a nursing home in the future.

2. What portion of these expenses will be paid by Medicare?

A study conducted in 1995, showed that Medicare paid for less than 2% of the costs and private insurance paid for about the same amount. . Medicaid paid for 46% of the expenses and the patient, or his or her family, paid the rest of these costs.

3. How does one qualify for Medicaid?

Since Medicaid (or Medi-Cal in California) was enacted to provide services for the impoverished of our nation, many persons with moderate estates will have to "spend-down" their assets to federal poverty levels in order to qualify for benefits. This may be done through gifts to children or grandchildren, provided the gifts are made at least 30 months prior to applying for Medicaid. Or the estate may be "spent-down" by just paying the ongoing nursing home costs.

Under current law gifts to one's spouse will not help, since the combined assets of couples must fall within the eligibility levels. These levels range from a minimum of $12,000 to a maximum of $60,000, and are selected by each state. Some assets, like one's personal residence, are exempt from the calculation.

4. How can you keep your estate from being depleted by the need for LTC.

There are currently a number of insurance companies which offer LTC insurance policies. Some are individual policies, while others are obtained through an association or employer (group policies). A major difference is that group policies are generally not "guaranteed renewable". In other words, the insurance company can change the premium, the benefits, or even cancel the master policy.

COMMON PROVISIONS IN LONG-TERM CAR POLICIES

1. AMOUNT OF THE BENEFIT- Most policies pay a fixed dollar amount for each day you are eligible for the benefit; e.g., $80 per day. A survey of nursing homes in your area can help determine the desired amount.

2. INFLATION PROTECTION - since costs inevitably increase, a policy without a provision for inflation may be outdated in a few years. Of course, an additional charge is incurred for this protection.

3. GUARANTEED RENEWABILITY - This important provision will prevent the insurance company from canceling your policy, for as long as you continue to pay the premium when it is due.

4. WAIVER OF PREMIUM - Some policies will waive the future premiums after you have been in the nursing home for a specified number of days; e.g., 90 days.

5. PRIOR HOSPITALIZATION - This provision requires one to be hospitalized (for the same condition) prior to entering the nursing home or no benefits will be paid under the policy. This is an undesirable provision.

6. PLACE OF CARE - Does the policy require that the nursing home be licensed or otherwise certified by the state to provide skilled or intermediate nursing care? Must the facility meet certain record keeping requirements?

7. LEVELS OF CARE

A. SKILLED CARE: Daily nursing and rehabilitation care under the supervision of skilled medical personnel; e.g., registered nurses and based on a physician's orders.

B. INTERMEDIATE CARE: The same as SKILLED CARE, except it requires only intermittent or occasional nursing and rehabilitative care.

C. CUSTODIAL CARE: Help in one's daily activities including: eating, getting up, bathing, dressing, use of toilet, etc. Persons performing the assistance ~o not need to be medically skilled, but the care is usually based on the physician's certification that the care is needed.

8. PREEXISTING CONDITIONS - Most policies limit coverage of preexisting conditions to discourage persons who are already ill from purchasing the policy. Many policies will provide benefits if the preexisting condition was overcome six months or more prior to applying for the policy. Also, some policies will not pay benefits if the preexisting condition recurs within six months after the effective date of coverage. After 1997, however, most group policies will not be permitted to impose pre-existing condition limitations, and initial waiting periods will be limited to one year so that prior coverages can be maintained to deal with pre-existing conditions under COBRA rules until eligibility for the new plan is established.

9. WAITING PERIOD - Most LTC policies require you to "pay your own way" for a specified number of days (generally ranging between zero and 120 days) before the insurance company will begin to pay benefits. Of course, the shorter the waiting period, the higher the cost.

10. PERIOD OF CONFINEMENT - This important provision indicates how long a person can stay out of the nursing home before being readmitted for the same condition, without being required to go through a new waiting period (or deductible). The period should typically not be less than 90 days.

11. ALZHEIMER'S DISEASE - Some policies exclude coverage for "organic brain disorders" (Alzheimer's Disease). Problems of this nature often do not begin with a visit to the hospital and could, therefore, be excluded if the policy requires prior hospitalization

12. HOME CARE - Does the policy offer home care coverage? Some companies offer it as a rider to the policy for an additional premium. Make certain that it supplements Medicare coverage and not just duplicates it.

5. <u>How are Long Term Care policies taxed</u>.

The premiums paid for Long Term Care policies are deductible as itemized medical expenses (subject to the 7.5 percent of AGI floor) up to certain designated limits (indexed from 1997) that range from $200/yr if the taxpayer is less than 40 to $2,500 if the taxpayer is over 70. Any additional amounts paid for long term care that are not reimbursed may also be taken as itemized medical expenses. There is also a basic exclusion for long term care benefits received of $175/day plus any additional payments that may be made by your policy for actual long term care costs in excess of that basic exclusion amount.

Planner’s Note: The "management of risk" is a crucial part of financial planning. The potential need for long-term care is a genuine risk. The prudent estate owner will examine Long-term Care Insurance to see if it has a proper place in his or her overall financial plan. Once the disabling condition appears, it is obviously too late to act. There is not a "perfect" LTC policy -- many policy features must be compared. As one would expect, the more benefits which are included, the higher the premium will be. Professional guidance is extremely important in this complicated area. Companies selected should be financially sound and have a reputation of treating policy holders fairly. As policies improve, better companies will be more apt to allow you to upgrade to a newer policy.

SECTION III: 7 EXAM QUESTIONS

RISK RETURN EVALUATIONS

To eliminate the basic economic risks to your family that are associated with the loss of your earning power due to an untimely death, most people choose to maintain some level of insurance coverage. The basic types of policies most commonly issues to consumers are noted below.

Basic types of Life Insurance Coverage

TERM INSURANCE

Term insurance provides face amount insurance coverage on a year by year basis. It has no cash surrender value build up. It is typically issued year by year. In your 20's it can be purchased for less than a dollar per thousand dollars of coverage. In your 80's it may cost you as much as 1/3 of the face value of your policy each year for coverage unless you have managed to become uninsurable over the years. To avoid concerns about escalating premiums and uninsurability, term policies are often issued with a guaranteed renewability feature for periods of 5, 10, 15 or 20 years at a level (but initially higher annual premium rate). When your die the proceeds of the policy go directly to your beneficiaries they are not part of your estate like the proceeds from permanent insurance.

PERMANENT (WHOLE LIFE) POLICIES

Whole life is sometimes called "permanent insurance" and is designed to stay in force throughout one's lifetime. Historically, whole life insurance has provided several remarkable tax benefits:

1. There is a tax free up of the cash values attributable to favorable investment experience of the insurance company.

2. The owner could borrow against the cash values at relatively low interest rates and without a tax.

3. At time of death, the beneficiary collected the proceeds free of income tax.

4. Accelerated Death benefits received by a terminally or chronically ill person are also generally excludable from income taxation.

5. By transferring ownership of the policy to another, or by using the proceeds to cover medical costs under an accelerated death provision, the proceeds could also escape Federal Estate Taxes.

Although tax reformers have periodically tried to eliminate or reduce these benefits, for most whole life contracts, they have been unable to do so.

SECOND TO DIE PERMANENT INSURANCE

One of the primary uses of permanent insurance is to give the decedents estate the necessary cash reserves to cover probate and estate tax burdens. This allows the beneficiaries to inherit assets in tact without being required to sell them to meet death tax obligations. Look at the Wrigley Family: they had to sell the Cubs to the Tribune Co. to cover their father's estate tax burdens. When the Tax Act of 1986 enacted the unlimited marital deduction, married couples found that the need for cash for estate taxes by in large moved from the first to die to the second to die. This has created the strong demand for second to die permanent insurance in recent years. The premium rates are also more agreeable because they tend to be based on the life of the younger healthier spouse.

MODIFIED ENDOWMENT CONTRACTS

Influenced by the heavy promotion of Single Premium Whole Life as a "tax-sheltered investment, "Congress took steps in the 1980's to eliminate the ability to borrow against these policies without the payment of income tax.

Under current law, any policy issued (or materially changed) on or **after June 21, 1988** which is paid up with less than seven level annual premiums is referred to as a "modified endowment contract." Once a contract becomes a "modified endowment" it will remain modified for the life of the contract.

Withdrawals from "modified endowment contracts" (including loans) will be taxed as current income until all of the policy earnings have been taxed. There is also a 10% penalty tax if the owner is under age 59 ½, unless payments are on account of disability or are annuity type payments.

Planner's Note: Well-designed premium payment schedules can avoid the "modified endowment contract" treatment and retain the four benefits listed above.

UNIVERSAL LIFE

Universal Life allows for a more flexible premium and coverage structure by blending whole life with term insurance concepts. Each year the policy premiums are used to cover the basic costs for the face value of your permanent coverage and the excess premiums and earnings on the account can be used to build up your cash surrender value, buy additional term coverage, or increase the face amount of your permanent insurance.

VARIABLE LIFE

Overview. Variable Life, first introduced in the United States in 1976, is Considered a permanent plan of life insurance and a fixed premium is payable. It is very different from traditional life insurance because its product design is to base death benefits and/or cash values on a variable basis tied to a separate investment pool of assets. Since Variable-Life's performance is associated with equity markets, it is considered somewhat risky and it can only be sold by agents registered with the National Association of Securities Dealers (NASD), SERIES 6 level, or higher. Financial planning experts agree in their caution to purchase a variable life contract only in addition to purchase a variable life contract only in addition to meeting the normal death benefit need through other traditional sources of product (whole life, UL, term, etc.).

Variable Life is approved in all states for sale, but its growth has been slow. But it is expected to eventually gain a larger market share. In general, the product offers the potential to outperform inflation in the long run because of its relationship to the stock market. Stocks have traditionally been considered a hedge against inflation, but short term fluctuations can be disruptive or upsetting to the unsophisticated investor.

To remove this short term susceptibility, variable products have expanded the number and types of accounts available for investment. In addition to stock accounts, and depending upon the product, the policyholder can direct funds into money markets, high growth stock funds, guaranteed accounts, global funds, balanced accounts and bond funds. Each Variable Life product must supply a registered prospectus as an element of marketing, in Compliance with current SEC (Securities and Exchange Commission) regulations.

Current Mortality Charges. As of January 1, 1989, insurance companies were required to use a 1980-CS0 table for mortality. The death benefit itself, under a typical variable contract, consists of two parts. There is a guaranteed death benefit which directly relates to the basic plan of life insurance stated in the contract. The second aspect of the death benefit is variable. Payment of the fixed premium assures full payment of the face amount regardless of policy account performance. If the underlying investments in the policy account perform well, then an additional death benefit is added to the original face amount purchase. As once lofty returns diminish so to will the extra death benefit, but never below the original face.

Loading Factors. Although transparent to some extent, cost is not as unbundled here as it is in a universal contract. In addition to mortality charges, there are deductions for state premium taxes, any riders selected and the usual administrative fees. One cost unique to Variable Life is an asset management charge based on the securities portfolio. Details of asset management charges are disclosed in the prospectus which must be provided to all prospects for Variable Life. The maximum sales load, with some exceptions, for Variable Life is 9% during the first 20 years of premium payment.

Interest Factors. Unlike traditional life and universal products, there is no cash value guarantee under a Variable Life contract. The actual cash value of variable policies will fluctuate daily, based on the market performance of underlying securities. If the policy has a guaranteed conservative account available under the contract, the cash value or a specifically directed percentage may be guaranteed.

The overall return paid will be dependent upon cash amounts invested in various available accounts and the investment income they produce. Normally, companies allow a policy holder to switch cash amounts form one fund to another and a fee may be assessed. If all the invested funds are in security type accounts, there is no guarantee of cash value. If more conservative accounts are chosen for placement of policy cash value, there will be little or no risk to capital. As discussed earlier, the concept of risk and return plays a key role in this contract. The placement of cash value into riskier accounts correspondingly increases the chance for gain or loss.

Possible Effect of Interest Factor on Premium Payment Since a negative return could conceivably wipe out all accumulated cash values within a policy, there are no cash value guarantees. Investment risk is placed solely upon the consumer. In the event all cash value is wiped out, the company would require the policyholder to pay an additional premium to keep the policy in force beyond the original premium payment period. Thus, a variable contract is not like any other insurance contract. All forms of traditional Whole Life insurance offer fixed and guaranteed premiums.

Typical Riders. Riders available to the variable contract can include a waiver of premium, term on additional insureds, accidental death and option to purchase additional insurance. A waiver of premium can protect the entire amount of the fixed premium payable under the variable contract or it may only pay the actual policy and insurance costs. A note concerning term on additional insureds: watch lapses due to cash value erosion very carefully. If the variable contract lapses, so do any coverages associated with it as riders. Option to purchase additional insured, in theory, would not be very attractive under a variable contract. Remember, the variable plan is supposed to be a hedge against inflation because the underlying securities have historically out-paced it.

VARIABLE UNIVERSAL LIFE

A newer version of Variable Life called Variable Universal Life combines some of the investment opportunities of Variable Life with the flexible premium payment and coverage aspects of a Universal Life Policy. Unlike a Universal Life Policy, however, it is an interest sensitive product, and it is not within the scope of this course due to its relative complexity.

Portfolio Management Concepts

To the extent that an individual anticipates a long and enjoyable life he will need at an early stage in life to begin building a portfolio of investments to provide for his retirement years. In this regard there are a few basic principles of portfolio management that must be kept in mind.

A) Higher Returns require higher Risks. Studies have shown that there is no way of getting around this. Real investment opportunities do carry risk and to generate better returns you must be willing to accept more risk.

B) Life styles & investments may need to reflect your Risk Tolerance. Taking on risk is more than an academic exercise. As humans we all have different physical capacities for absorbing risk. Thus a person with limited wealth and low risk tolerance may be a happier camper if they invest more conservatively and live more modestly in retirement.

C) You must diversify to limit your investment risk. Some investment risk is inherent and systematic. It stems from the fact that securities are bought and sold in a volatile marketplace. The risk that your portfolio will suffer because of one or two bad positions can largely be eliminated through diversification. In fact studies indicate that 20 well selected and diverse holdings in a portfolio will immunize it from 99% of the risk associated with bad investment choices.

D) Asset allocation is key to the investment process. How you allocate your portfolio among investment types i.e., stocks, bonds, cash equivalents (money markets, CD's etc.), and non-market investments (art, antiques, & collectibles, real estate, etc.) is probably a more critical decision than determining which specific investments you make within each type. Academic studies suggest that over 90 percent of a portfolio's long term performance is a function of asset allocation. Less than 10 percent is a function of asset selection and timing factors.

