Chapter 7: Retirement Issues

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Corrections were made to this workbook through January of 2005. No subsequent modifications were made.

MEDICARE

For almost 40 years, Medicare has provided safety net health insurance coverage for those over age 65, people with end-stage renal (kidney) disease, and certain disabled Americans under age 65. Medicare pays approximately half of all the medical expenses for those aged 65 and older and covers almost 40 million people. From its beginning in 1965, as a component of President Lyndon Johnson's Great Society program, Medicare currently has an annual cost approaching $250 billion.[1] It has projected large annual increases, not including the $532 billion projected cost of the new prescription drug benefit. Annual expenditures average over $5,500 per recipient.[2]

In 2003, sliding Medicare premiums were enacted as part of the Medicare Reform Act which added prescription drug benefits starting in 2006. With at least 75% of the cost of Medicare Part B being paid by general tax revenues, budgetary constraints may force future cutbacks in benefits coupled with premium increases. The average retiree sees a subsidy of almost $150,000 during his years on Medicare.[3]

BASIC STRUCTURE OF MEDICARE

Medicare is divided into two parts. In general, Part A covers hospital stays and some follow-up care related to hospital stays. Part B covers outpatient care and doctors' costs. The Part A hospitalization insurance covers a majority of the costs while the Part B medical insurance pays a significantly smaller portion of the covered expenses.

Note. See the *2003 University of Illinois Federal Tax Workbook,* Chapter 8, Elder Taxation, for additional information on Medicare qualifications.

Medicare is financed by three sources:

1. A tax, currently 2.9%, on workers' wages and self-employed earnings
2. A monthly premium for recipients, currently $66.60 a month
3. Funds taken from general government revenues

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1. Center for Medicare and Medicaid Services, Table 26, www.cms.hhs.gov/researchers/pubs/03cmsstats.pdf
2. Center for Medicare and Medicaid Services, Table 14, www.cms.hhs.gov/review/suppl/
3. *Managing Social Security,* Ron Woltjer

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Since January 1, 1994, the Medicare portion of the social security tax has been levied on all earnings subject to social security. Therefore, no limit exists comparable to the $87,900 OASDI limit (in 2004) on social security taxes.

Medicare rules are uniform nationally and are enforced by the Center for Medicare and Medicaid Services, a federal agency. General Medicare information is available from the Social Security Administration. On the administrative side, Medicare is run by large private companies called carriers or intermediaries. Most health care providers and beneficiaries interact with these intermediaries, which are usually large insurance companies such as Blue Cross/Blue Shield. The costs added by these bureaucracies, plus a significant amount of billing fraud, are estimated to account for up to one-third of Medicare expenditures.[4]

ELIGIBILITY

To be eligible for free Medicare coverage, the worker must have earned 40 quarters (credits) or be qualified through a spouse, ex-spouse, or deceased spouse. Americans over age 65, who are eligible for social security retirement benefits, are automatically eligible for Part A coverage and do not have to pay monthly premiums. Individuals who are not eligible for social security retirement benefits at age 65 may purchase coverage for a monthly premium. Individuals who are entitled to social security disability benefits become eligible for Medicare coverage after 24 months. Also, anyone who is on dialysis to enable them to live after permanent kidney failure, or while awaiting a kidney transplant, is automatically eligible for Medicare Part A.

Part B coverage is available to individuals who pay the premiums.

MEDICARE PART A — HOSPITAL INSURANCE

Medicare Part A covers almost all of the cost of care for those admitted as a hospital inpatient subject to limitations. An individual on Medicare will pay an $876 annual deductible in 2004. Hospitals, nursing homes, and other health care providers are licensed as medicare providers. Medicare only pays for care provided by licensed facilities. Outside the United States and its territories, care is generally not covered by Medicare, with minor exceptions.

Coverage Provided by Part A

Medicare Part A provides hospital inpatient coverage, up to 100 days of skilled nursing facility care (after at least three consecutive days in a hospital), psychiatric hospitals, and home health care, including hospice care to a terminally ill patient in their last six months of life.

Hospital Coverage. Medicare pays all hospital costs for the first 60 days of stay, except the deductible of $876 for 2004. This deductible increases each January 1. After 61 days, but less than 90 days, there is a daily co-pay ($219 in 2004, adjusted annually). After 90 days, coverage lapses, except that up to 60 additional “reserve” days may be used during one’s lifetime with a per-day co-pay of $438 for 2004.

Skilled Nursing Home Coverage. Medicare also serves as a short-term funding source for nursing home stays for workers. If the worker has sufficient quarters to be covered by Medicare and is over age 65, blind, or disabled, the coverage is triggered by a hospital stay that involves at least three consecutive nights. The nursing home must be a Medicare certified skilled nursing facility and the patient must be receiving “daily skilled nursing services.” With the above qualifications met, the patient is entitled to the following benefits:

- **For the first 20 days, full payment of allowable charges for board, room, and skilled nursing care.** If the patient has a shorter stay than 20 days, the remaining eligibility may be used at a later stay in the nursing home, provided the other qualifications are met.
- **For 21 to 100 days, Medicare pays allowable charges over the daily co-pay, which is $109.50 per day for 2004.** This co-pay is subject to an annual cost-of-living adjustment.

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4. National Center for Policy Analysis, *Daily Policy Digest,* February 2, 2002; www.ncpa.org/iss/hea/pd022102d.html

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This coverage frequently comes into play where a nursing home is used as a therapy provider after surgery for joint replacements, colostomies, and other medical conditions with significant recovery times. The patient is often sent home after a recovery period and Medicare serves as a funding source for these temporary stays. The $3,280 per month co-pay after the first 20 days may still be prohibitive to some patients. For some, expenses are covered by Medicaid if resources and income are low enough.

Note. Not all nursing homes accept Medicaid since this funding is significantly lower. See the *2003 University of Illinois Federal Tax Workbook* pages 300–302, for a description of the Medicaid program, including qualifications, income and asset limitations, benefits recovery, and protection from benefits recovery.

Psychiatric Hospital Coverage. Medicare Part A covers up to 190 days of inpatient care in a psychiatric hospital or psychiatric unit of a general hospital. This is a **lifetime limitation.** Coverage limits are also reduced by any days spent in an inpatient psychiatric hospital during the 150-day period before Medicare coverage begins.

Home Health Care. Medicare requires no deductibles for home health care. Medicare requires a 20% co-pay on durable equipment such as wheelchairs. A wide variety of services are covered, but providing agencies must be licensed as a Medicare provider.

Part A Premiums

For those entitled to retirement benefits at age 65, or entitled through other means, Medicare Part A is free. For those not covered, the premium is $343 per month in 2004, and it increases 10% for each year's delay if not taken in the first 12 months of eligibility. For those having 30 to 39 quarters of Medicare-covered employment, the Part A premium is $189 per month.

MEDICARE PART B — MEDICAL INSURANCE

Medicare Part B covers outpatient services, doctor bills for hospital or nonhospital visits, medically necessary ambulance services, physical therapy, chiropractors, optometrists, oral surgery, podiatrists, mental health care treatment and clinical psychologists, administered drugs, and medical equipment and supplies if prescribed by a doctor. All of these services are considered outpatient and have various restrictions as to what specifically is covered. Services not covered are those that are not a medical necessity, such as cosmetic surgery, routine physicals, eye and hearing exams, general dental work, and immunizations. Drugs and medicines taken outside a hospital or doctor's office are also not covered.

Premiums, Deductibles, and Co-payments

Each October 15, the annual Part B premium is announced for the following year. For 2004, the premium is $66.60 per month. This is typically deducted from the individual's monthly social security check, or it may be paid directly. It is crucial to enroll in Medicare at age 65 because the $66.60 premium increases 10% for each year receipt of benefits is delayed after age 65, if not working and covered by group medical coverage.

For Medicare Part B, a $100 deductible applies to eligible payments annually. After this deductible is met, there is a 20% co-payment by the patient. Several deviations from this co-payment exist, including:

- For hospital-related charges, the patient is liable for 20% of the actual charges, not 20% of the amount eligible for Medicare reimbursement.
- For mental health outpatient coverage, the deductible is 50%.

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Note. Medicare Part B is heavily subsidized by the federal government, with only 25% of the cost being contributed by premiums. The 1997 Taxpayer Relief Act had a provision, eliminated in conference committee, that would have placed premiums on a sliding scale based on income. The premiums could have gone as high as $180 per month for those with higher incomes. The 2003 Medicare Reform Act reinstates this concept, phasing out subsidized premiums for those with modified AGIs exceeding $80,000.

THE 2003 MEDICARE REFORM ACT

Congress narrowly passed the Medicare Reform Act in 2003. The law includes new and improved benefits, income-based premiums for Part B, and incentives aimed at structural reform. It has been controversial both due to its cost and the partisanship involved in its passage. Full drug benefits do not begin until 2006, but several provisions are effective immediately. Following is a description of the coverage.

MEDICARE DRUG COVERAGE

Discount Drug Cards

Note. Discount card sign-ups before the June 1, 2004 start date were disappointing. Fewer than three million eligible seniors applied for the cards.