E) Asset allocations for retirement should reflect your stage in life. The rule of 100 provides a good rule of thumb for this purpose. More specifically, if you assume that no more than 10 percent of your investment assets are in non market investments and cash equivalents, then the rest should be allocated between growth and income investments based on your age. Hence, at 10 years old you should be 90 percent growth and 10 percent income, and at 90 years old you should be 90 percent income and 10 percent growth. At least once every 5 years you should rebalance your asset mix to reflect this concept.

Use of Mutual Funds in Retirement Planning

Mutual Funds offer the investor immediate diversification into carefully selected and managed securities. An investment program can be started for a small amount of money (typically $500-$1,000) and subsequent purchases can be as small as $50. Automatic reinvesting of capital gains and dividends will speed up the growth of the investment.

A) FAMILY OF FUNDS - Many Mutual Funds have a broad spectrum of funds to meet the needs and temperaments of various investors. Since Fund names may be subject to marketing influences, you should always read the Fund's prospectus to determine its precise objective. A typical Family of Funds might include the following:

MONEY MARKET FUNDS
- Invest in short-term money instruments

MUNICIPAL BOND FUNDS
- Invest only in Municipal Bonds to provide tax-free income.

BOND FUNDS
- Invest in debt-type instruments
- Relatively high yield.
- Market value fluctuates inversely to interest

INCOME FUNDS
- Seek maximum income.

SECTOR FUNDS
- Concentrate on a particular area of the economy.

AGGRESSIVE GROWTH FUNDS
- Very Volatile, invest is high-performing stocks.

GROWTH FUNDS
- Invest mainly for capital growth.

GROWTH & INCOME FUNDS
- seek a balance of stocks & bonds

B) EXCHANGE PRIVILEGES - Exchange from one fund to another may be allowed at any time for a nominal fee (usually $5) and no commission charge. There will be tax consequences at the time of exchange if there is a profit or a loss.

C) TIMING SERVICES - For a fee, these organizations manage funds, typically shifting "in and out of the market" by switching from Growth Funds to Money Market Funds, through the exchange privilege.

The Investment Pyramid Concept for Retirement Planning

An investment program for retirement should-be built like a pyramid with a strong, broad base. The diagram on the next page illustrates a typical investment pyramid.

This Pyramid is intended merely to illustrate the concept. Each investor will differ on the levels to which various assets are assigned.

SPECULATIVE
Art
Gems
Metals
Exploration
Commodities
Naked Options
Venture Capital Units
****
GROWTH
Investment Real Estate,
Growth Stocks, Mutual Funds
Equity Partnerships
****
SECURE
Sale of Covered Options
Conservative Equities
(Utility Stocks, Convertible Bonds
Residence, G.N.M.A., Retirement Plans
Corporate Bonds, Annuities
Municipal Bonds, U.S. Govt. Notes & Bonds
****
LIQUID FOUNDATION
Savings Accounts, T-Bills
Money Market Funds/Accounts
Life Insurance (Cash Values)
****

SECTION IV: 14 EXAM QUESTIONS

RETIREMENT INCOME DISTRIBUTIONS: THE ANNUITY

General Discussion of Annuities

An annuity is a series of payments made for a specified period of time. It is an insurance contract, but any similarity between an annuity and life insurance is purely coincidental. An annuity has sometimes been called reverse life insurance because payment generally ceases upon the death of the policy owner(s) as opposed to beginning upon the death of an insured. Payments made to annuitants are based on actuarial tables of life expectancy. Theoretically, everyone living to anticipated maximum age limits would mean annuity providers would suffer no loss and would make no gain. In this manner, people who die prematurely enable those who live unexpectedly long lives to continue receiving benefits.

The role of an annuity is to liquidate an accumulated fund over a prescribed period of time. Earlier mention was made of the use of an annuity to payoff an Illinois Lotto lottery winner. An annuity can be classified in many ways including: number of lives covered, premium payment method, commencement of payment, fixed or variable units of accumulation and method of proceeds distribution. We will discuss annuities both in general and specifically where interest sensitivity is concerned.

Annuities have become increasingly popular, especially in the area of retirement planning. Various tax advantages have made annuities the preferred method of accumulation over life insurance. A solid understanding of annuities is essential in today's marketplace.

Immediate & Deferred Annuities. Income benefit payments can begin immediately or at a specified point of time in the future (deferred). Intervals between which payments can be received are normally monthly, but any mutually agreed upon (and financially sound) frequency is generally acceptable. An immediate annuity is made with a single premium payment and payments begin at the next frequency interval. Deferred annuities can be purchased in a single payment or through a fixed or flexible periodic premium payment. Most IRA (Individual Retirement Accounts) funded via an annuity are of a deferred nature with an annual premium payment that is fixed or flexible.

Annuity Payment Modes. An annuity has two general payment classes: pure and refund. The pure or straight life annuity provides income at regular intervals contingent upon the life of the annuitant. Under a pure annuity, payment stops at the death of the annuitant. In other words, if the annuitant purchased a single payment immediate annuity last month and tied this month, only one payment would be made and the insurance company keeps the balance.

A refund annuity, on the other hand, would pay benefits for as long as the annuitant lives and provides a refund to a beneficiary if the annuitant dies prior to receiving benefits that equal the premium paid. Period certain annuities are a form of refund annuity. Under a period certain, a guaranteed payment is made for life or for a specified period of time (usually 10 or 20 years), whichever is longer. The annuitant would receive payments for as long as he or she may live, or for the period certain in the event death occurs prior to the completion of the period certain. Any remaining, yet unpaid benefits are sent to either a named beneficiary or to the estate of the annuitant, if no beneficiary was named.

Payments under a pure annuity are higher than those under a refund or period certain contract. The longer the guaranteed period certain, the smaller the benefit payment. A refund or period certain annuity differs from a pure annuity because not the entire purchase price is used to provide the annuitant with income payments.

Payments can also be tied to more than one life. Joint and last survivor annuity provides for payment to continue for as long as either two or more lives still live. Since income will theoretically be paid for a longer period of time than for just one life, the periodic benefit paid will be a lower amount. Many companies pay one-half or two-thirds the amount to the survivor than was paid to both lives.

The annuity products offered by insurance companies providing guaranteed amounts of fixed income are backed by assets invested in the insurer's general account. These annuities are marketable because they pay a return equal or superior to the returns available through other sources. Return is usually greater than through other income methods because return (liquidation) of principal is involved in addition to interest earnings. Since annuities are guaranteed for life, the annuitant cannot outlive the income. Favorable tax treatment is also an excellent reason to purchase an annuity. One drawback to this type of fixed annuity is the possibility that future inflation will significantly diminish the Purchasing power of the fixed benefit payment. The Variable Annuity was designed to overcome the inflationary effects of time.

Annuities are used in both tax qualified and nonqualified markets. They can be used to fund pension and profit sharing plans that are qualified under the IRC code. The tax deferred annuity (TDA) or a tax-sheltered annuity (TSA) have been popular for years and are available to the employees of public educational institutions and specified tax-exempt organizations. Annuities can also be used to fund Section 457 plans for state and local government employees, U.S. agency employees, and non-charitable tax exempt entities.

Basic Overview of an Annuity

An Annuity is an insurance contract (LIFE class). The annuitant or recipient invests money with an insurance company and the company agrees to provide a lifetime income to the annuitant.

Annuities can be "fixed", "variable" or "combinations". The annuitant can invest or pay with a single premium, in a disciplined or regular fashion or flexibly (vary the amount and time of investment to suit personal convenience).

The time during which premium payments are made is called the accumulation stage.

Benefits can be received by the annuitant on either an "immediate" (single premium only) or "Deferred" (some future point in time) basis. Annuities that may be purchased include a single premium immediate, single premium deferred, and periodic payment (flexible) deferred.

One option for receiving benefit payments is called "Annuitization" (a fixed, lifetime basis). The other option available is to simply take all the money in a single lump sum withdrawal. However, once Annuitization is elected, no change to lump sum withdrawal can normally be made.

ANNUITY BENEFIT TYPES

1) Life Only (straight Life) - The annuitant receives payments fixed for life. When the annuitant dies, the contract ends (even if only one payment has been made).

2) Life Annuity with Period Certain - Payments are both guaranteed for life and for a minimum period of time (5, 10, 20 years, etc.), whichever is longer. Any balance of time remaining on the guaranteed period certain is paid to a named beneficiary or to the owner's estate.

3) Cash or Unit Refund Annuity - a lifetime of payment with the guarantee that, if the annuitant has not been paid benefits that equal the value of his account, any unpaid balance is paid to a beneficiary (usually in one lump sum, but normally the beneficiary also has the option of Annuitization).

4**) Joint Life with Last Survivor -** two or more lives are covered jointly such that, as long as one life continues, some benefits will continue to be made to the remaining life (payment is reduced to ½ or 2/3 of the joint amount).

General Annuity Concepts

●Age Factor - the older the annuitant and the greater the time before benefit payout, the larger the annuitized benefit payment amount (the converse is also true).

●Sex Factor - if sex-based mortality-tables are used, women will receive smaller benefits than men, at the same age, because women statistically have a longer life span.

●Contribution Factor - everything else being equal, the more money you put in, the larger the payment amount.

Fixed vs. Variable Annuity

a) Fixed Annuity (FA) - benefit payment amount is guaranteed and so is a minimum rate of interest paid on capital invested. A current interest rate may be higher but never lower than the stated minimum guaranteed interest rate. The General account, or portfolio of medium term debt securities (bonds, mortgages), is used to guarantee payments. All investment risk is on the insurance company; if returns are lower than expected, the company suffers the loss.

Potential disadvantage of the fixed annuity: since the benefit payment is fixed (never changing for life), it cannot keep pace with rising cost of living expenses (inflation).

b) Variable Annuity (VA)- no guarantee as to either payment or interest rate. Payout is based on returns in the investment portfolio called the "separate account". Investment risk is on the annuitant (consumer).

VA Mortality expense Guarantee - there is a lifetime guarantee of some type of payment. **The company does guarantee or take the risk of any increased mortality (people living longer than expected).**

VA Operating Expense Guarantee - if operating or administrative expense exceed original projections, the company, not the annuitant, bears the additional cost.

Perceived advantage of the variable annuity: designed to fight the effects of inflation by increasing payment amounts due to probable increased investment returns.

VA LICENSING REQUIREMENTS - due to the increased investment risk element, variable annuities are subject to both Federal Securities and State Insurance Regulations. The insurance agent must have a state life insurance license and be at least Series Six and Series 63 (NASD license) qualified.

THE SEPARATE ACCOUNT - since an investment portfolio is involved, technically an "investment company" exists. Investments into money markets, stocks & bonds are made, much like the diversified portfolio of a typical mutual fund. Therefore, insurance companies are required to register with the SEC as either 1 or 2, below:

1) **Fixed Unit Investment Trust -** (indirect investment) here the separate account does not manage securities, but merely holds positions for the annuitant's benefit. The shares of one or more mutual funds are bought & held in a trust and everyone owns an undivided interest in the shares purchased.

2) **Participating Unit Investment Trust** - (direct investment) The separate account does manage a securities portfolio and it operated like a mutual fund. All annuitants have an undivided interest in the securities held (these are called "accumulation units"). There is ongoing management by a professional investment advisor and a board of managers is set up to perform the same role as a mutual fund's board of directors.

a) Investment Return mirrors that of a mutual fund, namely the separate account grows with additions of both interest and dividends from the securities owned in the portfolio of investments. Any realized capital gains from securities sales are not distributed to clients. Since there is no constructive receipt of distribution, any income taxes on earnings are deferred.

b) Investment Objectives of variable annuities are geared to capital preservation and long term growth since a common function is to provide retirement income. The investor has many choices of different separate accounts within the Variable annuity (for example: bond income funds, common stock growth accounts, money market funds, etc.) and any given percentage of principal can generally be placed in any account by the investor. The main purpose of such an ability to diversify is to not only preserve capital, but to achieve different investment objectives within one product concept. The term "wrap-around-annuity" is given to an annuity which allows investment in many separate or "sub" accounts.

c) Voting Rights also mirror mutual fund ownership. The voting right is based upon each accumulation unit and not the unit holders themselves. Normally, contract owners can vote on Major policy items (i.e., investment objectives) and election of Board of Directors.

d) Annuity Contract Valuation has, as a key concept, a "unit type of measurement. The value of the investment portfolio of the separate account charges on a daily basis and it equals total market value of all portfolio securities (at the market close) minus liabilities. The two "units":

1) Accumulation units determine the share of ownership of the separate account which is attributable to an individual owner during the accumulation phase of the deferred annuity contract. It shows what proportion of the separate account is owned by an annuitant.

2) Sales charges may not exceed 8 ½ percent or 9 percent after charges are deducted, the net payment (amount remaining after the deduction of sales charges) is used to purchase accumulation units.

Determining the value of an annuity is accomplished by taking the value of one unit (which constantly changes on a daily basis) and multiplying it by the total number of units owned.

VALUE OF AN ANNUITY =
VALUE OF 1 UNIT X TOTAL UNITS OWNED

EXAMPLE:

Bert Jones owns 1,000 units of an ABC variable annuity and the current value is $10.00 per unit. Bert's account value is $10,000 ($10 x 1,000 units). Since this is a variable annuity, value is constantly changing.

If Bert owns more units in the future but the value of an individual unit drops, his account value can still decrease (i.e., Bert owns 1,500 units and each unit is worth $5.00. Bert's current value is only $7,500 ($5 X 1,500).

Death Benefits are usually marketed with variable annuity contracts and they cover the accumulation phase. When the contract is insured, the owners' beneficiary receives either the current value of the account or total payments made, whichever is greater, if the owner dies before Annuitization takes place. Without an insured annuity, beneficiaries receive only the current value of the account.

Annuity Units are used at Annuitization and essentially convert some fixed number of accumulation units into cash at the payout period of the variable contract. If Annuitization does not occur, an annuity unit is not calculated.

Once Annuitization is selected, annuity units are calculated by incorporating many variables: initial unit value, age and sex of the individual, and the selected or the assumed interest rate of the company. The insurance company calculates the specific number of annuity units which will actually be redeemed for each payment.

The only element fixed is the number of annuity units which will be redeemed in order to make each payment to the annuitant. The annuitant's payment will fluctuate because the value of the annuity units will fluctuate based on the performance of the investment portfolio of the separate account.

The Assumed Interest Rate (AIR) is selected by the annuitant or dictated by state law calculated on the separate account and it is the basis of projected future values. It is not guaranteed. It simply is used to adjust the value of an annuity unit as it changes relative to the investment return of the portfolio value of the separate account.

In this manner, the annuitant is always receiving the fixed number of annuity units multiplied by (the constantly fluctuating) value of the annuity unit. Therefore the following relationships are true concerning actual returns of the separate account and the Assumed Interest Rate (AIR):

	If Actual Returns Are Above "AIR"	If Actual Returns Are Below "AIR"	If Actual Returns Are Same as "AIR"
Ann. Unit	Increases	Decreases	Remains The Same
New Benefit Pd. Out vs. Prev. Benefit Pd. Out	Increases	Decreases	Remains The Same

EXAMPLE:

Mr. Wolf has owned an ABC variable annuity for 20 years and now wishes to annuitize to a monthly Income. He has 10,000 accumulation units with a current value of $10 per unit for a total current value of $100,000 ($10 x 10,000). He chooses a variable payout method instead of a fixed or combination alternative.

> The insurance company uses actuarial tables, Mr. Wolf's age and sex, an AIR of 5% and the variable payout selection in order to calculate the first payment amount. Based on all these factors it is determined that Mr. Wolf will redeem 50 units per payout. Since the current unit valuation is $10, Mr. Wolf's first payment will be $500 (l0x 50).
>
> In order for Mr. Wolf to keep receiving $500 per payout period, the actual return of the separate account must be at least 5% (to match the AIR).
>
> If the value of a unit drops to $9 by the next payout, Mr. Wolf would receive $450 ($9 X 50) as his payment amount. On the other hand, if unit value increases to $11, his payment will equal $550 ($11 X 50).

Basic Taxation Concepts for an Annuity

First you must distinguish between taxation of the insurance company and taxation of the annuitant.

INSURANCE COMPANIES - are not subject to taxation on dividends and/or interest earnings from the separate account since these earnings are reinvested back into the account.

There is no taxation on capital gains realized by the account to the insurance company because, once again, these earnings are reinvested into the separate account. Until an annuitant has constructive or actual receipt of earnings from a general or separate account there is no taxation on the account during the accumulation periods Until earnings or capital gains are actually paid out, taxation is deferred. The reason behind this: capital gain distributions and dividend distributions paid from general or separate accounts have to be reinvested in order to buy more accumulation units.

ANNUITANTS - are subject to ordinary income taxation on the earnings or growth portions of the annuity only when they receive proceeds. If a-client, owning a deferred annuity, makes random withdrawals from an account without Annuitization of the contract, the annuitant is required to withdraw the earnings or growth portion of the contract first. This is known as LIFO or last in first-out tax treatment when taking distributions. In other words, the first money deemed to be withdrawn is income first and principal second and therefore all money withdrawn over the amount paid in, or cost basis, is taxable income.

There is also a 10% tax penalty on any money withdrawn over and above the cost basis for an annuitant who is less than 59 ½ years old at the time of that withdrawal. The sole exceptions to this 10% penalty are withdrawals in the event of death or disability. Annuitization, or the systematic withdrawal of the principal and interest in the form of regular lifetime periodic payments, not taken less frequently than annually nor beginning sooner than 60 months after the annuity start date, are also excused from the 10% Penalty.

The IRS code sets forth tables which indicate the amount of taxable percentages applied against each benefit payment received. The portion of benefit which is over the cost base is considered ordinary income. Cost base for individual payments is calculated by dividing total cost base by life expectancy, as illustrated by the "Exclusion Ratio", below:

THE ANNUAL EXCLUSION RATIO FOR ANNUITIZATION PAYMENTS

If an investor has annuitized his annuity the annual payments are in part a tax free return of capital and in part taxable earnings. **The ratio of each for tax purposes is as follows:**

$$\textbf{EXCLUSION RATIO} = \frac{\textbf{AFTER TAX CONTRIBUTIONS}}{\textbf{EXPECTED BENEFITS}}$$

By applying the above formula, the annuitant's original after tax contributions are excluded as income upon annuity payout. The benefit amount which is expected is determined by multiplying the annual benefit payable by the number of years the benefit is expected to be paid (actuarial life expectancy for selected Annuitization).

A simplified method of determining the excludible portion of your payment is set forth in IRC Section 72. Depending on your age at the time of Annuitization , the code designates an arbitrary anticipated number of payments that you will receive under the annuity which varies from 360 if you annuitize at age 55, down to 160 if you annuitize after age 71. The amount treated as a return of capital can thus be determined by simply dividing the number of designated payments by the investors investment in the contract at the time it was annuitized.

SECTION V: 7 EXAM QUESTIONS

SPECIAL RETIREMENT DIST RIBUTION AND TAXATION ISSUES

10-Year Averaging of Lump Sum Distributions

Persons who were age 50 or older on January 1, 1986 (born before 1936) who do not elect to rollover their retirement benefits to an IRA account have an election as to how a lump-sum distribution from a qualified retirement plan is taxed:

1. 10-year forward averaging using the 1986 rates or

2. Tax on the lump sum at current rates.

The calculation of the tax is done apart from other income so that a retiree's current income bracket is not a factor.

Planner's Notes:

Additional state income taxes are not shown here and may be substantial. A 5-year forward averaging is also available to all taxpayers taking lump sum distributions before the year 2000.

An income tax deduction is available for any Federal Estate Tax attributable to the lump-sum distribution. See IRS Form 4972.

Social Security Benefits:

EARNINGS TEST: Generally you can receive full Social Security Benefits for the year if your earnings do not exceed the annual exempt amount.

AGE	1995
Under Age 65	$8,160
Age 65 thru 69	$11,280
Age 70 and over	**no limit**

If your earnings exceed these limits and you are under age 65, you lose $1.00 of benefits for each $2.00 you earn above the exempt amount. If you are 65-69 you lose $1.00 of benefits for each $3.00 you earn above the exempt amount.

Special Monthly Rule allows people who retire during a year to receive benefits for the remainder of the year regardless of their earnings before retirement. Under this rule you can receive full benefits for any month you do not exceed the monthly exempt amount and you do not perform substantial services in self-employment.

If self-employed a variety of factors are involved. Generally, if you work more than 45 hours in a month your services are considered substantial.

WHAT COUNTS AS EARNINGS?

Any wages earned from work as an employee and any net earnings from self-employment count as earnings. Wages include: bonuses, commissions, fees, vacation pay, pay in lieu of vacation, cash tips ($20 or more) in a month and severance pay.

WHAT DOESN'T COUNT AS EARNINGS?-

- **Investment income** including stock dividends, interest from savings accounts, income from annuities, limited partnership income, and rental income from real estate you own (unless you are a real estate dealer).

- Income from **Social Security, pensions, other retirement pay or Veterans Administration Benefits.**

Gifts or Inheritances.

- Royalties received after 65 from patents or copyrights obtained before that year.

- If you are a **retired partner,** retirement payments from the partnership don't count if:

1. The payments continue for life under a written agreement which provides for payments to all partners or a class of them, and

2. Your share of the partnership capital was paid to you in full before the end of the partnership's taxable year and there is no obligation to you other than retirement payments.

Income from self-employment received in a year after the year a person becomes entitled to benefits. This refers to income which is not attributable to services performed after the month of entitlement.

Social Security Retirement Benefits usually begin at age 65, unless a person elects to take a reduced benefit, in which case, benefits may begin as early as age 62. Normal retirement age for persons born after 1937 will be gradually extended until it reaches age 67 for those born in 1960 and later.

Early age retirement will reduce the monthly benefit by approximately 0.555556% for each month retirement precedes normal retirement age. However, the early payout will produce a larger gross payout if the retiree lives for only 9 or 10 years.

Persons in poor health or short life expectancy may benefit from the early retirement.

Social Security also provides some disability benefits for those unable to work because of illness or other disability. Also, if death occurs, benefits may be available to one's spouse and children.

Social Security Medicare Benefits are available at age 65 even though a person continues to work.

The status of Social Security Benefits should be checked every three years. Form SSA-7004 PC-OPl (available from your local SSA office or by calling **1-800-234-5772) should** be used and mailed to the Social Security Administration, P.O. Box 57, Baltimore, MD 21203.

For general planning purposes, retirement benefit projections are shown on the next page. The table is based on a conservative 2 1/2% annual increase and is taken from the Fund's Board of Trustee Studies and Estimates. More aggressive estimates are also available but it would be more prudent to use the more conservative table in planning for potential Social Security Benefits.

TABLE A

SOCIAL SECURITY CONSERVATIVE BENEFIT PROJECTIONS -

--- AGE 65 ---

Annual Benefit

Year	Low	Avg	Max
1995	6,553	9,928	13,237
1996	6,716	10,176	13,568
1997	6,884	10,431	13,908
1998	7,056	10,691	14,255
1999	7,233	10,959	14,612
2000	7,414	11,233	14,977
2001	7,599	11,514	15,351
2002	7,789	11,801	15,735
2003	7,984	12,096	16,129

The assumptions about increases in wages and prices on which these benefit amounts are based originate in the 1986 Reports of The Board of Trustees of the Social Security Trust Funds. Wage Increase assumptions were used to project the earnings of workers. Benefit Increases are based on assumed price increases. If these assumptions do not materialize precisely as shown, the benefit amounts payable will, of course, vary from those shown.

TABLE B
TAXATION OF SOCIAL SECURITY BENEFITS

A portion of Social Security benefits may be subject to income taxation.

a. DETERMINE MODIFIED ADJUSTED GROSS INCOME

1. Adjusted Gross Income $______

2. Deduction for exclusion for foreign earned income taken for the year. $______

3. All Tax-exempt interest received or accrued (e.g., municipal bond int.) $

4. MODIFIED ADJUSTED GROSS INCOME (Total of lines 1 through 3) $______

B. ½ OF SOCIAL SECURITY BENEFIT RECEIVED $______

C. BASE AMOUNT
(Single Taxpayer -- $25,000; Married filing jointly -- $32,000; Married filing separately and lived with a spouse at any time during the year -- zero)

IS THE SOCIAL SECURITY BENEFIT TAXABLE?

NO, if the base amount (line C) EXCEEDS the Modified Adjusted Gross Income (line A-4) PLUS one-half of the Social Security Benefit (line B).

YES, at least in part if the base amount (line C) is LESS THAN the Modified Adjusted Gross Income (line A-4) PLUS one-half of the Social Security Benefit (line B).

IRA (INDIVIDUAL RETIREMENT ACCOUNT) Deductions

1. DEADLINE TO ESTABLISH AN IRA - An IRA can be established and funded at any time between January 1st of the current year and the due date the individual income tax return; i.e., April 15th of the following year. **Extensions for filing the tax return do not extend this period.**

2. CAN THE DEDUCTION BE TAKEN PRIOR TO THE INVESTMENT OF THE FUNDS? - Yes. This, in effect, permits an individual to file his return early in the year; e.g., January, and use his or her tax refund to make the actual contribution prior to April 15th. Revenue Ruling 84-18, 1984-1 CB 88.

3. TWO TYPES OF IRA ARRANGEMENTS PERMITTED

a) INDIVIDUAL RETIREMENT ACCOUNTS
--a trust with a corporate trustee

b) INDIVIDUAL RETIREMENT ANNUITIES
-- a special qualified annuity issued by an insurance company

4. EFFECTS OF OTHER RETIREMENT PLANS Taxpayers (or their spouses)can make fully deductible IRA contributions up to the greater of their combined or $2,000 each, if their Adjusted Gross Income is below $40,000 if married filing jointly; $25,000 if a single taxpayer; and zero if married filing separately. If Adjusted Gross Income exceeds these amounts, the $2,000 limit is reduced by a formula which eventually permits no deduction, i.e., no IRA contribution is deductible for married couples (filing jointly) with Adjusted Gross Income over $50,000; single persons over $35,000; and married filing separately over $10,000. Employer Plans include regular qualified plans, Keogh plans, Section 403(b) tax-sheltered annuity plans, SEP (simplified employee pension) plans, and state, federal, and local government plans (not Sec. 457 non qualified deferred compensation plans.)

Individuals with income in excess of the above limits may still make IRA contributions on a non deductible basis, so as to benefit from the tax deferred growth.

5. TYPICAL PAYOUT PLANS - SINGLE SUM DISTRIBUTION - becomes part of Taxable income for that year. LIFETIME OF THE PARTICIPANT (and his or her spouse, if desired). To avoid penalties, minimum distributions must be made each year; however, life expectancy can be recalculated each year to Minimize actual distributions. A FIXED PERIOD OF YEARS - The period cannot exceed the participant's life expectancy (or joint life expectancies of the participant and spouse).

6. DISTRIBUTION PERIOD - Distributions generally cannot begin without a penalty until age 59 ½ or if the individual is disabled or dies. Distributions must begin by April 1 of the year following the calendar year in which the participant attains 70 ½ or actual retires, if later.

7. PREMATURE DISTRIBUTIONS - Withdrawals or distributions prior to age 59 ½ (other than for disability, death, Medical expenses in excess of 7.5 percent of AGI, and amounts allowed for health insurance payments during periods of unemployment) are normally subject to a 10 percent penalty and are subjected to current income taxation of the distribution, unless such distributions are made over the life expectancy of the IRA owner or joint life expectancy of the owner and a designated beneficiary. The distribution schedule cannot be modified for at least 5 years or attainment of age 59 ½, if later.

8. TAXATION - During Lifetime: Distributions are taxable as ordinary income. At Death: At the participant's demise, the distributions received by a beneficiary are taxed as ordinary income. Distributions must be paid out over a 5-year period or less (or over the life expectancy of a beneficiary, if such a schedule is elected within one year of the participant's death), unless they are paid to the surviving spouse; in which case they can be paid over the life expectancy of the spouse and begin when deceased participant would have attained age 70 ½. For Federal Estate Tax purposes, the death benefit is included in the gross taxable estate of the participant and may incur a 15% "excess accumulation" tax.

9. IRA INVESTMENT ALTERNATIVES - Generally, the best type of an investment for an IRA is one with a high cash flow since it is not currently taxable in the IRA account. High growth assets are usually better investments for the taxpayer's non-IRA dollars.

A. BANK AND SAVINGS AND LOANS: Certificates of Deposit are protected by FDIC and FSLIC. Fixed and Variable rates. There may be stiff penalties for early withdrawal.