Starting May 2004, Medicare recipients became eligible to receive discount drug cards. These cards have caused controversy, confusion, and strong interest among potential enrollees and professionals. The confusion is partly due to the large volume of information on the Internet and the need to use a website to determine the best card for an individual. More confusion is added by the procedures used for selecting the best card. Some cards are free and others are not. Discount card providers are allowed to charge up to $30.

Some controversy lies in the fact that seniors are finding the cards often don't produce prices lower than online or mail-order discount pharmacies. They are also much higher than Canadian drug prices. The reason for this became evident when a June 10, 2004 article in the *Minneapolis Tribune* revealed that most of discount cards are being offered by pharmacy benefit managers (PBMs), many of whom are owned by the drug companies.

Medicare dedicated a section of their website to assisting eligible seniors in making a decision about which discount card fits their situation best. Accessing the site is accomplished by using the link at www.medicare.gov and following the options. An eligibility worksheet is available for participants. Generally, anyone on Medicare Part A or B is eligible. If an individual's income is under $12,569 (single) or $16,862 (married couple), he can enroll for both a $600 credit toward prescription drug purchases and a discount card. If an individual's income is over these amounts, only discount card enrollment is available. Some card providers allow enrollment over the phone, while others require completion of paper forms.

Note. The author of this chapter assisted a client by securing a free discount card that saved the client more than $20 per month on two drugs for Type 2 Diabetes ($114–$193). The client related that he found similar pricing with a discount drug wholesaler in Florida, and that Canadian prices might be even less expensive. However, the client was pleased to find an 18.5% discount with his local pharmacy, especially since the discount card was free.

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Example 1. A Typical Enrollment Process. Donald receives a letter from Medicare announcing discount prescription drug benefits. It briefly explains the new benefits and directs him to contact either Medicare's toll-free number at 800-633-4227 (800-MEDICAR), a state health insurance assistance program (SHIP) (the IL SHIP's toll-free number is 800-548-9034), or Medicare's website (www.medicare.gov).

Donald chooses to use the website. There he finds information in the form of fact sheets and explanations. There are approximately 300 pages of information that Donald can read and print from Medicare's website.

Donald reads enough to realize that his next step is to click on the hyperlink of a list of approved cards for Donald's area that gives a price comparison. He enters his zip code and chooses the drugs he takes for his diabetes. He is directed to a list of available cards that cover his prescriptions. The list contains many cards, with significant variations in the cost of the drugs and the card.

In Donald's case, the greatest discount is from a card which happens to be free. Two other cards on the list provide similar discounts, but cost $25 and $30. The website allows Donald to check a box for a closer comparison of prices for a month's supply of his prescriptions and the distance from the individual's home. He does this for the three cards that produce the greatest discounts. The result is a list of local pharmacies within the radius he specified, with pricing information for each. For Donald, the top three cards produce 33, 16, and 31 participating local pharmacies. The list includes Donald's existing pharmacy. For the free card, Donald's drugs will cost between $93.08 to $94.87 at the 33 area pharmacies. His bill last month was $114.59. Since the card is free, there appears to be no downside. Donald enrolls by calling the supplied toll-free number.

It takes 10 minutes for Donald to enroll over the phone. He is asked personal information, including his date of birth, Social Security Number and Medicare number. With all of the information provided, Donald is advised that his card will be mailed to him within five days.

In addition, Donald is asked a series of questions about his medical condition and whether he uses certain products. Donald gets the impression he is providing marketing information. Donald is concerned that enrolling with a discount card provider may subject him to the risk of identity theft or exposure to fraud.

Donald receives a call from his card provider less than three hours after applying for his discount card. He is asked about his Medicare supplement provider and is offered a new blood testing meter for his diabetes on a 90-day trial offer, which he accepts.

Less than one week later, Donald receives an Assignment of Benefits Form in the mail. It provides authorization for Medicare to make payments directly to the discount card provider or to directly bill his supplemental insurance provider. This also includes a written agreement indicating Donald would pay everything not covered by Medicare or the supplement. In short, it has Donald set to transfer his entire drug and supplies business to his discount card provider, guarantees payment, and allows a release of his medical information to anyone the card provider believes is necessary.

Caution. It is strongly recommended that individuals confine card choices to those approved by Medicare and listed on their website. As shown in the example, as a marketing tool, these cards may be a bonanza for those offering them.

Example 2. Use the same scenario as **Example 1** except, Donald's income is below $12,659. He can also enroll in the program that provides $600 of free drug coverage for the remainder of 2004. This program is renewable for the same amount of coverage in 2005. Unused coverage for 2004 may be carried to 2005.

Note. Those already having drug coverage from Medicaid, TRICARE for Life or an employer-group health plan are not eligible for the $600 of free drug coverage.

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Drug Coverage in 2006

There are changes scheduled to occur in 2006. These are subject to change and will be discussed in later workbooks.

MEDICARE ADVANTAGE PLAN CHOICES EXPANDED

Medicare Advantage Plans (formerly Medicare + Choice) are alternatives to traditional Medicare. With these plans, the government makes comprehensive payments to the providing organization that assumes responsibility for all of the enrollee's medical care. Beginning in 2004, the new law expands the choices available for these alternatives, mainly HMO and PPO plans, to include regional Preferred Provider Organization (PPO) plans. These PPOs are quite common and popular with working Americans and help the participant save money choosing from doctors and providers on the plan's "preferred list." They do not normally require the worker to get a referral. Their popularity, in addition to government financial incentives focused on improved rules and benefits is an inducement for both retirees and providers to use these plans.

> **Note.** The Medicare + Choice alternatives have been offered for several years, but have seen limited acceptance. This is disappointing to those who would like to encourage the shifting of the government's Medicare role to the private sector. With a projected future deficit estimated in the tens of trillions of dollars, shifting this responsibility is a high priority of those who wish to limit government spending.

IMPROVED PREVENTATIVE BENEFITS

Starting in 2005, Medicare recipients will receive preventative benefits, including:

- A one-time initial wellness exam within six months of enrolling in Medicare Part B,
- Screening blood tests for early detection of cardiovascular (heart) disease, and
- Diabetes screening tests for Medicare enrollees at risk of diabetes.

These benefits add to the preventative services already covered by Medicare, including cancer screenings, bone density measurements, and vaccinations.

FEDERAL SUBSIDIES FOR PRESCRIPTION DRUG PLANS

The Medicare Reform Act provides billions of dollars of subsidies to businesses who offer prescription drug plans to their retirees. This is primarily a provision that affects large businesses and has become controversial in that the subsidies are payable even if the majority of the cost is borne by the employee. The Medicare Reform Act also excludes these subsidies from the incomes of the businesses.

SOCIAL SECURITY TAXATION

As a result of the 1983 Social Security Reform Act, social security income becomes taxable when half of the worker's social security income plus all other "provisional income" exceeds $25,000 (single filers), and $32,000 (married, filing jointly). "Provisional income" also includes municipal bond interest and similar nontaxable income, with all income reported on line 22 of Form 1040.

The amount of "provisional income" taxed is the lesser of:

1. Half of the "provisional income" over the threshold amount, or
2. Half of the social security benefits received, provided that the "provisional income" does not exceed $34,000 (single filers) or $44,000 (married, filing joint).

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The $34,000 and $44,000 thresholds were added by OBRA ’93. If these levels of income are reached, 85% of social security income may be taxable. If the taxpayer’s income is high enough, the 50% rate for conversion to taxability phases out, requiring 85% of the social security income received to be included as taxable income. The actual amount of benefits subject to tax is the lesser of:

1. 85% of social security benefits received, or
2. 85% of income over the higher OBRA ’93 threshold, plus the smaller of:
   a. $4,500 (single filers) or $6,000 (married, filing jointly), or
   b. 50% of the social security income received.

Beginning in 2000, 15 states also taxed social security benefits. They include: Colorado, Connecticut, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Rhode Island, Utah, Vermont, West Virginia, and Wisconsin. Some of these states tax social security in lesser amounts. Wisconsin and Iowa do not require the higher ’93 OBRA thresholds for 85% taxability. Other states have state schedules similar to the Federal Schedule R that allow social security to be deducted as part of a retirement income exemption. Minnesota, Colorado, New Mexico, Utah, and West Virginia fall into this category.

Social security taxability has become a burden for many retirees. The $32,000 income threshold, established in 1983, for making 50% of an individual’s social security benefits taxable, has shrunk to near poverty levels, especially when that threshold includes half of an individual’s social security benefits. In 1984, only 8% of social security recipients saw any of their benefits taxed. This figure has increased to over 36% in 2004.

For retirees of middle class means or better, taxation of their social security benefits is essentially automatic. However, for some, this may be an area of personal taxation that merits attention. Those with the ability to manage their income downward will see a double benefit. Lowering income to a level where social security benefits are not taxed also saves tax dollars on the income that has been managed downward.

Managing Income Downward

A basic goal to decrease taxability of benefits is lowering adjusted gross income (AGI) for social security recipients. This may be accomplished by any normal means of tax planning for taxpayers who have a degree of control. Taxpayers such as these that still own a business, may be able to shift taxable income to nontaxable forms, or may be able to adjust the mix of dollars used for their income needs. Here are some options to consider.