B. ANNUITIES: Individual Retirement Annuities issued by insurance companies. May include a disability waiver of premium provision.

C. MONEY MARKET: Yield fluctuates with the economy. Can't lock in the higher interest rates. Easy to switch to other investments.

D. MUTUAL FUNDS: Trades are permitted within a family of funds without a penalty. Capital gains are taxed as ordinary income at withdrawal.

E. ZERO COUPON: Bonds bought at a deep discount originally. No interest payments to worry about reinvesting.

F. STOCKS: Wide variety of investments. High returns are possible. Capital gains are taxed as ordinary income at withdrawal. Losses are not deductible.

G. LIMITED PARTNERSHIPS: Some Limited Partnerships are especially designed for Qualified Plans; specifically in the areas of energy, real estate, and mortgage pools.

10. PROHIBITED INVESTMENTS OR TRANSACTIONS FOR IRA'S -

A. LIFE INSURANCE - **IRA accounts cannot include life insurance contracts.**
B. LOANS TO IRA TAXPAYER - Self borrowing triggers constructive distribution of the entire amount in an IRA. It becomes currently taxable plus a 10 percent penalty, if less than 59 ½. IC Sec. 408(e)(2)

C. COLLECTIBLES -Purchases of art works, antiques, metals, gems, Stamps, etc., will be treated as a taxable distribution. (Coins issued under state law and U.S. gold and silver coins are exceptions.)

D. DEBT FINANCED - **Any borrowing to invest; e.g., buying stock on Margin**.

Planner's Note; for IRA investments consider the following 1) For money market IRA accounts are the interest rates offered fixed or variable? If interest rates drop, a fixed rate is better, especially if you can make future contributions at the same fixed rate. If interest rates go up, you may be able to roll the account over to another IRA. 2) How is yield calculated? More frequent compounding will produce a higher return. 3) How often can you change investments, and what is the charge?

11. IRA ROLLOVER AS A QUALIFIED PLAN CONDUIT -When an employee terminates employment or a qualified plan is terminated a special IRA arrangement can be used to hold a qualified plan distribution until it is transferred into a NEW qualified retirement plan. Tax-sheltered Annuity distributions may also be rolled to an IRA rollover account. This will defer current income taxation of the qualified plan distribution, as long as they are left in the IRA rollover account or moved under one of two options.1)another IRA, or 2)another Qualified Plan (if it permits). This will requalify the funds for special 10-year averaging. To avoid the harshness and back-up withholding of this 60-day rule, whenever funds are transferred from plan to plan, direct transfer arrangements should be established.

12. OTHER IRA TAX CONSIDERATIONS

A. A "Qualified Lump Sum Distribution" must include everything standing to the account of the participant and must be completely distributed within one calendar year. The participant must be at least **59 ½ or disabled** or there must be a separation from employment or a plan termination. Partial rollovers are permitted as long as more than 50% of the distribution is rolled over. The balance would be taxed as ordinary income.

B. Nondeductible employee contributions cannot be rolled over to the IRA. Noncash assets which are distributed can be sold and the cash proceeds transferred to the IRA rollover without realizing a current tax on any gain.

TABLE C

DOES IT MATTER WHEN YOU CONTRIBUTE TO AN IRA?

When contributions to an IRA are consistently made at the beginning of the year rather than at the end, the funds have an extra 12 months in which to grow. Over a period of years there is a substantial difference in the amount accumulated.

$2,000 PER YEAR ACCUMULATED AT 7% AND 10% RATE OF RETURN

Number of Years From Beginning of First Year	**7 % RETURN** Contrib. Made Jan. 1	Contrib. Made Dec. 31	Increase in Amount Accumulated
5	$12,306	$ 11,501	805
10	29,567	27,633	1,934
15	53,776	50,258	3,518
20	87,730	81,991	5,739
25	135,353	126,498	8,854
30	202,146	188,921	13,225
35	295,825	276,474	19,351
40	427,260	399,270	27,990

Number of years from the beginning of the first year	10% RETURN Contrib. Made Jan. 1	Contrib. Made Dec. 31	Increase in Amount Accumulated
5	$13,431	$ 12,210	1,221
10	36,062	31,874	3,188
15	69,899	63,544	6,355
20	126,004	114,549	11,455
25	216,363	196,694	19,669
30	361,886	328,988	32,898
35	596,253	542,048	54,205
40	923,702	885,186	88,516

SECTION VI: 29 EXAM QUESTIONS

EMPLOYER AND BUSINESS RETIREMENT DISTRIBUTIONS AND INSURANCE RELATIONSHIPS

Nonqualified Deferred Compensation Plans

AGREEMENT

CORPORATION	***KEY EMPLOYEE***
- Pays compensation for a set period after retirement	- Gives current service. - Agrees not to compete after retirement or death. - Gives consultation as needed.

BENEFITS

- Corporation retains key employees.	- Provides extra retirement benefit when tax bracket may be lower.

TAXATION

- Deductible to the corporation when payments are made TO EMPLOYEE	- Taxed when payments are made or "constructively received".
-Unless funded by insurance, earnings in fund accrue on a taxable basis	-Unless funded by insurance earnings in fund accrue on a taxable basis

COMMENTS

1. Deferral must be agreed upon before the compensation is earned.

2. If the plan is unfunded, the compensation is not taxable until received unless the amount is placed into a trust and the promise to pay is secured.

3. **If the plan is "funded", the employee's rights must be forfeitable** (e.g., if he competes with the employer after retirement, he loses his benefits) **and they must be nontransferable. If they become nonforfeitable or transferable they become taxable**.

4. Employers can pick and choose which employees to benefit.

5. A life insurance contract can be used to informally fund an agreement. It can provide the necessary funds at either death or retirement.

6. Non qualified plans are not subject to the 15% excess accumulation penalty tax imposed on qualified plans, IRAs, etc.

Life Insurance in Qualified Plans

KEY EMPLOYEE CONSIDERATIONS

1. It is an easy way to provide additional protection for one's family if death occurs prior to retirement age.

2. It frees up other personal dollars now being spent for life insurance outside the plan.

3. The majority of the premium for ordinary and universal life insurance is not taxable to the employee.

4. The policy can be moved to another plan if the employee changes employment.

5. At retirement age, the employee may be able to take a fully paid up policy, rather than face the expense of converting his or her group insurance.

6. The pure insurance portion (the face amount less the accumulated cash values) of the death benefit passes to the beneficiary’s income tax free.

7. The nontaxable insurance proceeds may be used to pay the income taxes and/or estate taxes due on the other plan assets or other estate assets.

8. A waiver of premium may be added which will continue to pay the life insurance premiums should the employee become disabled.

9. Uninsurable participants may be able to purchase a limited amount of "guaranteed issue" insurance. In larger plans, it may be a substantial amount.

10. When a participant in a defined benefit plan is "rated" for insurance risk purposes (usually for poor health or occupational hazards), the plan can pay the higher premium without increasing the cost to the participant.

11. Investment returns on modern insurance policies have greatly improved in recent years.

12. Group life coverage may be limited by recent tax changes. Life insurance in the qualified plan may replace this lost protection. Also, the Table I costs reported as income under group coverage in excess of $50,000 are not recoverable. Costs incurred for the "pure insurance" portion of policies in qualified plans may be recovered at the time of distribution.

13. To the extent life insurance is funded by the employer to provide a death benefit for the employee, the $5,000 Death Benefit exclusion is no longer available for tax purposes after 1996.

14. Ordinary or universal life policies can be used as an annuity at retirement age. The insurer will give the participant the higher of either the rate guaranteed in the contract or the then current rates.

15. Traditional financial and estate planning seeks a balanced approach to investment portfolios. Ordinary and universal life insurance policies can represent the "fixed" side of the program. Some current policies also offer an equity or stock' market option for the cash value portion of the policy.

KEY EMPLOYER CONSIDERATIONS

1. The premium is deductible by the Employer as a part of the plan contribution.

2. The employer may be able to reward key employees with insurance protection to replace reduced benefits under group insurance as required by TEFRA.

3. If the employee has a paid-up policy under the qualified plan at retirement age, he or she may not need to convert group insurance to permanent. With larger, experience rated group life contracts, there is typically a charge (sometimes substantial) to the "experience" when a policy is converted.

4. Under a defined benefit plan, if the insurance proceeds equal the entire pre-retirement death benefit and a participant dies, all of the other equity assets can be used to reduce future employer contributions to the plan.

5. If traditional whole life contracts are used and dividends are used to reduce the premium, the long-term cost of the plan is very favorable.

6. In defined benefit plans the employer may be able to make a larger contribution and deduction by including ordinary life insurance in the plan. This is often helpful because of the restrictions on retirement plan benefits and contributions.

7. Corporate retirement earnings problems may be lessened by increasing the contribution to a defined benefit plan which provides for life insurance. Trust assets do not appear on the corporation's balance sheet.

8. Younger employees may look at the protection as a "current benefit," whereas retirement age may seem to be a long way off.

9. Life insurance policies, within the proper limits, meet the prudent man and diversification test.

DRAWBACKS TO LIFE INSURANCE IN QUALIFIED PLANS -

1. If there is an estate tax problem the life insurance will increase the size of the gross estate. If the surviving spouse is the beneficiary, there will be no immediate death tax due to the Unlimited Marital Deduction; however, the surviving spouse's estate will be increased, thereby increasing his or her potential estate tax. Perhaps the additional coverage should be owned by an Irrevocable Life Insurance Trust designed to keep the insurance out of the estates of both spouses.

2. It is a **"tax-shelter" within a "tax-shelter".** Under current law the buildup of cash values in a life insurance contract are tax-deferred and placing them in a qualified plan to get this tax advantage is unnecessary.

LEGAL LIMITATION TO LIFE INSURANCE IN QUALIFIED PLANS -

1. IRA'S and IRA Rollovers may not pay the premium for life insurance policies.

2. TSA's may invest in special contracts called retirement income policies or a combination of annuities and whole life. Under these contracts, the death benefit equals 100 times the anticipated monthly retirement benefit.

3. DEFINED CONTRIBUTION PLANS - the percentage of the total annual employers' contribution which can be allocated to life insurance premiums varies with the type of policy.

- TERM and UNIVERSAL LIFE INSURANCE - Less than 25% of the total contribution.

- ORDINARY WHOLE LIFE INSURANCE - Less than 50% of total contributions.

_ COMBINATION - One-half of the ordinary life premium and the entire term premium must be less than 25% of the total - there is no limit on the face amount.

NOTE: IN SOME CASES, ALLOCATION IN PROFIT SHARING PLANS WHICH ARE MORE THAN TWO YEARS OLD MAY BE TOTALLY INVESTED IN LIFE INSURANCE. REV. RULE 61-164, 1961-2 CB 99.

4. DEFINED BENEFIT PLANS - the face amount of the insurance may not exceed 100 times the anticipated monthly retirement benefit. For example, if a $5,000 per month retirement benefit is anticipated, the maximum amount of life insurance would be $500,000. Alternatively, the total premiums for ordinary life must be less than 66 2/3% (or 33 1/3% for term or universal life insurance) of the assumed aggregate contributions (a special separately computed limitation) that have been made for the participant from the beginning of his or her participation in the plan.

5. Insurance in plans must be purchased on a uniform and nondiscriminatory basis.

6. Participants can be given the right to choose the kind and amount of insurance they desire.

Qualified vs. Non-Qualified Plans in General

In a non qualified plan, the employer retains absolute discretion concerning which workers are allowed to participate in the program. Since the employer may discriminate between employees, there is no before tax advantage, as can be found in a qualified plan. Tax-deferred cash accumulation is allowed.

Non qualified plans are attractive to the employer who does not particularly wish to spend money on a retirement plan but does want to motivate or hire favored individuals. Since non qualified plans can be structured to restrict benefits if an employee leaves a company before a given period of time, they are quite popular in some business circles.

Non qualified plans can be used as strictly a tax shelter program for highly paid employees instead of launching a retirement plan. Their use can also include being used in addition to a retirement plan already in place.

The qualified plan allows contributions to be made on a before tax basis with subsequent tax-deferred cash accumulation. For these reasons, qualified plans are more popular than non qualified plans.

The main reasons employers utilize qualified plans:

a) Help employees meet tax shelter needs

b) Attract, keep and motivate workers

c) Meet the demands of unions in labor negotiations because retirement programs are considered to be wages

d) Helps older employees as they leave the work force

e) Is socially desirable

Defined Contribution vs. Defined Benefit Plans in General

Defined Benefit plans specify a defined benefit for employees to receive at retirement which is generally limited to $150,000 per year (indexed from 1997). The employer has the responsibility of providing the necessary funding on an actuarially sound basis to meet this future benefit to his employees.

Defined Contribution plans specify annual dollar amounts which are placed in each employee's account. The maximum amount which can be placed into an account each year is generally 25% of salary subject to an overall compensation limit of $150,000(indexed from 1997) which effectively limits contributions to $22,500. The main concept is to provide a benefit based on career-average salaries while providing a tax shelter AND cash accumulation retirement system.

The main advantages of a defined contribution program are:

a) It is easily understood by employees
b) Less costly to administer than a defined benefit plan
c) Greater flexibility concerning lump-sum distributions
d) Employees have control over individual accounts
e) Employer can determine costs without having risk
f) Portable benefits for job switching employees

A main structural difference between defined contribution and benefit plans is defined benefit plans provide more retirement income for employees, especially older workers. A defined benefit plan can adjust payments to a retiree based on income levels received just prior to retirement. In a defined contribution plan retirement benefits are based on career average earnings, an amount which may be significantly less than the final few earning years.

The bottom line in understanding the difference relates to employer risk. If the employer is truly concerned about making certain that worker retirements will be comfortable and secure, then the defined benefit plan is instituted. When an employer is unable to assume long term risk associated with maintaining a retirement program, then a defined contribution plan is a smarter alternative.

Employers who have both a defined benefit and a defined contribution plan are subject to the separate contribution limits applicable to each plan but after 1999 will no longer be subject to an overall combined plan limit.

Traditional Defined Benefit Pension Plans allow an employer to set up a qualified plan that permits the employer to contribute an actuarially determined amount sufficient to pay each participant a fixed or defined benefit at his or her retirement.