For Those in Business. To manage income downward, business owners might consider:

- Bunching income and deductions to alternate high and low years.
- Taking all available deductions. This involves closely tracking expenses and mileage, and using a home office if allowable.
- Paying a spouse involved in the business a wage and starting an IRC §105 plan to deduct all medical expenses for both spouses.
- Establishing a health savings account for the owner and spouse (if employed).
- Forming an entity to manage taxes and provide fringe benefits, especially if single and a spousal IRC §105 plan is appropriate.
- Using IRC §179 on purchases, possibly vehicles with gross vehicle weight over 6,000 pounds.
- When selling a business, structuring the sale to minimize taxes by using favorable allocations and lower monthly payments through installment sales, and so on.

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- Using pension options, such as the new individual 401(k), which, as a qualified plan, allows contributions after age 70½, and individual retirement arrangements (IRAs), as well as pension contributions if income is below the threshold for deductibility.

For Wage Earners. To manage income downward, individual wage earners might consider:

- Maximizing use of pre-tax medical spending account options.
- Using the new health savings accounts, if available.
- Using deferred compensation plans, if available.
- Using traditional IRAs, if AGI and age allows them to be deductible. This option is especially effective if AGI falls below $50,000 (for married, filing jointly) or $25,000 (for single filers). At these levels, the saver's credit is an added bonus, producing tax savings of over 50% of contributions in some cases.
- Using elective pension plans, such as SIMPLEs, 401(k)s, 403(b)s, or 457 plans.

Other Options. Options for lowering income include:

- Taking investment losses by selling after-tax investments to trigger recognition. Losses can erase capital gains income and provide a net capital loss of $3,000 per year to offset other income.
- Drawing down nonretirement plan investments and leaving taxable distributions for later, or bunching IRA distributions into one year (assuming the taxpayer is age 70½) if tax brackets allow.
- Choosing after-tax investments with high tax efficiency, such as mutual funds with low turnover ratios, or stocks that don't pay dividends.
- Prior to drawing social security benefits, converting traditional IRAs to Roth IRAs so withdrawals during retirement don't raise income and increase social security taxability. In some cases, the conversions may not produce added tax since credits or business losses may offset the recognition of income.
- Evaluating whether to contribute to a tax-deferred retirement account or a Roth IRA. A close look at the Roth 401(k) option is merited when it becomes available in 2006.

As a practicality, these moves only work for those with very moderate levels of income. Some will not fit certain taxpayers because of unique circumstances. Taxpayers whose AGI is higher may be able to lower the taxable percentage of their social security benefits from 85% to 50% by some of these strategies. For those with higher incomes, these strategies are still worth considering because they may make excellent tax sense independent of the social security issue.

> **Note.** Currently, 36% of senior citizens see their social security benefits taxed. This is estimated to increase to 40% by 2014. Since the thresholds are not indexed for inflation, the total tax increases as a share of total benefits.

FILING REQUIREMENTS FOR FORM 5500

The Employee Retirement Income Security Act (ERISA) was passed in 1974. It governs employee benefits. Title I of ERISA includes Department of Labor (DOL) provisions concerning reporting and disclosure, participation, vesting, funding, fiduciary responsibilities, and enforcement and administration. Title II of ERISA contains tax provisions.

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Title III involves jurisdictional provisions and establishes the responsibilities of the two federal agencies which administer and enforce ERISA, namely, the IRS and the DOL. The IRS is concerned with participation, vesting, and funding issues and enforces compliance primarily through tax disqualification and by imposing excise taxes. The DOL primarily is concerned with reporting, disclosure, and fiduciary issues and enforces compliance by assessing fines, and filing civil or criminal actions. It also has responsibility in the nonqualified plan area for issues similar to those of the IRS regarding qualified retirement plans.

The form used to report information to the IRS is Form 5500, *Annual Return/Report on Employee Benefit Plan.* It must be filed every year for every pension benefit plan, welfare benefit plan, and for every entity that files as a Direct Filing Entity (DFE) as specified below (IRC §6058 and ERISA sections 104 and 4065). Some taxpayers have pension plans or benefit plans that are exempted from these filing requirements, or qualify for filing the simpler 5500EZ. These are described, in addition to the guidance provided by the IRS Form 5500 instructions.

Pension Benefit Plans

All pension benefit plans covered by ERISA are required to file Form 5500, except as described below. The return/report is due whether or not the plan is qualified. The report is due even if benefits no longer accrue, contributions were not made during the plan year, or contributions are no longer made. Both defined benefit plans and defined contribution plans are required to file Form 5500.

Form 5500 Is Required. The Form 5500 is required for the following:

1. Profit-sharing, stock bonus, money purchase, 401(k) plans, and so on.
2. Annuity arrangements under IRC §403(b)(1).
3. Custodial accounts, established under IRC §403(b)(7), for regulated investment company stock.
4. IRAs established by an employer under IRC §408(c).
5. Pension benefit plans, maintained outside the United States, primarily for nonresident aliens, if the employer who maintains the plan is a:
    - Domestic employer, or
    - Foreign employer, with income derived from sources within the United States (including foreign subsidiaries of domestic employers), if contributions to the plan are deducted on its U.S. income tax return.
6. Church pension plans electing coverage under IRC §410(d).
7. Pension benefit plans that cover residents of Puerto Rico, the U.S. Virgin Islands, Guam, Wake Island, or American Samoa. This includes a plan that elects to have the provisions of section 1022(i)(2) of ERISA apply.
8. Plans that satisfy the Actual Deferral Percentage requirements of IRC §401(k)(3)(A)(ii) by adopting the "SIMPLE" provisions of §401(k)(11).

Form 5500 Not Required. The Form 5500 is not required for the following:

1. An unfunded excess benefit plan. See ERISA section 4(b)(5).
2. An annuity or custodial account arrangement under IRC §§403(b)(1) or (7) not established or maintained by an employer, as described in DOL Regulation 29 CFR 2510.3-2(f).
3. A Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) that involves SIMPLE IRAs under IRC §408(p).
4. A simplified employee pension (SEP) or a salary reduction SEP described in IRC §408(k) that conforms to the alternative method of compliance in 29 CFR 2520.104-48 or 2520.104-49.

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5. A church plan not electing coverage under IRC §410(d).
6. A pension plan that is a qualified foreign plan, within the meaning of IRC §404A(e), that does not qualify for the treatment provided in IRC §402(e)(5).
7. An unfunded pension plan for a select group of management or highly compensated employees that meets the requirements of 29 CFR 2520.104-23, including timely filing of a registration statement with the DOL.
8. An unfunded dues financed pension benefit plan that meets the alternative method of compliance provided by 29 CFR 2520.104-27.
9. An IRA, or annuity not considered a pension plan under 29 CFR 2510.3-2(d).
10. A governmental plan.

Most of the common pension plans used by farms and small businesses are not required to file Form 5500. These include SEPs, SARSEPs, SIMPLEs, and the recently introduced Individual 401(k)s, if their balances, including rollovers, are under $100,000. These latter plans do not come under ERISA, unless they include an employee who is not an owner or owner's spouse.

Welfare Benefit Plans

Welfare benefit plans provide benefits such as medical, dental, life insurance, apprenticeship and training, scholarship funds, severance pay, disability, and so on. All welfare benefit plans covered by ERISA are required to file a Form 5500, except as provided in this section.

IRS Notice 2002-24 does not suspend the filing of Form 5500, or any required schedules for a welfare plan subject to Title I of ERISA. Welfare plans that are associated with fringe benefit plans must file the Form 5500 in accordance with welfare benefit plan filing requirements, unless they are exempt as specified below. Welfare plans for which a Form 5500 must be filed may be eligible for limited filing requirements.

Form 5500 Not Required. The Form 5500 is not required for the following:

1. A welfare benefit plan that covers fewer than 100 participants, as of the beginning of the plan year, and is unfunded, fully insured, or a combination of insured and unfunded.

> **Note.** A "voluntary employees' beneficiary association," as used in IRC §501(c)(9) ("VEBA"), should not be confused with the employer or employee organization that sponsors the plan.[5]

   a. An unfunded welfare benefit plan has its benefits paid as needed directly from the general assets of the employer or employee organization that sponsors the plan. An IRC §105 plan would fall under this category.

   b. Plans that are **not** unfunded include those that received employee (or former employee) contributions during the plan year, and/or used a trust or separately maintained fund (including an IRC §501(c)(9) trust) to hold plan assets or act as a conduit for the transfer of plan assets during the year. However, a welfare plan with employee contributions that is associated with a fringe benefit plan under IRC §125 may be treated for annual reporting purposes as an unfunded welfare plan if it meets the requirements of DOL Technical Release 92-01, 57 Fed. Reg. 23272 (June 2, 1992) and 58 Fed. Reg. 45359 (August 27, 1993).

5. ERISA §3(4)

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c. A fully insured welfare benefit plan has its benefits provided exclusively through insurance contracts or policies, the premiums of which must be paid directly to the insurance carrier by the employer or employee organization from its general assets or partly from its general assets and partly from contributions by its employees or members (which the employer or employee organization forwards within three months of receipt). The insurance contracts or policies discussed above must be issued by an insurance company or similar organization (such as Blue Cross/Blue Shield or a health maintenance organization) that is qualified to do business in any state.