THEY WORK LIKE THIS:

1. An employer contributes an actuarially determined amount each year to the plan.

2. Employer contributions aren't deductible. IC Sec. 404(a).

3. Contributions are not taxed currently to the employee. IC Sec. 402(a) and 403(a).

4. Earnings accumulate income tax-deferred. IC Sec. 501(a).

5. Distributions can be rolled over into an IRA at retirement or death. IC Sec. 402 and 403.

METHODS OF DEFINING THE BENEFIT

1. LEVEL PERCENTAGE PLAN. Example: The benefit is equal to 50% of compensation.

2. SOCIAL SECURITY OFFSET PLAN. Example: The benefit is equal to 50% of compensation, offset by 50% of the Social Security benefit.

3. SERVICE PLAN. Example: The benefit is 2.5% of compensation for each year of service. Younger participants may also be favored if the benefit formula is service related.

4. STEP RATE INTEGRATED FORMULA. Example: The benefit is 35% of the 1st $12,000 of annual compensation plus 60% of annual compensation exceeding $12,000.

5. FLAT BENEFIT. Example: $500.00 per month for everyone.

ADDITIONAL CONSIDERATIONS

1. INVESTMENT OF PLAN ASSETS. Plan assets can be invested in equity products, like mutual funds, stocks, real estate, insurance products, or debt instruments, like T-Bills, or CD's.

2. SOCIAL SECURITY INTEGRATION. Since the employer already contributes to the employee's social security retirement benefit, these benefits can be integrated into the benefit formula of the plan.

3. PARTIES FAVORED. Favors older employees.

MAXIMUM BENEFIT - The maximum benefit under a Defined Benefit Plan is measured in two ways:

1. PERCENTAGE: The retirement benefit cannot exceed 100% of the average of the highest 3 consecutive years of coverage. This is reduced by 10 percent for each year of service less than ten.

2. DOLLAR AMOUNT: Subject to some transition rules, the maximum dollar benefit is generally limited by the overall compensation limit of $150,000/yr (indexed from 1997) for retirement at age 65 or Social Security retirement age, if later. For earlier retirement the amount is reduced each year actuarially. The amount is also increased for late retirement.

FIRST YEAR CONTRIBUTIONS - A number of assumptions must be made in determining the amount of current contributions necessary to accumulate the future retirement benefit. These assumptions include the following:
1. Interest rate on Earnings 2. Salary increases
3. Annuity rates at retirement 4. Death benefits
5. Statutory requirements and limits
6. Retirement age 7. Participant current age
8. Form of the annuity

ANNUAL CONTRIBUTIONS - Year to year contributions will fluctuate based on the following:

1. Earnings on previous contributions
2. Gains and losses on investments (realized & unrealized)
3. Participants' actual compensation
4. Death of participants before retirement
5. Disability retirements
6. Age mix of participants
7. Turnover in participants
8. Cost of annuities at retirement
9. Rate of vesting
10. Use of life insurance
11. Timing of contributions
12. Assumptions mandated by IRS in calculations
13. Funding limits and requirements of the Internal Revenue Code

Annual funding is done on the assumption that each participant will retire. Accrued benefits are earned each year and if the participant does not work until scheduled retirement, he or she will not be entitled to the entire benefit. Maximum benefits are also reduced for less than 10 years of plan participation.

A tax deductible interest penalty is imposed for employers’ failure to make estimated quarterly contributions to the plan. If the employer contributes too much, there is a nondeductible tax penalty. Most advisors recommend not making quarterly payments.

ADVANTAGES TO EMPLOYER

1. Contributions are tax deductible.

2. Can reward long term employees with some substantial retirement benefits even though they are close to retirement age?

3. Larger contributions for older employees may reduce corporate tax problems; e.g., excess accumulated earnings, high tax bracket current earnings, etc.

4. Forfeitures of terminating employees will reduce future costs.

5. It can provide employees with permanent life insurance benefits that need not expire or require costly conversion at retirement age.

6. The employer directs investments.

7. Quarterly contribution penalties can produce a larger contribution.

ADVANTAGES TO EMPLOYEES

1. Annual contributions are not taxed to the participant.
2. Earnings are not currently taxed
3. Distributions at death or retirement are tax-favored.
4. Participants may also have an IRA, (subject to income levels and filing status).
5. There is the ability to purchase significant permanent life insurance, which is not contingent upon the company group insurance program.
6. An employee is guaranteed a known retirement benefit.
7. An employee can borrow from the plan within certain very strict legal guidelines, if provided for in the plan documents.

DISADVANTAGES TO EMPLOYER

1. In low profit years, the employer is often still obligated to make contributions.

2. Even if profits are low, there is less flexibility with the level of contribution than with some other types of plans.

3. Investment risks are on the employer.
4. Administration costs are higher because an actuary must certify as to the reasonableness of the contribution and deduction (unless it is a fully insured plan).

5. Under current governmental attitude, employers have much less predictability as to what their contributions will be.

6. Participants often do not understand the defined benefit plan as easily as they do other types of plans.

DISADVANTAGES TO EMPLOYEES

1. Younger employees will not receive as good of a benefit as they would under other plans.

2. The plan concept is more difficult to understand.

OVER FUNDED DEFINED BENEFIT PLANS

With the impact of the benefit cutback restrictions imposed by TEFRA/TRA'86, many defined benefit plans are finding that they are in an over funded position. This means that the employer cannot make a contribution and take the deduction to which it is accustomed. "OBRA" '87 has also had a severe impact on the funding pattern of Defined Benefit Plans.

Several alternatives should be examined, and based upon the fact situation; perhaps one or more of the following will help:

1. The actuary may be able to change some of the funding assumptions to produce a current contribution.

2. The actuary may be able to utilize a different funding method so that a contribution will be necessary; however, this approach may only be postponing the inevitable problem.

3. The plan could be terminated with the excess funds reverting to the employer. The employer could then use these monies to fund a non qualified deferred compensation programs or perhaps a different type of qualified plan.

4. For an uninsured plan, adding whole life insurance to the plan may require a contribution.

5. Converting to a fully insured plan may be helpful.

6. Consider accruing benefits at a faster rate.

Traditional Profit Sharing Plans

Employer contributions to the plan need not be a specific percentage and they need not be made every year, as long as they are "substantial and recurring." Profits are no longer required in order to make a contribution.

GENERAL OVERVIEW

1. Employer contributions are tax deductible. IC Sec. 404(a).

2. Contributions are not taxed currently to the employee. IC Sec. 402(a) and 403(a).

3. Earnings accumulate income tax deferred. IC Sec. 501(a).

4. Distributions can be rolled over into an IRA at retirement or death. IC Sec. 402 and 403.

KEY CONSIDERATIONS

1. MAXIMUM ANNUAL DEDUCTION. Up to 15% of a covered payroll can be contributed and deducted by the corporation.

2. SALARY BASE. Total compensation is generally used.

3. INDIVIDUAL LIMITS. Subject to certain transitional rules, the allocation of contributions to a participant's account may not exceed of 25% of his covered compensation subject to using an overall compensation limit of $150,000/yr (indexed from 1997).

4. DISCRETIONARY CONTRIBUTIONS. Most plans are discretionary as to the amount which the employer contributes. If there are profits, the employer is expected to make substantial and recurring contributions. As a rule of thumb, contributions during 3 out of 5 years or 5 out of 10 years will usually gain IRS approval.

5. EXCLUDING PERSONS. Certain persons can be eliminated on the basis of months of service, age and coverage in a union plan; for example, persons under age 21 can be excluded from the plan.

6. INVESTMENT OF PLAN ASSETS. Plan assets can be invested in equity products, like mutual funds, stocks, real estate or debt instruments, like T-Bills, CD's; or in insurance products, like life insurance and annuity policies.

7. SOCIAL SECURITY INTEGRATION - Since the employer already contributes to the employee's Social Security Retirement Benefit, these contributions can be integrated into the allocation formula of the plan.

8. PARTIES FAVORED - Typically younger participants are favored because they have a longer time for their fund to grow and share in forfeitures.

9. HOW MUCH WILL THERE BE AT RETIREMENT?

This will depend upon four factors:

1. The frequency and amount of contributions,
2. The number of years until retirement,
3. The timing of deposits,
4. The investment return.

The risk of poor investment returns rests upon the employee. However, if the investment results are favorable, the participant will have a larger fund at retirement age.

10. TOP HEAVY PLANS - If more than 60% of the plan assets are allocated to "key employees" then the employer must contribute at least as much for non-key participants as it does for key employees. This requirement applies only to a contribution of up to 3% of compensation (higher in some instances).

ADVANTAGES OF PROFIT SHARING PLANS TO EMPLOYER

1. Contributions are tax deductible.

2. Contributions and costs are totally flexible.

3. The plan is easy to understand by the employees.

4. It can provide employees with permanent life insurance benefits that need not expire or require costly conversion at retirement age.

5. The employer can direct investments.

ADVANTAGES OF PROFIT SHARING PLANS TO EMPLOYEES

1. Annual contributions are not taxed to the participant.

2. Earnings on the account are not currently taxed.

3. Distributions at death or retirement are tax-favored.

4. Participants can have the right to direct investments.

5. Participants can also have an IRA account, subject to income level and filing status.

6. There is the ability to purchase significant permanent life insurance, which is not contingent upon the company group insurance program.

7. Younger employees can accumulate a larger fund than with a defined benefit plan.

8. The unvested portion of accounts of former participants may be allocated to the active participants' accounts. This can have a substantial impact on the future benefits.

9. Employee can borrow from the plan within certain guidelines, if provided for in the plan documents.

DISADVANTAGES OF PROFIT SHARING PLANS TO EMPLOYER

1. The profit sharing plan will generally not produce as large a contribution and deduction for older employees as will a defined benefit plan.

2. Contribution limitations are set at 15% of covered compensation.

DISADVANTAGES OF PROFIT SHARING PLANS TO EMPLOYEES

1. There is no guarantee as to future benefits.

2. Investment risk rest on the participant.

3. Older participants will not receive as large a benefit as with a Defined Benefit Plan.

4. There is no assurance as to the frequency and amount of employer contributions.

An Overview of HR-10 (KEOUGH) Plans

Keogh Plans are retirement plans for self-employed individuals, i.e., sole proprietors, partners owning 10% or more of the partnership, or employees of either. The tax law differences between corporate plans and the Keogh Plan used to be a major reason for many persons incorporating their business or profession. However, most of these differences have been eliminated over the years.

CONTRIBUTION LIMITS - For defined contribution plans, 25% of earned income after the HR-10 deduction (20% before the deduction) subject to the overall compensation limit of $150,000/yr (indexed from 1995). Defined benefit contributions determined by plan actuary.

FUNDING - May use a Trust, a custodial account, or an Insurance Company Annuity.

WRITTEN PLAN - The plan must be in writing and meet certain Coverage and nondiscrimination requirements for present and future employees.

DISTRIBUTIONS - There is a 10% penalty for distributions before 59 ½ unless the participant dies or is permanently disabled. However, if an employee terminates service on or after age 55 and receives a payout based on his or her life expectancy (or joint life expectancy with spouse or beneficiary, if desired), then the penalty will be waived. Payments must begin when the participant reaches age 70 ½.

PAYMENT PLANS AVAILABLE - 1) Lump-sum distribution. 2) The lifetime of the participant (and spouse, if desired). 3) A fixed period of years, not to exceed the participant's life expectancy (or joint life expectancies of participant and a spouse or designated beneficiary) IC Sec. 401(a)(9).

OTHER PLANS - A participant in a Keogh Plan may also have an IRA (subject to income level and filing status).

TAXATION - Rollovers to IRA’s are permissible.

An Overview of Money Purchase Pension Plans

The employer contributes a defined or fixed percentage of the participating employee's salary each year. Whatever that fund grows to, is what the retiring employee receives.

HOW IT WORKS

1. Employer contributes a fixed percentage of the participant's salary each year to the plan.

2. Employer contributions are tax deductible. IC Sec. 404(a).

3. Contributions are not taxed currently to the employee. IC Sec. 402(a) and 403(a).

4. Earnings accumulate income tax-deferred. IC Sec. 501(a).

5. Distributions can be rolled over into an IRA at retirement or death. IC Sec. 402 and 403.

MAXIMUM ANNUAL CONTRIBUTION - Subject to transition rules, the maximum annual contribution is 25% of covered compensation up to the overall compensation limit of $150,000/yr (indexed from 1997).

CONTRIBUTION RATE - Plan contributions are normally based on total compensation, e.g., base salary, bonuses, overtime, etc.

EXCLUDED PERSONS - Certain persons can be eliminated on the basis of months of service, age and coverage in a union plan; for example, **persons under age 21 can be excluded from the plan.**

INVESTMENT OF PLAN ASSETS - Plan assets can be invested in equity products, like mutual funds, stocks, real estate, insurance products, or debt instruments like T-Bills & CD's.

SOCIAL SECURITY INTEGRATION - Since the employer already contributes to the employee's Social Security Retirement Benefit, these contributions can be integrated into the contribution formula of the plan.

PARTIES FAVORED - Typically younger participants are favored because they have a longer time for their fund to grow.

HOW MUCH WILL THERE BE AT RETIREMENT? -

This will depend upon four factors:

1. The amount of contributions,
2. The number of years until retirement,
3. The investment return.
4. The timing of your annual contributions.

The risk of poor investment returns rests upon the employee; however, if the investment results are favorable, the participant will have a larger fund at retirement age.

ADVANTAGE TO EMPLOYER

1. Contributions are tax deductible.

2. Contributions and Costs are known in advance.

3. Contributions will rise as compensation rises, but they are controlled both by formula and absolute dollar amounts.

4. Forfeitures of terminating employees may reduce future costs or be reallocated among the accounts of those still in the plan.

5. The plan is easier to understand by the employees, than is a Defined Benefit Plan.

6. It can provide employees with permanent life insurance benefits that need not expire or require costly conversion at retirement.

7. The employer can direct investments.

ADVANTAGES TO EMPLOYEES

1. Annual contributions are not taxed to the participant.

2. Earnings on the account are not currently taxed.

3. Distributions at death or retirement are tax-favored.

4. Participants can be given the right to direct investments.

5. Participants can also have an IRA account, subject to income levels and filing status.

6. There is the ability to purchase significant permanent life insurance, which is not contingent upon the company group insurance program.

7. Younger employees can accumulate a larger fund than with a Defined Benefit Plan.

8. Employee can borrow from the plan within certain legal guidelines, if provided for in the plan documents.

DRAWBACKS TO EMPLOYER

1. In low profit years, the employer is still obligated to make contributions.
2. There is no flexibility with the level of contributions.

3. The money purchase plan will generally not produce as large of a contribution and deduction for older employees (i.e., age 55 and older) as will a Defined Benefit Plan.

DRAWBACKS TO EMPLOYEES-

1. There is no guarantee as to future benefits.

2. Investment risks rest on the participant.

3. Older participants may not receive as good a benefit as with a Defined Benefit Plan.

An Overview of the Simplified Employee Pension (SEP)

A SEP provides an employer **who has 25 or fewer employees** with a simplified way to make **contributions to an employee's Individual Retirement Account or Individual Retirement Annuity.**

HOW IT WORKS -

A. Employer contributions are made directly to SEP-IRAs set up for each employee with a bank, insurance company or other qualified financial institution.
B. Employer contributions are tax deductible. IC Sec. 404(g)
C. Contributions are not taxable to the employee. IC Sec. 404(g)
D. Earnings accumulate income tax-deferred.

ANNUAL CONTRIBUTION - No annual contribution is required, however, if a contribution is made, it must be the same percentage for each eligible employee.

INDIVIDUAL LIMITS - Subject to transition rules, the allocation of employer contributions to a participant's account may not exceed 15% of compensation up to an overall compensation limit of $150,000/yr (indexed from 1997). Hence, the overall compensation limit currently limits contributions to $22,500. In addition, employees can make their $2,000 annual IRA contribution to the SEP plan (or a separate IRA) as well.

TIME OF CONTRIBUTION - Contributions can be made until the due date (plus extensions) of the employer's return.

VESTING - Vesting must always be 100%.

ADDITIONAL IRAs - Additional IRAs are permitted if the combination meets overall IRA limits.

WHO MAY PARTICIPATE? - Any employee who is at least 21 years old and has performed "service" in at least 3 of the last 5 calendar years must be permitted to participate under the SEP, unless his or her total compensation is less than $400 per year (indexed from 1995).

INVESTMENT OF PLAN ASSETS - Plan assets can be invested in most equity products or debt instruments, but may not be invested in life insurance, "hard" assets, or collectibles (except for U.S.gold and silver coins). Participants direct the funds contribution on their behalf.

WITHDRAWALS - Participants may withdraw or cash-out at anytime. However, withdrawals are subject to immediate taxation. Prior to age 59 ½, there is an additional 10% excise tax, unless such distributions are made over the life expectancy of the IRA owner or joint life expectancy of the owner and a designated beneficiary or because of death or disability. Once the annuity format is chosen, it cannot be modified for 5 years, without a penalty. IC 72(t)(4)

ADVANTAGES OF SEPS TO EMPLOYER-

1. Contributions are **tax deductible**.

2. Contributions and **costs are totally flexible**.

3. **Reporting is very minimal** using Form 5305 SEP.

4. The plan is easy to understand by the employees.

5. The plan is usually set up by simply using IRS Form 5305-SEP.

6. There is little or no administrative expense.

ADVANTAGES OF SEPS TO EMPLOYEE

1. Annual contributions are not taxed to the participant.

2. Earnings on the account are not currently taxed.

3. Participants have the right to direct investments.

4. Participants can also have a regular deductible IRA, if the combined accounts meet overall IRA requirements.

5. Funds can be withdrawn at any time; e.g., in the event of an emergency, although there will be penalties if the participant is not yet 59 ½, unless the participant is deceased or disabled.

DRAWBACKS OF SEPS FOR EMPLOYER

1. Contributions must be made for part-time and seasonal employees.

2. Employees can withdraw the funds as fast as they are put into the account.

3. Employees are always 100% vested -- there are no forfeitures to reduce employer contributions.

4. Employees control investments.

5. An employer may not use the IRS Model Plan to adopt an SEP if it has ever installed a Defined Benefit Plan.

DRAWBACKS TO SEPS FOR EMPLOYEES

1. There is no guarantee as to future benefits.

2. Investment risks rest on the participant.

3. There is no assurance as to the frequency and amount of employer contributions.

4. No tax-free disability payout is available.

5. There are no forfeitures to be reallocated.

6. **Life insurance funding is not available.**

7. Cannot contribute over the 15% limit (compared to a 25% limit permitted under Qualified Defined and Contribution Plans).

8. Distributions from SEP's are not eligible for 10 year averaging.

An Overview of Simple Retirement Plans

Prior law allowed a SAR-SEP to provide an employer with a simplified method of establishing a SEP retirement plan that allowed employer contributions and also permitted employees to direct their own pretax earnings through salary reduction (or foregoing receipt of a bonus) into the SEP. SAR-SEP programs were repealed as of 12/31/96 and have been replaced by SIMPLE RETIREMENT PLANS.

HOW IT WORKS - a simple plan can be adopted by any employer with 100 or fewer employees with at least $5,000 in compensation for the previous year and who do not maintain any other employer-sponsored plan. If an employer's simple plan later becomes disqualified he is given a two year grace period to requalify or terminate the plan.

FORM OF PLAN - A simple plan can be set up either as a 40lK defined contribution plan or a group IRA with limited employer fiduciary responsibilities and burdens. In either form the plan will not be subject to the nondiscrimination rules and top heavy rules. In addition simplified reporting rules will apply.

INVESTMENT OF PLAN ASSETS - Plan assets can be invested in most equity products or debt instruments, but may not be invested in life insurance, "hard" assets, or collectibles (except for U.S.gold and silver coins). Participants direct the funds contribution on their behalf.

CONTRIBUTIONS - All contributions are 100% vested and the employer with a simple plan is required to satisfy one of two contribution formulas;
A) Matching Formula - under the matching formula an employer is required to match employee contributions to the plan on a dollar for dollar basis up to 3 percent (reducible to 1 percent under specified conditions in simple IRA's but not simple 401K's)
of the employees compensation.

B) Contribution Formula - in lieu of matching contribution employers can elect a mandatory annual contribution equal to 2 percent of employee compensation, subject to the overall compensation limit of $150,000 (indexed from 1995).

OTHER FEATURES

a) Distributions are taxed in the same manner as IRA distributions and can be rolled into a new simple plan or an IRA.

b)Employee contributions through salary deferral are limited to $6,000 per year (indexed from 1997).

An Overview of Stock Bonus Plans and Employee Stock Ownership Plans(ESOPs)

STOCK BONUS PLANS were originally established as a form of Defined Contribution Retirement Plan that could have the employer's stock as its sole or a primary portfolio asset holding rather than being limited to 30 percent of the value of the plan assets like other qualified plans. An ESOP is a stock bonus plan that has been modified to allow the stock bonus plan to borrow money to purchase the company stock in its plan. Today virtually all stock bonus plans are also qualified to be ESOP's, and ESOP's are available to S and C corporations of all sizes. However, S-corporations do not enjoy all of the tax benefits associated with ESOP for C-corporations.

HOW IT WORKS

1. An employer contributes company stock or cash to the plan.

2. Employer contributions are tax deductible. IC Sec.404(a).

3. Contributions are not taxed currently to the employee. IC Sec. 402(a) and 403(a).

4. Earnings accumulate income tax free. IC Sec. 501(a).

5. Distributions can be rolled over into an IRA at retirement or death. IC Sec. 402 and 403.

MAXIMUM ANNUAL DEDUCTION - Up to 15% of covered payrolls can be contributed and deducted by the corporation.

INDIVIDUAL LIMITS - Subject to transition rules, the allocation of contributions to a participant's account may not exceed 25% of covered compensation up to an overall limit of $150,0000/yr (indexed from 1997).

DISCRETIONARY CONTRIBUTIONS - Most plans are discretionary as to the amount which the employer contributes. If there are profits, the employer is expected to make "substantial and recurring" contributions. As a rule of thumb, contributions during 3 out of 5 years or 5 out of 10 years will usually gain IRS approval.

EXCLUDING PERSONS - Certain persons can be eliminated on the basis of months of service, age and union plan; for example, persons under age 21 can be excluded from the plan.

INVESTMENT OF PLAN ASSETS - Plan assets are required to be invested in employer stock with some exceptions for those nearing retirement. In addition, assets may be used to purchase life insurance in some circumstances.

PARTIES FAVORED - Typically younger participants are favored because they have a longer time for their fund to grow. There are also some special advantages to the major shareholders.

HOW ESOP DIFFER FROM STOCK BONUS PLANS -

1. Under an ESOP the participants have the absolute right to demand distribution of company stock.

2. The plan may repurchase the distributed shares of stock but is not required to do so; only the employer is so required.

3. The plan must pass certain voting rights through to the participants.

4. If the stock is not publicly traded or is "restricted," the participant or his or her heirs must have the right to offer the stock for sale to the employer.

5 The plan may borrow money from a bank to purchase stock with the employer guaranteeing such loans without it being considered a prohibited transaction. Further, **an employer can contribute and deduct up to 25% of compensation for a leveraged ESOP which is repaying loan principal.** In addition, it can make deductible contributions to pay interest on the loan used to purchase securities.

6. The plan may borrow money from a prohibited person without incurring any penalty. IC Sec. 4975(d)(3).

7. The plan may not be integrated with Social Security.

8. Whereas a Stock Bonus Plan is not required to invest in employer securities, an ESOP must invest primarily in employer securities.

9. The employer can contribute company stock directly to the plan.

10. The plan may purchase the securities on the open market for public companies, issue new shares, or purchase them from the shareholders.

ADVANTAGES OF ESOP TO EMPLOYER

1. Contributions are tax deductible.

2. Contributions and costs are totally flexible.

3. The plan is easy to understand by the employees.

4. It can provide employees with permanent life insurance benefits that need not expire or require costly conversion at retirement age.

5. Since all or substantially all of the assets may be invested in employer's stock, this is a good method for raising additional capital without going to the marketplace.

6. In effect the corporation can raise capital with deductible contributions to its plan.

7. Stock, rather than cash, can be contributed to the plan.

8. An ESOP may be used to facilitate the buy out of a stockholder.

9. Dividends paid on stock acquired with an ESOP loan may be deducted if they are passed through to the participant (They are not eligible for the dividend exclusion.)

10. In effect, both the interest and principal of loans are made on a deductible basis

ADVANTAGES OF ESOP TO EMPLOYEES

1. Annual contributions are not tied to the participant.

2. Earnings on the account are not currently taxed.

3. Distributions at death or retirement are tax-favored.

4. Special treatment of unrealized gains upon the distribution of stock, permit significant deferral.

5. Participants can also have an IRA account, subject to income level and filing status.

6. There is the ability to purchase significant permanent life insurance, which is not contingent upon the company group insurance program.

7. Younger employees can accumulate a larger fund than with a Defined Benefit Plan.

8. The untested portion of accounts of former participants is allocated to the active participants accounts. This can have a substantial impact on the future benefits.

9. Employees participate in employers’ growth.

10. A potential market is created for deceased owners’ stock.

DRAWBACKS OF ESOP TO EMPLOYER

1. The ESOP will generally not produce as large of a contribution and deduction for older employees as will a Defined Benefit Plan.

2. Contribution limitations are set at 15% (25% if needed to cover payment obligations under an ESOP loan)of covered compensation.

3. Voting rights must be passed through to the participants unless ESOP loan balances are outstanding.

4. The cost of having the stock valued and appraised each year may be costly.

5. Future repurchase may not come at a convenient time and must be made with after-tax dollars. This could place a financial strain on the employer.

DRAWBACKS OF ESOP TO EMPLOYEES

1. There is no guarantee as to future benefits.

2. Investment risk rest on the participant.

3. There is no assurance as to the frequency and amount of employer contributions.

4. Older participants will not receive as good a benefit as with a Defined Benefit Plan.

5. The value of closely-held stock may be difficult to determine at retirement age.

6. If the founder or key people die, retire or terminate employment, the company stock may be worth very little.

7. The company may not be financially able to repurchase the stock, even though required to do so.

8. If the employer's stock is depressed in value at retirement time, there could be a significant loss in the retirement account.

An Overview of SECTION 401K or CODA(cash or deferred) PLANS

Any Profit Sharing or Stock Bonus Plan which meets certain participation requirements of IC Sec. 401(k) can be a cash or deferred plan. An employee can agree to a salary reduction or to defer a bonus which he or she has due.

HOW IT WORKS

1. Employee has option of taking cash or having it paid to the trust for retirement.

2. Any additional employer contributions are tax deductible. IC Sec. 404(a).

3. Contributions are not taxed currently to the employee. IC Sec. 402(a) and 403(a). (Except Social Security and unemployment taxes.)

4. Earnings accumulate income tax-deferred. IC Sec. 501(a).

5. Distributions can be rolled over into an IRA at retirement or death. - IC Sec. 402 and 403.

TWO TYPES OF PLANS

1. SALARY REDUCTION. An employee can agree to a salary reduction; e.g., 10% of compensation, which the employer can then pay to the Retirement Plan Trust. It is deductible to the employer, but is not included in the employee's gross income. (This is clearly the most common type of plan.)

2. CASH OR DEFERRED. The employer can decide to pay a bonus and give the employees the following choices: a. Take the cash. b. Defer it to the Trust. c. Take part and defer the rest.

MAXIMUM ANNUAL ALLOCATION. - Subject to transition rules, up to 15% (13.04% of pretax income) of covered compensation can be contributed subject to the overall compensation limit of $150,000/yr (indexed at 1997).from the combination of employer and employee contributions.

INDIVIDUAL CONTRIBUTION LIMITS - An employees elective contributions to the plan are limited to 9,540/yr (indexed from 1997). Amounts deferred must not violate special nondiscrimination rules.

INVESTMENT OF PLAN ASSETS - Plan assets can be invested in equity products, like mutual funds, stocks, real estate or debt instruments, like T-Bills, CDS, or insurance products.

PARTIES FAVORED - Since funds are typically employee dollars, the higher paid, a younger employee is favored because he or she has a longer time for funds to accumulate tax-deferred.

MATCHING PROGRAMS - Some employers choose to match each dollar put in by the employee with some multiple of a dollar; e.g., 50 cents, 75 cents, etc. If the employee does not contribute, neither does the employer.

QUALIFICATION ON CONTRIBUTIONS. - If the "non highly compensated" employees have not deferred enough, relative to what the "highly compensated" employees would like to defer, the Treasury Regulations permit the employer to make a contribution which is sufficient to bring the non-highly compensated employees up to the level necessary to support the highly compensated employee's deferral percentage. This type of contribution must always be fully vested.

Highly Compensated Employees include: (1) 5% owners, and (2) officers earning more than $80,000 (indexed from 1997), and if elected by the employers board is also in the top 20 percent of employees ranked by compensation.