2. A combination unfunded/insured welfare plan has its benefits provided partially as an unfunded plan and partially as a fully insured plan. An example of such a plan is a welfare benefit plan that provides medical benefits as in (a) above and life insurance benefits as in (b) above.[6]

3. A welfare benefit plan maintained outside the United States primarily for persons substantially all of whom are nonresident aliens.

4. A governmental plan.

5. An unfunded or insured welfare plan for a select group of management or highly compensated employees which meets the requirements of 29 CFR 2520.104-24.

6. An employee benefit plan maintained only to comply with workers' compensation, unemployment compensation, or disability insurance laws.

7. A welfare benefit plan that participates in a group insurance arrangement that files a Form 5500 on behalf of the welfare benefit plan as specified in 29 CFR 2520.103-2.[7]

8. An apprenticeship or training plan meeting all of the conditions specified in 29 CFR 2520.104-22.

9. An unfunded dues-financed welfare benefit plan exempted by 29 CFR 2520.104-26.

10. A church plan under ERISA section 3(33).

11. A welfare benefit plan solely for (1) an individual or an individual and his or her spouse, who wholly owns a trade or business, whether incorporated or unincorporated, or (2) partners or the partners and the partners' spouses.[8]

Form 5500 Filing Requirements for Flexible Spending Plans

A 2001 IRS announcement stated that employers are no longer required to file Form 5500 and Schedule F for cafeteria plans, educational assistance plans, and adoption assistance programs. Prior to the IRS change, all employers with a flexible benefits plan, regardless of the size of the group or number of participants, were required to complete Form 5500 and Schedule F.

Flexible benefit plans are programs that include any of the following, or a combination thereof:

- Pre-tax premiums, or premium only plans (POP)
- Spending accounts
- Full flex plans that offer choices among various levels of coverage

6. 29 CFR 2520.104-20
7. 29 CFR 2520.104-43
8. 29 CFR 2510.3-3(b)

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Flexible benefit plans are considered fringe benefit plans. Therefore, the requirement of filing the annual return was specified under IRC §6039D. Employers sponsoring POP and dependent care flexible spending account plans are no longer required to file. In fact, the IRS does not require past filings for those who never filed or who were late to file.

Employers sponsoring plans that include a health care flexible spending account arrangement may still be required to file Form 5500, excluding Schedule F, if the health care flexible spending account has more than 100 employees participating in the plan.

Direct Filing Entity (DFE)

Some plans participate in certain trusts, accounts, and other investment arrangements. These plans file the Form 5500 as a DFE, in accordance with the DFE filing requirements.

A Form 5500 must be filed for a master trust investment account.

A Form 5500 is not required but may be filed for a common/collective trust (CCT), pooled separate account (PSA), 103-12 investment entity (103-12 IE), or group insurance arrangement (GIA). However, plans that participate in CCTs, PSAs, 103-12 IEs, or GIAs that file as DFEs generally are eligible for certain annual reporting relief. For reporting purposes, a CCT, PSA, 103-12 IE, or GIA is not considered a DFE unless a Form 5500 and all required attachments are filed for it in accordance with the filing requirements.

Small businesses or farms are highly unlikely to have a DFE of any type.

Requirements for Filing 5500-EZ

The plan may file Form 5500-EZ, *Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan*, if it provides deferred compensation solely for:

- An individual, or an individual and his spouse who wholly own a trade or business, whether incorporated or unincorporated, or
- Partners, or the partners and the partners' spouses involved in a partnership.

Form 5500-EZ may be filed if the plan:

1. Satisfies the minimum coverage requirements of IRC §410(b), without being combined with any other plan maintained by the employer,
2. Does not cover a business that is a member of a "controlled group," and
3. Does not cover a business for which leased employees (as defined in IRC §414(n)(2)) perform services.

For this purpose, a "controlled group" is a controlled group of corporations under IRC §414(b), a group of trades or businesses under common control under IRC §414(c), or an affiliated service group under IRC §414(m) that includes the business of the owner or partner covered by the plan.

A plan that fails to meet any of the above conditions must file Form 5500, rather than Form 5500-EZ. If the plan (and any other plans of the employer) had total assets of $100,000 or less, at the end of every plan year beginning on or after January 1, 1994, it is exempt from filing either Form 5500-EZ or 5500.

> **Note.** Many pension plans belonging to farmers have total assets under $100,000. Unless the farmers do something unusual, such as a rollover, they are exempt from filing Form 5500.

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Many helpful websites are available on employee benefit filing. Some of them are:

- **Form 5500 Filing Tips, IRS** (www.irs.gov/retirement/article/0,,id=110293,00.html)
- **Troubleshooter's Guide, DOL** (www.dol.gov/EBSA/PDF/troubleshootersguide_pt1.pdf)
- **Reporting and Disclosure Guide for Employee Benefit Plans, DOL** (www.dol.gov/ebsa/pdf/rdguide.pdf)
- **ERISA Filing Acceptance System, DOL** (www.efast.dol.gov)

RETIREMENT FUNDING: LIFE INSURANCE AND ANNUITIES

Using life insurance as a part of a retirement plan is often confusing to tax preparers. This section attempts to answer some of the questions commonly asked by preparers.

There are two methods under which life insurance and annuities may be utilized as a vehicle for retirement funding. One method is within a qualified retirement plan such as a profit sharing plan or a 401(k) plan. The other is under a nonqualified arrangement.

This section discusses the benefits and pitfalls of utilizing annuities, as well as cash-value life insurance, as a retirement income-generating vehicle under both scenarios.

Note. The explanations given in this section regarding taxation of life insurance assumes that the owner of the policy is an individual (not a trust or corporation) and that the policy is not a modified endowment contract. A modified endowment contract is a cash-value life insurance policy that does not pass a seven-pay test. The "seven-pay test" is based upon a cumulative amount of premium paid into the policy in its first seven years and is calculated using the insured's age and the total death benefit of the policy. If the premiums paid in the first seven years exceed this limit, the contract may fail the test and will not receive all of the tax benefits in the following discussion.

NONQUALIFIED LIFE INSURANCE CONTRACTS

Cash-value life insurance has some unique features during the accumulation phase. This period represents the time in which contributions or premium payments are being made or the asset is accumulating (or growing), but there is no intention by the policy owner of withdrawing funds. During this accumulation period, the policy's cash value grows tax deferred. This means that any interest, dividends, or capital gains that are credited to the policy's cash value during the year need not be reported on the income tax return. This is the case whether or not the policy passes the modified endowment contract test.

Taxation of Cash-Value Accumulations and Gains

Taxation of life insurance is governed by IRC §101. If structured properly, the cash value in a life insurance policy may never be taxed. With a life insurance policy, the IRS allows what is called "FIFO (first in first out) treatment." This means the policy owner may withdraw his basis first. Basis equates to the total of contributions made or premiums paid to the contract, minus previous loans or withdrawals. Once the basis is removed, the remaining cash is attributed to the gain or the growth that the policy cash value accumulated over the years. If these dollars are withdrawn from the contract, they are subject to income tax at the policy-owners marginal rate. However, these dollars can be accessed without taxation through the use of policy loans. In order to avoid taxation on contract gains, the following must be in place:

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1. **The policy must NOT be a modified endowment contract.** A modified endowment contract is one which meets the requirements of IRC §7702. In order to qualify, the contract must:
   - Meet certain premium requirements, and
   - Fall within the cash value corridor if the death benefit payable under the contract at any time is at least equal to an applicable percentage of the cash surrender value (see table below).

In the Case of the Insured With an Attained Age as of the Beginning of the Contract Year of:		The Applicable Percentage Decreases by a Ratable Portion for Each Full Year:	
More Than...	**But Not More Than...**	**From...**	**To...**
0	40	250%	250%
40	45	250%	215%
45	50	215%	185%
50	55	185%	150%
55	60	150%	130%
60	65	130%	120%
65	70	120%	115%
70	75	115%	105%
75	90	105%	105%
90	95	105%	100%

2. There must also be **enough cash remaining in the policy so that there is a death benefit** on the date of death (whenever that might be).

Withdrawals Prior to Age 59½

There is no penalty for early withdrawals. Life insurance cash value is not a qualified retirement account; the cash value may be accessed at any time without incurring the 10% early withdrawal penalty.

When life insurance terminates at death, generally the death proceeds are received by the beneficiary tax-free. Because of this, the tax code allows a policy owner to make tax-free loans against the policy's cash surrender value and not be subjected to income taxes. This generally reduces the amount of death proceeds by the amount of the loan. When analyzing life policies to be utilized for cash accumulation and subsequent loans, it is important to look for the loan provisions and the cost of borrowing money in the future. Many contracts allow for loans with a 0% net loan interest rate, making this technique very attractive.