SALARY REDUCTIONS AGREEMENTS - Participants must sign a salary reduction agreement permitting a payroll deduction.

WITHDRAWAL OF FUNDS - As with other Profit Sharing Plans, if the plan terms permit, the funds can generally be withdrawn without a penalty in the event of (a) Termination of employment after age 55 (with restrictions), (b) Death or Disability or © Attainment of age 59 ½. However, under a Sec. 401(k) plan, elective contributions can be withdrawn if the participant has a financial hardship. Under the proposed Treasury Regulations, this is defined as "immediate and heavy financial need where funds are not reasonably available from other sources." There are "safe harbor" rules which spell out the conditions and requirements for "hardship distributions."

TOP HEAVY PLANS - In order to meet top heavy minimum allocation requirements, employee contributions are not recognized. Therefore, in a top heavy plan, the employer will be required to contribute up to 3% of compensation if any key participant contributes up to 3% of his or her compensation.

DISCRETIONARY EMPLOYER CONTRIBUTIONS - In addition to any matching and/or top heavy contributions, an employer may make discretionary contributions from year to year so long as the allocation among the participants is on a nondiscriminatory basis. These contributions can be made to the plan up to the due date of the return plus any extension granted to the employer. Any employer contributions made on a discretionary basis that are not required to maintain the plan qualification may have gradual vesting.

NON DISCRIMINATION RULES - A mathematical test is used to determine whether a plan is discriminatory. First, all employees eligible to participate are divided into two groups according to their compensation. The highly compensated may defer up to two times what the nonhighly compensated can for the first 2%. If the non-highly compensated on average defer between 2% and 8%, the highly compensated may contribute an additional 2%. (If more than 8%, then up to 125% of the rate.) The amounts contributed by the non-highly compensated employees will set the limit on how much the highly compensated can defer. The deferral percentages must be satisfied for the entire year.

IF THE NON-HIGHLY COMPENSATED EMPLOYEES DEFER - (on average)/THEN THE HIGHLY COMPENSATED EMPLOYEES CAN DEFER - (on average) e.g. .75% /1.5%, 2% / 4% , 4% /8% etc....... An excise tax is assessed if excess amounts are not returned within 2 ½ months after the close of the plan year. If contributions are from an employer bonus (not salary reduction), the employer may require that a certain percentage of the bonus be deferred in order to assure that the discrimination test will be met.

IC Section 403(b)

An Overview of Tax Shelter Annuities

Since they are not employed by corporations eligible to set up Defined Benefit and Defined Contribution Retirement Plans, the IRS has traditionally allowed Employees of religious, charitable, educational, scientific, and literary organizations described in IC Sec 501(c)(3) or public school systems. (Public Law 87-370) to set up Tax Sheltered Annuities to provide for retirement. Beginning in 1997 most of these organizations will also be allowed to set up 401K plans as an alternative if they desire to do so.

CAN THE EMPLOYER MAKE CONTRIBUTIONS? - Yes, but typically the employee agrees to have his or her salary reduced by the amount to be contributed. If the Employer contributes its own funds the arrangement is subject to the same rules that govern regular qualified plans.

HOW MUCH CAN BE CONTRIBUTED? Generally follow the same guide lines as 40lk deferral limits i.e., $9,540/yr (indexed from 1997), and very special and complex rules relating to past service costs may permit larger employee contributions. In any case, a salary reduction agreement must be entered into **before the reduced amounts are earned.**

WHAT MAY THE FUNDS BE INVESTED IN? -
1. **Annuities** (fixed or variable and individual or group)
2 Retirement income or endowment **insurance policies**
3. **Custodial accounts** invested in **mutual funds**
4. Combination of **whole life insurance and annuities**

WHO IS THE CUSTODIAN OF THE ASSETS? Annuities and insurance are with an insurance company. Mutual funds are placed with a corporate trustee.

WHEN IS A DISTRIBUTION REQUIRED? Generally the funds are withdrawn at retirement. In order to avoid penalties, withdrawals must begin by April 1st of the year following the calendar year during which the taxpayer became 70 ½ and, at a minimum, must be taken out over the life expectancy of the taxpayer and, if desired, his or her spouse.

CAN TSA FUNDS BE BORROWED? - Participants **can borrow funds** from their TSA and later restore them without incurring a tax, **if established conditions are met** regarding maximum loan amount, amortization requirements, time period for repayments, etc.

WHAT IS THE PENALTY FOR EARLY WITHDRAWAL - There is a 10% penalty for withdrawals prior to age 59 ½ and all withdrawals are taxed currently as ordinary income, unless the distribution is rolled-over, transferred to another TSA or the annuitant is totally disabled, separates from service (after age 55), or dies. Also, the salary reduction amount (but not the earnings) is available for financial hardship, e.g., an immediate and heavy financial need which cannot be met with other assets.

WHAT HAPPENS AT THE DEATH OF A TSA PARTICIPANT? - The proceeds become a part of the taxable estate for Federal Estate Tax purposes and they are considered as ordinary income to the beneficiary, except for any "pure" insurance proceeds.

HOW DOES A PARTICIPANT CHANGE FROM ONE TSA TO ANOTHER? - The transfer of funds from one 403(b) investment to another will not be considered a taxable distribution if the funds remain subject to any distribution restrictions on the prior investment. Revenue Ruling 90-24.

CAN THE DEFERRED AMOUNTS BE COUNTED AS CURRENT COMPENSATION IN COMPUTING BENEFITS UNDER A SEPARATE QUALIFIED PENSION PLAN? - Yes, see Revenue Ruling 84-74, 1984-1 CB 118, and the Small Business Job Protection Act of 1996 which also extends this concept to the deferrals under 40lk and 457 programs.

OTHER TAX CONSIDERATIONS:

1. The employee avoids current income taxation on the deferred amount (except it is included in the Social Security base.)

2. The earnings on the accumulating funds are not taxed until they are distributed.

Overview of Section 457 Plans

To allow some form of employee funded retirement for state and local government workers, U.S. Federal Agency employees and the employees of tax exempt entities (other that 501(c)(3) entities eligible for 403b plans) the IRS permitted Section 457 plans. In the past these plans had unique features that distinguished them from 403b plans but since the tax reforms of 1996. Section 457 plans and 403(b) plans have operated in much the same manner except that no employer contributions are permitted to Section 457 annuities.

Overview of Cafeteria (IC SECTION 125) Plans

Cafeteria Plans (also called "Flexible Benefit Plans") allow participating employees to choose among two or more welfare (not retirement or fringe) benefits consisting of cash and "qualified benefits." IC Sec. 125(d)(1)(B).

There is no need to change current benefit programs and if the employer is unable to pay for the benefits, the employee can enter into a salary reduction agreement with the employer. The employer then uses these funds to pay for the employee's benefits. This allows the employee to pay for his or her own benefits with PRETAX DOLLARS.

Some of the Qualified Welfare Benefits which can be added to the "menu" include the following:

- Group Term Insurance
- A qualified group legal services plan
- Dependent care assistance
- Accident and health plan benefits (including medical expense reimbursement benefits)
- Adoption Assistance Programs
- Health Insurance Benefits

Benefits which are specifically excluded from the menu include

- Scholarships or fellowships under IC Sec. 117
- Qualified transportation (e.g., van pooling) IC Sec. 124
- Miscellaneous fringe benefits under IC Sec. 132
- Non qualified deferred compensation plans IC Sec. 125(d)(2)
- Qualified retirement plans (including 401K)*
- Otherwise Qualified Welfare Benefits that fail to meet the IRS standards that have been imposed on them.

*may be administered in conjunction with a cafeteria plan but not technically a part of the Section 125 plan

CAFETERIA PLAN/EMPLOYEE BENEFITS

1. Lower gross income means **lower FICA and Income Tax withholding.**

2. Employee can choose the benefits most needed.

3. Employee is not required to take benefits which his or her spouse already has with another employer.

4. **Tax Savings can be put aside for retirement needs,** e.g., in a Sec. 401(k) plan, life insurance, etc.

CAFETERIA PLAN/EMPLOYER BENEFITS

1. **Lower gross pay means lower payroll taxes** (FICA, FUTA, and sometimes Worker's Compensation insurance).

2. Employer is **allowed to share the cost** of benefits, if desired.

3. Helps employer retain key employees.

4. May reduce the need to expand coverage under existing fringe benefits to additional employees. For example, amounts deferred under Section 125, 401k, 403b, and 457 are considered compensation for the purposes of the overall compensation limit of $150,000 (indexed at 1997) for retirement plan contribution caps.

5. Boosts employee moral by showing employer concern

CAFETERIA PLAN REQUIREMENTS

The plan must be written and include only employees. The plan should include:

1. A description of the benefits and coverage periods.

2. Eligibility rules for participation.

3. How benefit elections are to be made.

4. How employer contributions are to be made (i.e., employer funds or salary reduction).

5. Establish the maximum amount of employer contributions.

6. Determine the plan year.

7. A definition of employees who qualify for the plan which the IRS determines as not discriminatory in favor of highly compensated or key employees.

SECTION VII 14 EXAM QUESTIONS

OTHER RETIREMENT PLANNING FACTORS

Overview of Social Security Benefits

The social security system provides economic benefits for **old age, survivorship, disability and health insurance.** This program was established by the United States federal government in the 1930's as a response to being more socially responsible to a population not deemed to be able to adequately prepare for its own future. The scope of social security has evolved from one of being a simple supplemental retirement benefit to the general population to a very broad and comprehensive social insurance program. The funding for social security has taken on enormous proportions and is capturing an ever increasing percentage of worker and employer income through mandatory federal employment and payroll taxes.

To be eligible under social security, an individual must be covered by the social security system and earn credit for specified types and amounts of work. These credits are earned through a system which provides quarters of coverage basis. For instance, in 1988 a worker would receive a one quarter credit of coverage for each $470 in annual earnings on which the social security taxes were paid. However, no matter how much an individual may earn in any given year, no more than four quarters of coverage may be earned in any one calendar year. There are also provisions stating that if an individual earns enough money in just one quarter they can satisfy the maximum number of quarters although they only worked a few months out of the year.

A person becomes fully insured under the social security system as long as they meet one of the following two criteria:

a) Credit for 40 hours of coverage

b) Coverages for at least as many quarters of coverage as there are years elapsing after 1950 (or after the year in which age 21 is reached, if later) and before the year in which the person dies becomes disabled or reaches the age of 62, whichever happens first.

SURVIVORSHIP BENEFITS - An individual who is fully insured under the social security system is eligible to start receiving a monthly benefit as early as age 62. However if an individual elects to receive a retirement benefit before the age of 65 it will result in a permanently reduced benefit. Furthermore dependents of persons who are eligible to receive retirement benefits may also be entitled to monthly benefits based on the retired person's own account.

The covered workers' spouse who is age 62 or older is entitled to a benefit and again the benefit will be reduced permanently if the spouse elects to receive benefits prior to reaching the age of 65. **A spouse of any age will receive benefit so long as at least one child of the retired worker is still being cared for**. Dependent children who are under the age of 18 and unmarried continue to receive a benefit until age 19 as long as the child is a full time student in an elementary or high school.

OLD AGE BENEFITS - Old age benefits are paid according to a worker's primary insurance amount (pia). The primary insurance amount is based on the worker's average index monthly earning (aime) level at which social security taxes were paid. In estimating a client's social security benefit the most exact manner in which this should be accomplished is by requesting the specific individual's data from the social security administration. Refer to Section II for details. A few weeks after the form is mailed into the social security administration, the data for that specific individual will be returned and the information can be incorporated into the retirement or financial planning framework of the person involved.

It is an invaluable tool not only in helping your client understand the exact nature of the benefit social security will offer them, but it will also show how close or far from their desired standard of living they will be in relying too heavily on the social security benefit. Such information can easily prompt an individual to be more motivated to start setting aside money immediately for retirement, once they understand that the system in place for their benefit may be inadequate.

Social Security benefits automatically increase each January as long as there has been an increase in the consumer price index for the previous one year period ending in the third quarter. This cost of living adjustment was originally designed to help a senior citizen have a benefit which will increase and at least attempt to keep pace with inflationary pressures. An exception to the cost of living adjustment is that if the reserves of the social security trust fund drop below specified levels, the cost of living adjustment could be scaled back.

Another main concern regarding social security is the age at which the worker elects to start receiving retirement benefits. Currently, full benefits are paid to individuals who wait until age 65 to begin benefits. **If a worker elects to receive benefits prior to age 65 the monthly benefit is reduced by 5/9 of one percent of every month that the early retirement begins before age 65**. A worker who retires at age 62 will receive only 80 percent of the primary insurance amount to which they would otherwise be entitled if they waited until age 65. A spouse who decides to retire before age 65 has benefits reduced by 25/36 of one percent per month.

On the other hand, **workers who decide to wait past the age of 65 to begin drawing benefits are rewarded with an increased benefit. This benefit delay adds an amount which is equal to 1/4 of one percent for each month beyond the age 65, up to age 70 (3 percent per year).**

SOCIAL SECURITY COVERAGE - Not everyone is covered by the social security system. Civilian employees of the federal government employed by the government before 1984 are covered by the civil service retirement system. All civilian employees hired by the government after 1984 and other employees who elect coverage under the system, are covered by social security. Also, **older railroad workers are covered under the "Railroad Retirement Act", a separate entity from social security.** Employees of various state and local governments and Subdivisions of state and local governments are covered under state and local pension systems. Other groups of individuals who are not covered under social security can include ministers who elect out of the coverage due to religious principles, and specified American citizens who work overseas for foreign affiliates of U.S. employers.

In a typical case study of any individual concerning whether or not social security benefits can be adequate upon retirement it is necessary to make several projections. Based on an individual's current status in the social security system and projecting benefits of a future point in time can be a tricky and uncertain business. The bottom line is going to be that a reliance completely on social security benefits for retirement income will result in a very meager lifestyle. Even if social security benefits are paid in the future to the tune of thousands of dollars per month in benefits, such payments must be tempered against increases in the cost of living. The cost of living adjustment mentioned earlier for social security benefits each year has historically fallen behind the actual increases in the cost of living experienced in the economy. The time value of money concept is critical in understanding the short falls of the social security benefit.