Borrowing Too Much Money from a Life Insurance Policy

If the policy lapses during the insured's lifetime with no cash value, but has outstanding loans, all of the previously borrowed gain is subject to income tax. When taking loans from a policy, it is important to ensure there is enough cash remaining in the contract to maintain a death benefit. However, the death benefit can be less than the original face amount of the policy. This can be achieved by utilizing face amount reductions as the insured gets older.

Note. There are expenses associated with maintaining a death benefit. It is important, when advising clients, to compare the costs associated with maintaining the policy versus surrendering the policy for its cash surrender value and paying income tax on the gain in the cash value accumulation.

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Example 3. John contributes $26,349 to his life insurance contract per year for twenty years for a total of $526,980. The net benefit of the life insurance plan is $500,000 plus net policy account. In the twenty first year of his contract, John is 66 years old and decides to withdraw $700,000 as a loan. John's policy lapses when he turns 85 years old. If John did not repay the loan prior to turning 85, the difference between the loan and his contributions ($173,020) is taxable as ordinary income.

Policy Year	Age	Annualized Premium Payment	Loans or Withdrawals	Net Policy Account	Net Cash Surrender Value	Net Death Benefit
1	46	$26,349	$ 0	$ 24,867	$ 12,817	$ 524,867
2	47	26,349	0	51,105	39,055	551,105
3	48	26,349	0	78,989	66,939	578,989
4	49	26,349	0	108,114	96,064	608,114
5	50	26,349	0	138,536	126,486	638,536
6	51	26,349	0	170,306	159,059	670,306
7	52	26,349	0	203,508	193,064	703,508
8	53	26,349	0	238,189	228,549	738,189
9	54	26,349	0	274,415	265,579	774,415
10	55	26,349	0	312,244	304,211	812,244
11	56	26,349	0	351,737	344,507	851,737
12	57	26,349	0	392,962	386,535	892,962
13	58	26,349	0	436,001	430,378	936,001
14	59	26,349	0	480,926	476,106	980,926
15	60	26,349	0	527,821	523,804	1,027,821
16	61	26,349	0	576,820	573,607	1,076,820
17	62	26,349	0	628,024	625,614	1,128,024
18	63	26,349	0	681,547	679,940	1,181,547
19	64	26,349	0	737,504	736,701	1,237,504
20	65	26,349	0	795,945	795,945	1,295,945
21	66	0	700,000	97,417	97,417	597,417
22	67	0	0	98,656	98,656	598,656
23	68	0	0	99,615	99,615	599,615
24	69	0	0	100,251	100,251	600,251
25	70	0	0	100,507	100,507	600,507
26	71	0	0	100,333	100,333	600,333
27	72	0	0	99,675	99,675	599,675
28	73	0	0	98,473	98,473	598,473
29	74	0	0	96,660	96,660	596,660
30	75	0	0	94,155	94,155	594,155
31	76	0	0	90,824	90,824	590,824
32	77	0	0	86,366	86,366	586,366
33	78	0	0	80,619	80,619	580,619
34	79	0	0	73,404	73,404	573,404
35	80	0	0	64,518	64,518	564,518
36	81	0	0	53,903	53,903	553,903
37	82	0	0	41,399	41,399	541,399
38	83	0	0	26,809	26,809	526,809
39	84	0	0	9,922	9,922	509,922
40	85	0	0			

Note. The net amount of risk to the insurance company remains level at $500,000 after loans and withdrawals ($700,000) are taken in year 21. The policy lapses at age 85.

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Example 4. Use the same facts as **Example 3** except, John's net death benefit is $100,000 plus net policy account. John's policy does not lapse at age 85. The policy is able to stay in force, leaving the $700,000 withdrawal and loan, as well as the inevitable death benefit, income-tax free to the policy owner, and to his beneficiaries.

Policy Year	Age	Annualized Premium Payment	Loans or Withdrawals	Net Policy Account	Net Cash Surrender Value	Net Death Benefit
1	46	$26,349	$ 0	$ 24,867	$ 12,817	$ 524,867
2	47	26,349	0	51,105	39,055	551,105
3	48	26,349	0	78,989	66,939	578,989
4	49	26,349	0	108,114	96,064	608,114
5	50	26,349	0	138,536	126,486	638,536
6	51	26,349	0	170,306	159,059	670,306
7	52	26,349	0	203,508	193,064	703,508
8	53	26,349	0	238,189	228,549	738,189
9	54	26,349	0	274,415	265,579	774,415
10	55	26,349	0	312,244	304,211	812,244
11	56	26,349	0	351,737	344,507	851,737
12	57	26,349	0	392,962	386,535	892,962
13	58	26,349	0	436,001	430,378	936,001
14	59	26,349	0	480,926	476,106	980,926
15	60	26,349	0	527,821	523,804	1,027,821
16	61	26,349	0	576,820	573,607	1,076,820
17	62	26,349	0	628,024	625,614	1,128,024
18	63	26,349	0	681,547	679,940	1,181,547
19	64	26,349	0	737,504	736,701	1,237,504
20	65	26,349	0	795,945	795,945	1,295,945
21	66	0	700,000	99,595	99,595	199,595
22	67	0	0	103,335	103,335	203,335
23	68	0	0	107,161	107,161	207,161
24	69	0	0	111,066	111,066	211,066
25	70	0	0	115,046	115,046	215,046
26	71	0	0	119,093	119,093	219,093
27	72	0	0	123,203	123,203	223,203
28	73	0	0	127,367	127,367	227,367
29	74	0	0	131,577	131,577	231,577
30	75	0	0	135,822	135,822	235,822
31	76	0	0	140,074	140,074	240,074
32	77	0	0	144,264	144,264	244,264
33	78	0	0	148,356	148,356	248,356
34	79	0	0	152,316	152,316	252,316
35	80	0	0	156,101	156,101	256,101
36	81	0	0	159,708	159,708	259,708
37	82	0	0	163,107	163,107	263,107
38	83	0	0	166,259	166,259	266,259
39	84	0	0	169,121	169,121	269,121
40	85	0	0	171,648	171,648	271,648

Note. By reducing the net amount at risk to the insurance company to only $100,000, the policy is able to stay in force after age 85.

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Tax Trap: Policy Endows or Matures at Age 100

With advances in modern medical science, there are more individuals living beyond age 100. If a policy endows or matures, the owner receives the policy cash value at that time. If this occurs and there is gain in the policy, it is considered a taxable distribution to the extent the cash value exceeds the total of all premium payments.

This situation creates a potential pitfall to the technique of utilizing withdrawals and loans from life insurance cash values to generate a tax-free retirement income. It is especially true if the client has a family history of longevity or is likely to live beyond age 100. The individual who has been taking tax-free loans from his policy for 20–30 years, and turns age 100 may be exposed to a tremendous tax liability. The taxpayer must pay tax on all the gain that has been removed from the cash value. This could create a situation in which there is not enough cash remaining in the policy to pay the tax.

Note. In **Example 4,** John's policy will remain in force well past age 100.

How can this pitfall be avoided? In order to understand the answer to this question, it is helpful to have a clear understanding of the difference between a life insurance policy that **endows** at age 100 and a life insurance policy that **matures** at age 100.

Endowment means that the policy is structured in such a way that under the guaranteed provisions of the contract, the cash value will be equal to the face amount at age 100. This means that the policy's premium is calculated by taking into account the guaranteed maximum costs associated with the contract (costs include mortality and expense charges) and the guaranteed minimum credited interest on the cash value (typically 4% in this type of policy). These factors are used to determine the amount needed to go into the cash value account to guarantee that the cash value will grow to equal the initial face amount when the insured turns age 100. Because these calculations are based on guarantees and not the current environment, policies often endow with more money in the cash value than reflected in the initial face amount.

The downside of an endowment contract (commonly whole life) is that since it must endow, the calculated premium is rigid (scheduled premium must be paid) and often quite expensive in relation to other forms of coverage. The benefit is that this type of policy often provides strong guarantees and the assurance that the policy will not lapse or require additional premium dollars to stay in force. However, the insured must pay the scheduled premium.

The alternative to an endowment type contract is a policy that **matures.** The difference here is that the cash value at age 100 in a policy that matures can be any amount. The policy is structured in such a way that all that has to happen during the accumulation phase is that the premiums or the cash value be adequate to cover the internal charges of the policy. At age 100, a check in the amount of the policy's cash surrender value is written to the policy owner, but there is no preconceived notion that the cash value be equal to any amount, let alone being equal to the initial face amount. To the extent that the policy surrender value at maturity plus previous loans and withdrawals exceed the basis, the gain is subject to tax at the ordinary income tax rates of the owner.

In order to help avoid this contingency, many insurers have implemented a provision called the "Extended Maturity Rider" into their contracts that mature. These are typically Universal Life or Variable Universal Life policies. The extended maturity rider provision extends the maturity to well beyond age 100. In some cases, the insurer will provide that the mortality expense be waived during this time period helping to guarantee that when the policy terminates at death it will be tax-free. Without the rider, the policy is potentially taxable at maturity. In addition, a policy that matures provides more flexibility to the premium payer. He can pay more or less premium in any given year during the accumulation phase.

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Tax Deduction for Premium Payments

If taxpayers could deduct the premiums they pay for life insurance it would be too good to be true. Imagine tax deferred growth, tax-free income through structured withdrawals and loans, tax-free death benefit…AND deductible premiums. Unfortunately, the IRS draws the line here. In most cases, life insurance premiums are paid with after-tax dollars, although there are situations where the IRS allows a taxpayer to purchase life insurance with pre-tax dollars. One common method can be achieved by purchasing cash-value life insurance inside a company's qualified retirement plan. This changes the rules for accessing the cash value from the policy. The rules regarding life insurance in a qualified plan are discussed first. The following is only a general overview:

1. A qualified plan may have cash-value life insurance as an investment option, provided it is allowed in the plan document.
2. When purchasing life insurance in a qualified plan, it is advisable to consult a professional tax advisor or financial planner regarding the use of policy riders.
3. Life insurance benefits provided by the plan must be "incidental" to the ultimate provision of benefits upon retirement or a plan may lose its favorable tax qualification. This is called the **"Incidental Benefit Rule."** This rule governs the amount of insurance that may be purchased and is dependent on the type of plan. In a defined benefit plan, the rule is satisfied if the amount of insurance purchased does not exceed one hundred times the projected monthly benefits specified under the plan document. For defined contribution plans, up to 50% of employer contributions can be used to purchase whole life, provided that the plan requires the trustee, at or before the participant's retirement, to either convert the policy to cash, provide the participant retirement income without the life insurance protection, or distribute the policy to the participant. Up to 25% of employer contributions can be used to purchase universal life or variable life.
4. In the U.S. Supreme Court decision of *Norris vs Arizona*, it was established that employment based benefits may not discriminate on the basis of sex. Thus all policies must be issued on a unisex basis. This is the **"Unisex Requirement."**
5. The plan trustees, on behalf of the plan, must be listed as the policy owner in trusteed plans.
6. Most qualified retirement plans are subject to the **"Retirement Equity Act"** rules. These rules specify that plan participants, if married, must name their spouse as sole beneficiary of their qualified plan benefits.
7. If the insured plan participant is given the right to name the beneficiary, this represents an incidence of ownership. In order to maintain the tax-free status of death proceeds received from life insurance, the insured must show the economic benefit or one-year term cost, of the pure death protection in his taxable income. This cost is found in IRS Notice 2001-10, Table 2001.

Taxation of Cash-Value Life Insurance Owned by a Qualified Plan Taxed

Generally, the distribution of a cash-value policy to the insured at retirement is taxed to the insured to the extent of the cash value minus basis term costs, assessed throughout the life of the contract or nondeductible contributions made to the plan. This cost is found in IRS Notice 2001-10, Table 2001. This tax may be further deferred by either purchasing the policy from the plan at retirement for its cash value or by rolling the policy to an annuity within 60 days of distribution.

> **Note.** For estate-planning purposes, the taxpayer could consider having an irrevocable life insurance trust purchase existing life insurance policies from a qualified plan at retirement.

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RETIREMENT INCOME THROUGH ANNUITIES

An annuity is a contract issued by an insurance company, which will accomplish either of the following:

1. Accumulate and grow an investment on a tax-deferred basis as in a single premium deferred annuity (SPDA).
2. Provide a guaranteed amount of income for either a specified period of years, for the lifetime of an individual or joint individuals, or some combination of life income with a period certain provision. These types of annuities are called single premium immediate annuities (SPIA).

Whether an SPDA or an SPIA is selected, there are two fundamental types of annuity contracts. A discussion about some of the hybrid-type contracts is included later in this chapter. There are both fixed-annuity contracts and variable-annuity contracts.

Fixed Annuity

When investing in a fixed annuity, a person is usually investing in the general account of the insurance company issuing the contract. Insurance companies provide a fixed rate of return on the investment for a specified period of years. After this specified period expires, the amount of interest credited to the annuity owner's account becomes adjustable and is typically tied to a bond index. Most fixed contracts have a minimum interest rate guarantee, and the insurance company carries the interest rate risk.

These types of contracts are designed for individuals who are either risk averse, or need to know that they will be receiving a specified rate of return from their investment regardless of future interest rate adjustments.

Variable Annuity

In a variable annuity, the investment risk is transferred from the insurance company to the annuity owner. With a variable annuity, the contract owner picks his own investments from a selection of separate accounts. Depending upon the issuing insurance company, these managed accounts provide options such as common stock investments, bonds, mortgage-backed securities, international investments, sector investing, such as health care or technology, and in some cases real estate investment trusts (REITs).

By assuming the risk associated with the investment returns, the annuity owner benefits from the gains of such investments. The potential downside of this arrangement is that if the underlying investments lose value due to a decline in the markets, the annuity owner is risking some of the account's principal.

Taxation of Annuities

The tax advantage of annuities is that as long as there are no withdrawals taken from the contract, and both the owner and the annuitant have not changed, there is no tax assessed for gains or interest payments received during the year. Annuities may also carry the 10% early withdrawal penalty if account values are accessed prior to age 59½.

Once the owner begins to **withdraw** from the account, the withdrawals are given LIFO treatment. To the extent that there is gain in the contract, growth dollars come out first and are subject to ordinary income tax rates in the year of withdrawal. If there is no gain in the contract, withdrawals are considered a return of basis and are not taxable.

When a fixed annuity is "annuitized," it is treated differently for tax purposes. Annuitization occurs when the owner/annuitant releases the right to access the lump sum value of the contract in exchange for an income stream. This income stream is calculated using a specified rate of return and a specified period of years. At the end of the period, all interest and principal is paid in full. If the period of years is the life expectancy of the taxpayer, mortality tables are used. If an individual is taking withdrawals from an annuity in this fashion, an exclusion ratio is calculated by the insurance company, which specifies what portion of the total payout is return of principal and what portion represents interest. Only the portion that represents interest is subject to income tax at the taxpayer's ordinary rates.

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With a variable annuity, the contract can either be converted to a fixed annuity payout or the contract owner may elect a variable annuity payout. Calculating the tax on this type of payment option is a bit more difficult. Payments made under this arrangement are actually similar to RMDs from a qualified plan. In a nonqualified annuity, the insurance company must recalculate at the beginning of the year how much to pay to the owner/annuitant based on the contract value. Then they calculate the amount of each payment that is return of principal, and the amount that is represented by gain. At the end of the year, the insurance company issues a Form 1099 showing the portion of the year's payment that is taxable. The amount depends upon how well the underlying investments performed in the previous year and the number of years of payments remain until the annuity is exhausted. This can be either a specified period or the life expectancy of the annuitant.

10% Penalty for Withdrawals Prior to Age 59½

In order to discourage the use of annuities as a short-term tax shelter, the IRS imposes a penalty for premature withdrawals. This penalty does not apply to distributions:

1. Made on or after the date on which the taxpayer becomes age 59½.
2. Attributable to the taxpayer's becoming disabled.
3. Allocable to investment in the contract before August 14, 1982, including earnings on pre-August 14, 1982 investment.[9]
4. Made from a qualified pension, profit sharing or stock bonus plan, or under a contract purchased by such a plan, or under an IRC §403(b) tax sheltered annuity, or from an individual retirement account or annuity. Such payments are subject to similar premature distribution limitations and penalties.
5. Made on or after the death of the holder or the primary annuitant in the case where the holder is a non-natural person.
6. Made under an immediate annuity contract.
7. Made from an annuity purchased by an employer upon the termination of a qualified plan and held by the employer until the employee's separation from service.
8. Under a qualified funding asset. This includes any annuity contract issued by a licensed insurance company that is purchased as a result of a liability to make periodic payments for damages, by suit or agreement, on account of personal physical injury or sickness.
9. That is part of a series of substantially equal periodic payments made for the life or life expectancy of the taxpayer or the joint lives or joint life expectancies of the taxpayer and his designated beneficiary. These payments must be made at least annually. Payments excepted from the 10% penalty by reason of this exception may be subject to recapture if the series of payments is modified, other than by reason of death or disability, prior to the taxpayer's reaching age 59½, or before the end of a five-year period beginning on the date of the first payment even if the taxpayer has reached age 59½. According to the report of the TRA '86 Conference Committee, the modification that triggers recapture is a change to a method of distribution which would not qualify for the exemption. The tax on the amount recaptured is imposed in the first taxable year of the modification and is equal to the tax, as determined under regulations, that would have been imposed had the exception not applied. Interest is also assessed.[10] The IRS announced that the methods used to avoid the 10% penalty when making substantially equal periodic payments from a qualified retirement plan may also be used to qualify as substantially equal periodic payments from a nonqualified annuity.[11]

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9. Rev. Rul. 85-159, 1985-2 CB 29. See also H.R. Conf. Rep. 97-760 (TEFRA '82) reprinted in 1982-2 CB 685-686
10. H.R. Conf. Rep. No. 99-841 (TRA '86) reprinted in 1986-3 CB Vol. 4 403.
11. Notice 2004-15, 2004-9 IRB 526

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Apparently, if the annuity contract was issued between August 13, 1982 and January 19, 1985 a distribution of income allocable to any investment made 10 or more years before the distribution is not subject to the penalty. For this purpose, amounts includable in income are allocated to the earliest investment in the contract to which amounts were not previously fully allocated.[12] To facilitate accounting, investments are considered made on January 1 of the year in which they are invested.[13]

Note. This section was excerpted from "National Underwriter's Tax Facts" website at www.nucopub.com.