The "Pension Max" Concept

Pension Maximization is normally applied to a set of spouses who are trying to decide which option to avail themselves of for their pension benefit. **The dilemma is: if the benefit is tied to only one life, the monthly income is higher than if monthly income is tied to two lives** (one person and then the survivor). The general issue is: do you take the higher amount tied to one life and hope that person lives the longest, or do you take the lower benefit and hedge your bet either way? By taking the higher monthly amount tied to only one life there is an option because the extra amount of monthly income in excess of the survivorship benefit (the amount when benefit is tied to two lives) can be used to either purchase a life insurance program (normally considered the most prudent choice) or it can be used to accumulate additional funds for retirement.

AVOIDING PENSION SURVIVORSHIP INCOME COSTS

At retirement, married pension plan participants are required to make a choice. They could:

1. take the maximum monthly income for tho life of the retiring employee only (e.g., at 1,000 per month); or
2. take a substantially reduced pension for their joint life expectancies (e.g., $800 per month).

In the absence of any planned alternatives, most employees and their spouses feel compelled to take the reduced life income at retirement. Unfortunately, once this option is selected it may not be changed.

Consider the Potential Costs:

- If spouse lives but a short time, the surviving retiree faces a lifetime of reduced pension benefits.

- If both live a full life and die within a year or so of each other, little benefit is ever realized after 20 years or more of reduced pension.

- In no case do children or other heirs realize benefits.

CONCLUSION: PENSION SURVIVORSHIP OPTIONS EQUATE TO VERY EXPENSIVE TERM LIFE INSURANCE WHICH MAY NEVER PAY A BENEFIT.

THE SOLUTION: Purchase permanent life insurance prior to or at retirement (ideally all premiums will be paid before retirement) in an amount that would:

1. Provide the survivor or other heirs with a similar income benefit, and then

2. Still take the maximum monthly pension benefit.

CAUTION: In some cases, eligibility for continuing surviving spouse's group health care is dependent on Survivor Option Election.

Will Your Nest Egg Last Long Enough?

The concept of monetary projections based on changing time values of money is of critical concern in this instance. If several assumptions are made that you will have a fixed amount of money saved by retirement, the secondary issue becomes whether or not that sum of money will last a sufficient length of time for the party or parties involved. Obviously the more money that you set aside the better, but how much is enough? Following this discussion is a chart illustrating the process by which a nest egg evaluation and determination can be made. It's a very complex concept to determine nest egg sufficiency.

FIVE STEP PROCESS - In determining whether or not there is sufficient financing to maintain a desired retirement lifestyle, a five step process is usually used.

1) Add all current income sources (social security, private savings and pension benefits).

2) Determine the amount of income necessary for the client to achieve the desired retirement lifestyle by calculating the percentage of a client's salary that client wishes to have available at retirement (normal ranges are from 70 to 90 percent) by taking an average of the last several years of income prior to retirement.

3) An estimate of the actual retirement income status at retirement must be made. This is achieved by determining the target requirement income in step 2 and subtracting from it the current estimate of what the actual retirement income will be. This amount may be positive or negative if it is negative it indicates there is a deficit present and additional savings must be accomplished.

4) Resources which need inflation protection must be determined because in order to appropriately calculate actual retirement need, inflation protection must be considered from a point of view of both before and after retirement.

5) Calculating the target amount of how much extra money is needed if a deficit is present. A person must decide how much money needs to be saved on a monthly and annual basis and in the manner which is most keeping with the client's investment attitude.

There are several main concerns in the retirement planning process, but none is more crucial than protecting clients from outliving their income. Mortality tables must be used to determine over how long a period of time to liquidate assets but there is danger in relying solely on such tables. The main reason is that at least 50 percent of the population in America lives beyond the mortality table projections. Current demographic trends made available by the U.S. census bureau. Although there are several techniques an individual can use to assure that a client will not outlive a nest egg, the most common method has always centered around various annuity products (refer to the section on annuities).

AMOUNT OF INCOME PRODUCED
BY A "NEST EGG"

Use the following formula and chart to determine the length of time that a nest egg will last:

1) List current amount in
retirement fund................................$____________

2) List how much annual income
is needed to live according
to desired lifestyle ....$____________

3) (list current fixed income
sources, i.e., pension, social
security, other)
Subtract #3 from #2, above .... $_____________

4) Balance (#3-#2) must come
from nest egg ....$_____________

5) Nest egg withdrawal as a percentage
of entire fund (# 4 divided by #1).. _________%

6) Assumed average rate of
return earned on the fund .... __________%

In the chart below, the place at which the two columns intersect indicates the number of years a fund will last. The lower right area indicates an infinite time.

The Nest egg will last this long:

% on # 5	**Assumed rate of return on investment (#6)**											
	5	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**
40	3	3	3	3	3	3	3	3	3	3	3	3
35	3	3	3	3	3	4	4	4	4	4	4	4
30	4	4	4	4	4	4	4	5	5	5	5	5
25	5	5	5	5	5	5	6	6	6	6	7	7
24	5	5	5	5	5	6	6	6	6	7	7	7
23	5	5	5	6	6	6	6	7	7	7	8	8
22	5	5	6	6	6	6	7	7	7	8	8	9
21	6	6	6	6	6	7	7	7	8	8	9	10
20	6	6	6	7	7	7	8	8	9	9	10	11
19	6	7	7	7	7	8	8	9	9	10	11	12
18	7	7	7	8	8	9	9	10	10	11	13	15
17	7	7	8	8	9	9	10	11	12	13	15	19
16	8	8	9	9	10	10	11	12	14	16	20	☞
15	8	9	9	10	11	12	13	14	16	21	☞	**I**
14	9	10	10	11	12	13	15	17	22	☞		**N**
13	10	11	11	12	14	15	18	23	☞			**F**
12	11	12	13	14	16	19	24	☞				**I**
11	12	14	15	17	20	25	☞					**N**
10	14	16	18	21	27	☞						**I**
9	17	19	22	29	☞							**T**
8	20	24	31	☞								**Y**
7	26	33	☞									
6	**37**											

Trends In Health Insurance

Perhaps no greater issue confronting the American people in the l99O's will be that of health insurance: who will pay for it and how good will it be? Costs for health care in the American economy have far out paced the average inflation rate. As health care becomes more and more difficult to receive and costs for it become greater and greater, it is Americans who earn average to lower than average incomes who will face the greatest challenges in obtaining decent and affordable health services.

Since the cost of health insurance has been increasing at a very fast pace to match the increasing cost of health care in general, premium payment is a main concern. Historically employers supplied health insurance to the work force and paid for most, if not all, of the coverage in order to be competitive. Today employers are shifting the burden of cost from themselves to employees as a commonplace activity.

Increasing numbers of individuals find themselves in need of health insurance that they must purchase. The individual has always found it not difficult to get decent health insurance and cost has always been greater than for people covered under group health insurance contracts.

Look for the issue of who is going to pay premiums in the future to affect the economy in many ways. Chief among them will be labor unions versus companies in fighting over tooting the bill for health premium. As major labor unions (auto workers, teachers unions and major utilities) fight over this issue, the American public can expect much instability through anticipated strike actions and increased cost in delivering the products and services these unions represent. Since people have not been accustomed to paying for their own health premiums, this shift in burden of payment is sure to be met with loud cries of protest rather than meek acceptance.

A recent governmental study prepared and presented by the "Pepper Commission" indicates health care costs, on an annual basis in America, in 1990 to be nearly 700 billion dollars. Seven hundred billion dollars, to put that amount of money in perspective, is equal roughly to double the United States' current defense budget expenditures. The Pepper Commission, in their report, offered sweeping changes in the way health insurance is delivered to the American public but provided no insight as to how the bill will be paid for these services.

The Pepper Commission and many people in the American population have advocated that the federal government take some or all of the burden of providing decent health care and health insurance to the American population. The general objection some people have to a national system of health care is to point to the government's inability, in the past, to manage such nationalized programs (the Medicare health care system for senior citizens, for example).

Although it is unclear who will pay for health care, how it will be provided, and the exact effect this major social change will have on the American public and economy, one thing is certain. The way people receive health care and the manner in which it is paid for is going to change and change very drastically in the upcoming millennium.

Possible Future Taxation Changes in life Insurance

Another main concern for Americans is the recent trend in federal income and estate taxation. In the early 1980's the federal government lowered significantly the top income tax bracket payments in favor of eliminating the availability of many offsetting tax advantage products and situations. One area of tax advantage has always been that of the life insurance contract, but many changes have occurred in the past 10 years there, as well. For instance, the elimination of endowment insurance as a type of policy because it built too much cash too quickly and therefore was deemed an investment is one example.

Although the nature of a permanent insurance product's cash value being allowed to accumulated tax deferred has remained untouched, the amount of money that can be placed into this cash value at any given period of time has been altered. The "modified endowment contract" change through TAMRA in 1988 indicates the lack of patience the federal government has in allowing life insurance products to be too bold in the tax advantages they offer.

But what of the future? Is it possible that Congress will significantly curtail the current tax advantages offered to life insurance contracts? Or will they leave alone these concepts and perhaps even broaden them in the future? In view of the Congress' recent attempts to gain additional revenues for perceived shortfalls to run the government, it is doubtful that tax changes in the future will be to the advantage of the life insurance industry. If fundamental advantages to life insurance are systematically curtailed in the future, despite the efforts of the strong lobby of the life insurance industry, then the way in which life insurance is purchased could also be forever changed.

When life insurance products offered tremendous advantages to the American public in the past, most members of the consuming public were pretty much unaware of the significant tax advantages available to them through the purchase of annuity and death benefit products. If future taxes are aimed at insurance products which remove advantages that still exist, the fear of the life insurance industry is that marketing will be more difficult than it is now when the main enemy is consumer ignorance.

Whether you contemplate the economic impact of health care and health insurance or the taxation concepts associated with marketing life insurance products, the 1990's represent a decade in which broad and sweeping changes can be anticipated. These changes should not be perceived in strictly a negative light since broad and sweeping changes usually carry with them enormous opportunities to change the way in which products are constructed and marketed. As always, those financial service professionals who keep pace with fast changing markets and understand the nuances and implications therein will be the professionals who benefit not only themselves but their clients as well.

SECTION VIII: 5 EXAM QUESTIONS

BASIC HUMAN CONSIDERATIONS IN RETIREMENT PLANNING

Client Attitudes About Long Term Planning

Perhaps the greatest obstacles to individual Americans in providing funds for a comfortable retirement are their own attitudes towards sacrificing and the scope of their own general ignorance regarding alternatives available in the marketplace. The client who lacks the understanding of their own needs can sometimes be enlightened with important information made available to them. Sadly however, a significant portion will decline to consider seriously the role they actually must play in their own retirement planning, no matter the attempt made in trying to help them

The main issue of sacrificing is a simple concept. Either an individual gives up some income in the present to store it away for a more comfortable tomorrow, or they can live it up today and have a very uncomfortable tomorrow. Many clients have been heard to comment "Why should I give up enjoying my life today so that I can enjoy tomorrow, I could be dead tomorrow!" The simple and sad truth is, for most people, if they do not adequately save for tomorrow they may feel better off dead because their financial status Will be meager at best and poverty stricken at worst.

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How can the financial services professional encourage the client to give up enjoyable yet costly and somewhat unnecessary vices (such as going to dinner too often, going on too many vacations etc.) so that the person will give these things up to some extent and put the money they cost into programs designed to help them tomorrow? The answer is: it won't be easy! In many cases it is impossible to change the mental perception such that a person will significantly alter a current lifestyle. But that is the fundamental choice: the lifestyle of today versus the lifestyle of tomorrow. It is that basic, it is that simple~

The other main obstacle in the retirement planning process, as it regards client attitudes, is that of the overall financial ignorance of the consumer in America. The typical American is so involved and engrossed with the details of daily life that they don't usually have the time, nor feel the need, to investigate and learn about tax law basics and general products available to help them in the long term planning process.

For instance, the number of people who do not know that life insurance death benefits paid to beneficiaries are income tax free, is staggering. Recent surveys have shown that less than one in four people know this simple fact. When it comes to more complex issues such as tax deferred savings, ability to access cash values, cash value building life insurance policies and the general taxation of annuity, the number of people understanding dwindles even more. A fundamental issue to be dealt with is: How can people be expected to have a desire to engage in long term financial planning and retirement planning when they don't understand they have a need or problem to begin with? Even if they are vaguely aware that there is a need for concern perhaps they feel helpless to be able to do anything about it because of the overall perceived Complexities of the choices involved. This is another reason it is much easier to live for today and to let tomorrow take care of itself.

The Insurance Producer's Role

For the most part, the role of the insurance producer is fairly simple. Motivating a client to action and then satisfying the expressed needs with appropriate product integration is the fundamental role of the producer. Developing the requisite techniques involved is where the complexity enters the picture. Motivating a client to action is not a simple task. It involves the command of several psychological analysis abilities and a refined technique and approach in dealing with, and talking to, people. Listening and understanding what a person really wants and really needs, despite what they actually may say, is an acquired skill that too few people in the financial services industry ever seem to be able to master. Once a planner understands what will motivate a client, then that planner is in a position to actually motivate. Once the planner understands what the client is really saying then, and only then, can a list of needs be evolved and understood.

As a client’s needs become apparent and visible, hopefully to both parties involved, then it is up to the insurance professional to be able to provide the appropriate product which will integrate and satisfy the needs of the client. This required product knowledge on the part of the agent although important, is not critical since understanding needs and being able to motivate people to act are much more fundamental. An insurance professional who has great and wide ranging Understanding of insurance products will find this knowledge useless without the ability to understand and motivate clients.

As America enters a new millennium, the role of retirement planning in the economy will take on monumental proportions. As over 40 million Americans (also known as the baby boomers) approach over 40 million individual retirements within the next few decades, the need for good retirement planners is enormous. Americans are going to live longer than ever before and need more money than ever before to fund these retirements. Unfortunately, the vast majority of them are so busy living life for today and just trying to get by, day to day, that few are doing anything substantial to prepare for tomorrow. The role of the insurance producer in the coming economy is critical: to not only the success of individual clients in meeting retirement needs, but to the way a majority of Americans will experience lifestyle in the future.

<u>To complete this course</u>

FIRST, REFER TO THE NONSUPERVISED "OPEN BOOK" EXAM FOR COMPLETION OF THIS CONTINUING EDUCATION COURSE.

SECONDLY, SUBMIT THE EXAM ANSWER SHEET, THE PROPER REGISTRATION FORM AND REQUEST FOR GRADING AND CERTIFICATION TO DOHRN INSURANCE TRAINING AS REQUIRED.