Why Own a Tax-Deferred Annuity in a Qualified Plan or IRA?

Although there are additional fees, including mortality costs and expenses associated with annuity contracts, variable annuities have benefits that are unique, and may be desirable as an investment for qualified plans or IRAs. Some of these benefits include:

1. **A guaranteed interest account.** Many annuities have a separate account, which pays a guaranteed rate of interest that may be very attractive to risk-adverse investors, especially in low interest rate environments.
2. **A guaranteed death benefit**. Many **variable** annuities include a provision that will lock in gains as a death benefit.
3. **Investment company diversification.** Under the separate accounts of many variable annuities, the investor may be allowed to transfer money from one family of funds to another without incurring additional fees.
4. **Guaranteed income stream.** The ability to convert retirement savings to guaranteed life income at retirement.

CALCULATING THE RETIREMENT NEED

It is becoming more common for a client to ask his tax advisor how much money he needs for retirement. Many tax professionals have a difficult time answering this question.

Over the past several years, the demand for individuals who can effectively plan for retirement has grown substantially. With the recent declines in the stock markets, and baby boomers approaching retirement age, the need for expertise and professional guidance in this area is expanding. In order to answer the question "Can I retire?" a retirement planning specialist must first make sure he has all pertinent facts. The information needed to create a plan of action includes:

1. **State of health and family history.** Since so much of the plan is dependent upon how many years retirement will last, it is important that the planner take into consideration the potential life expectancy of the retiree. A life expectancy table can be found on the National Center for Health Statistics website (www.cdc.gov/nchs/fastats/lifexpec.htm) or the Social Security website (www.ssa.gov/OACT/STATS/table4c6.html).
2. **Assumed rate of inflation.** What is the client's assessment of the future of inflation? Most planners use between 3–5% (precise information and a calculator can be found at the U.S. Department of Labor website at www.bls.gov/).

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12. §72(q)(1) prior to amendment by DEFRA §222(a)

13. DEFRA §222(c)

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3. **Lifestyle.** How much does the client need to support his lifestyle? Create a comprehensive budget worksheet the client must complete. Always consider expenses that terminate, such as mortgage payments, unsecured debts, tuition payments for children's education, and so on. However, remind clients that some of these expenses may be replaced by expenses such as gifts, travel, entertainment, charitable tendency, or medical needs.

4. **Projected rate of return on investments.** The length of time that the money lasts may be directly linked to the return on investment. Establishing an investment portfolio that is designed to generate a given rate of return can be complicated and should be handled by a financial professional.

5. **Will they be getting social security benefits, railroad benefits, or teacher's benefits?** If the client expects these benefits, he will have received a statement of benefits. If he has not received the statements, the statements can be requested. Social security benefit requests can be made at www.ssa.gov/mystatement/. It is a good idea to ask about the SE benefits. Some clients who are concerned about the future of the social security system may elect to see how their retirement picture looks without the benefit of these payments.

6. **Assets and liabilities.** What does the client's asset picture look like? Create a personal balance sheet for each client. This should include a list of all assets, their current FMV, their cost basis, any outstanding liens, and how the assets are titled.

7. **Risk tolerance.** What is the client's tolerance to risk? If the planning suggestions are keeping the client up at night due to his risk adversity, then the plan must be changed. It is also important to keep the investment return assumptions in line with the client's risk return attitude.

   There are several ways to assign a tolerance to risk. Some planners like to use the rule, "The allocation of investment assets should be calculated by subtracting their age from 100, and the resulting sum would be equal to the percentage of their portfolio that ought to be allocated to a stock investment, with the balance invested in bonds or cash." While some planners find this approach overly simplistic and lacking flexibility, there are other ways to arrive at an appropriate asset allocation for clients who are approaching or in retirement.

   Most mutual fund families and insurance companies that sell variable contracts issue questionnaires that help investors create a portfolio based on their risk tolerance. These questionnaires tend to create at least three risk categories into which the client can fall. These categories include the Conservative Investor, the Moderate Investor and the Aggressive Investor. This means the planner should not assume a 10% return on investment if the client is a conservative investor. A more realistic assumption for the conservative individual might be 4–6% return over their entire retirement. For a moderate investor assuming 6–8% would be appropriate, and 8–10% might be realistic for the more aggressive investor.

8. **Outside income.** Is there income from other sources? Always ask about pension benefits, land leases, rental property, notes receivable, and imminent inheritances.

Once the information has been obtained, a calculation can be made to assess the need and if the client is financially able to retire.

Calculating the Need

Typing "Calculating the retirement need" into a popular search engine on the Internet resulted in 179,000 hits. The reality is that there are literally thousands of websites that can help with this calculation.

If the planner is adept with a financial calculator, she can make the computation right on the calculator. It is a little more complex and requires several steps, but can be done as long as she takes all of the previously described client information under consideration. Most financial planning organizations have either developed or purchased sophisticated software that can help clients decide whether or not they can afford to retire.

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Note. Planners may want to refer clients to a University of Illinois Extension website, *Plan Well Retire Well* at www.retirewell.uiuc.edu. This site has a number of calculators which allow individuals to plan for their retirement.

CREATING INCOME TO HELP GUARANTEE INCOME FOR LIFE

Once the planner has completed his retirement calculation, he may find that based on his client's total investment asset holdings, tolerance to risk, and age, the likelihood that they will run out of money before they die is high. Now what?

If this happens the client's choices are limited to the following;

1. Live on less
2. Work longer, delay the retirement start date
3. Turn nonincome producing assets into income producing assets
4. Invest more before retirement
5. Invest more aggressively

Reverse Mortgage

If the client selects option three, a popular technique involves using a reverse-mortgage. In order to use a reverse mortgage, the client must own her home or another piece of nonincome producing real estate. Arrangements for the reverse mortgage are made either with a bank, or a mortgage lender.

The most common type of reverse mortgage currently available is called the Home Equity Conversion Mortgage (HECM), and is backed by U.S. Department of Housing and Urban Development (HUD). One reason for the popularity of this type of arrangement is the money may be used for any reason.

It is also possible to make an arrangement with some state and local governments. These arrangements typically specify that the loaned money must be used for a specific reason such as necessary home repairs, or the payment of property taxes. These types of arrangements are only available to homeowners with low or moderate incomes.

The final type of reverse mortgage is called a "proprietary" reverse mortgage. Neither HUD, nor any government agency, funds these types of arrangements. Rather, private investors fund them. The income received from proprietary reverse mortgages may be used for any purpose. This type of arrangement is often more costly, once the fees and interest rates are examined. There are three types of arrangements that can be made:

1. **Monthly income.** Under this arrangement, the homeowner receives a specified amount of income for a specified number of years, typically for life or joint lives of retiree and spouse based on actuarial tables. This gives the retirees the right to stay in their home for as long as they live.
2. **Lump sum.** If this type is elected, the retiree is given a single payment.
3. **Line of credit to be accessed as needed.** This is similar to the lump sum arrangement. With this arrangement, the homeowner can control interest costs by delaying the withdrawal of the lump sums until it's needed.

Regardless of which distribution method is used, the loan is typically not repaid until the death of the homeowner(s). After the death of the homeowner, or the second to die, in the case of joint homeowners, the residence is sold by the estate. All principal and interest must be paid from the sale proceeds. If the property appreciated and there is any excess money after paying the principal and interest, those dollars become part of the estate and may then be distributed to the heirs. More information about reverse mortgages can be found at www.seniorjobbank.org or www.aarp.org.

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Question A. How are proceeds from reverse mortgages taxed?

Answer A. Since reverse mortgages are viewed as a loan, the payments are not taxed.

Question B. Why wouldn't everyone use a reverse mortgage?

Answer B. Unfortunately, reverse mortgages are not the solution for everyone. There are other factors that may make this approach unattractive or unavailable, such as:

1. Not enough equity in the residence,
2. Unattractive interest rate environment,
3. Restrictions made by the lender due to age, purpose, or use of the proceeds,
4. Excessive fees, and
5. The desire to retain the home for the heirs.

Reverse mortgages have their place in planning for retirement income for clients, but they are not for everyone.

A NEW GENERATION OF ANNUITIES

Our current interest rate environment is teaching us a very valuable lesson about planning for retirement income. With investments that provide guarantees such as bank accounts, government bonds, and money markets paying historically low rates of interest, conservative and moderate investors have been forced to search for more creative ways to guarantee income for all retirement years.

According to Ibbotsons,[14] the average annual rate of return on investments over the 78-year period beginning December 31, 1925 and ending December 31, 2003 by sector are as follows (all figures shown are before taxes and inflation):

Small Company Stocks	12.7%
Large Company Stocks	10.4%
Long-term Government Bonds	5.4%
U.S. Treasury Bills	3.7%

This illustrates that if the client wants to guarantee principal and interest on her investment savings by investing in government-backed vehicles, the taxes and inflation alone could very well reduce the principal.

Many insurance companies have responded to this need to invest in equities, but have eliminated much of the downside risk with some very clever annuity contracts. Some examples follow.

Indexed Annuities

With the indexed annuity, the retiree selects an index such as the DOW or the S&P 500. The invested amount is then allocated to that index and the investment follows the index. If the index goes up in value, goes down in value, or stays the same, the investment does likewise. If the underlying investment goes down in value, the insurance company provides a guarantee, typically 3 or 4%. However, if the underlying investment goes up in value, the investor only shares in a percentage of the overall gain. This can range anywhere from 50 to 80%.

14. Ibbotson Associates, *SBBI Decades of Performance Poster*

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Combination Fixed and Variable Annuities

These are very unique and often have many features. Only a broad overview is provided since these are very complex.

The insurer allows the contract owner to select from a series of investment options or separate accounts. These options might include stocks or bonds or a combination of stocks and bonds. Once the principal is invested, the annuitant may withdraw a specified percentage of the assets each year, such as 5 or 6%. This withdrawal amount is guaranteed regardless of how the underlying accounts perform. If the underlying investment exceeds the amount withdrawn, the surplus is available for future withdrawals. If the underlying investments under-perform, the insurance company continues to provide a guaranteed income stream for the remainder of the annuitant's life, guaranteeing that the retiree never runs out of income.

Therefore, as the interest environment changes, there are always options available that allow retirees to guarantee income for life.

THE EFFECT OF DEPLETION ORDER ON RETIREMENT PLANNING

The final thing to consider when planning for a client's retirement is depletion order. For those who have not accumulated enough assets to live on interest alone, the planner must suggest an order in which to deplete assets.

If the client falls into this category, an annuity might be useful. The annuity guarantees that the client does not run out of money in her lifetime. Once annuitized, this asset is no longer part of the depletion order, as it will be depleted through to life expectancy, at which point it is no longer available to heirs.

To the extent possible, the client should retain assets that are tax-deferred for as long as possible. The power of compounding interest, with a little help from the federal government, can be quite meaningful over time. These types of assets include Qualified Plans, a residence, or any real estate investment. These assets also include growth stocks, municipal bonds, collectibles such as art, antiques or jewelry, and cash value life insurance.

If assets must be depleted to meet living expenses, it might make sense to start with cash and savings. With all things being equal (rates of return on investments), by depleting the assets whose interest payments and dividends are exposed to taxes first, the client greatly enhances his chances of retaining a higher level of income for life.

Example 5. Mark is a 65-year-old male. He purchases a single-premium immediate annuity. In the current interest rate environment, he expects to get income of between $650 and $700 per month for the rest of his life, regardless how long he lives.

STRETCH IRAS

A client's concern that he will run out of income producing assets is very real. However, there is a flip side to this concern, and planners have a responsibility to preserve assets for clients where possible. A client may have little or no need to access her qualified retirement savings account. However, the IRS forces taxpayers to take their RMDs beginning at age 70½. When this occurs, the client must take the distribution, and pay the income tax on the distribution. The disadvantage for the client is that her assets are no longer accumulating on a tax-favored basis. If the distribution is not needed to create current income, the re-invested value is potentially worth less to the heirs.

Example 6. Lyla is a 72-year-old widow. She is required to take a $1,000 distribution from her IRA. She is in the 33% tax bracket. She pays the tax and reinvests the remaining $670 in a mutual fund that returns 7% per year. The investment is taxable. The net return on this investment is 5% per year.

Lyla lives 10 more years to age 82. Her mutual fund account is transferred to her heirs when she dies. The unused $670 now is worth approximately $1,090.

If Lyla had been able to keep that $1,000 in her IRA with that same 7% investment, the value to the heirs would be $1,960. This money would be taxable to the heirs. If the heirs are in the same 33% tax bracket, their net inheritance is now $1,320. By keeping that additional $1,000 of income growing on a tax-favored basis for 10 more years, the wealthy individual can leave an additional $220 to her heirs.

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Extending the deferral period can be accomplished by creating what the industry refers to as the **"Stretch IRA"** (also known as the **inherited IRA** or the **multi-generational IRA**).

The extension is created is by naming a younger family member as beneficiary to the owner's IRA. Typically a spouse is named as the beneficiary. When there is no surviving spouse, then children or grandchildren can be named as beneficiaries.

Once a younger income beneficiary is named, RMDs can be calculated based on the life expectancy of the two or more lives. If more than one income beneficiary is named, required minimum distributions are based upon the age of the oldest beneficiary. This lowers the amount of required minimum distributions to the older generation. Once the older generation dies, the beneficiary or beneficiaries must continue to take the RMDs. This continues the tax deferral on the inheritance. Following are some of the advantages and disadvantages of a "Stretch IRA."

ADVANTAGES

1. Smaller RMDs for the older generation.
2. No restrictions on withdrawals. If the IRA owner wishes to make larger withdrawals, he may.
3. In some states, assets that are held in an IRA are protected from the claims of creditors. This means more asset protection for the older generation, as well as the younger generation, since they will continue to take only their RMDs.
4. Provides some level of income for life for the named beneficiaries.

DISADVANTAGES

1. Complex to design.
2. Requires professional assistance to make sure the plan is compliant and meets all of the regulations.
3. The assets in the "Stretch IRA" can create a situation in which income tax on IRA distributions can be effectively deferred to future generations, but the estate tax is still due nine months from the date of death. It is important that the planner verify that there are sufficient liquid assets elsewhere in the estate to cover the estate tax liability.

Another strategy, if there are multiple beneficiaries, is to split the IRAs so there is one IRA per beneficiary. This will create a separate joint life RMD calculation for each account, thus preserving more of the assets for the younger individuals.

RETIREMENT PLANS FOR OWNER-ONLY BUSINESSES

In the past, 401(k) plans were not a viable option for owner-only businesses because salary deferrals were considered to be contributions made by the employer that applied toward the employer's maximum deductible contribution. There was no advantage for the owner-only business to adopt a 401(k) plan instead of a profit sharing plan. In addition, the traditionally high costs associated with administering a 401(k) plan reduced any potential tax benefits.

Recent legislation has changed the benefits of 401(k) plans to owner-only businesses. Owner-only businesses now have an opportunity to defer a significantly greater portion of their income with the introduction of **Owner's 401(k)** and **Owner-Only Defined Benefit Plans.** These plans may also be referred to as a **Solo 401(k)** plans.

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Before discussing 401(k) plans, a review of the traditional choices is appropriate:

- **IRA** — Anyone who has a salary can defer up to 100% of their income or $3,000, whichever is less, for themselves and their spouse. Taxpayers over age 50 may defer an additional $500 in 2004.
- **SIMPLE IRA** — Allows an owner to defer the greater of 100% of salary or $9,000 in 2004. Taxpayers over age 50 may make an additional $1,500 catch-up contribution. In addition, the employer may match an amount equal to the lesser of 3% of salary or the amount of the salary reduction. The maximum allowable salary is $205,000.
- **SEP** — Maximum contributions are limited to 25% of W-2 income, after reductions, or self-employment income. The maximum deferral amount to a SEP in 2004 is $41,000. This increases to $44,000 for individuals age 50 and older.
- **SARSEP** — No new SARSEP plans may be established after December 31, 1996. But, for individuals with SARSEPs already in place, their contributions are limited to the lesser of 25% of W-2 income or $13,000 in 2004. This increases to $16,000 in 2004, if the taxpayer is age 50 or older.

DEFERRAL LIMITS

Owner-Only 401(k)

Under the new legislation, an owner-only business may defer the lesser of 100% of salary or $13,000 in 2004. If the taxpayer is age 50 or older, this increases to $16,000 in 2004. In addition, the employer may make a discretionary contribution to the plan for the benefit of the employee. The overall limit, salary deferral plus employer contributions, may not exceed $41,000 in 2004. Taxpayers age 50 and older have an increased limit of $44,000 in 2004.

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Many high quality mutual fund companies and money managers have packaged these plans in such a way that they have become very cost efficient. Some companies charge as little as $10 per year. If the plan extends to non-owner employees, or if plan assets exceed $100,000, a Form 5500 is required.

Commonly Asked Questions — Owner-Only 401(k)

Question A. Is this plan limited to owner-only businesses?

Answer A. These plans were not designed for businesses with full-time employees other than the owner. However, the plan works well for sole proprietorships, partnerships, and corporations who employ the owner, the owner's spouse, children, parents, or grandchildren.

Question B. When must the plan be established?

Answer B. The deadline for creating an owner-only 401(k) is the end of the plan year, typically December 31.

Question C. How is the employer contribution calculated?

Answer C. The employer may contribute a maximum of 25% of total compensation to the participants in the plan. However, the 25% limit is calculated after salary deferrals have been deducted from salary. Therefore, the net effect is approximately 20% of net profits. It can be deducted. For a C corporation, no deferral deduction is required.

Question D. How much salary is eligible for calculating deferral limits?

Answer D. In 2004, the compensation limit is $205,000.[15]

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15. IRC § 401(a)(17)

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Question E. Are there eligibility requirements?

Answer E. If a small business owner is interested in creating this type of plan, but has "rank and file" employees, the plan may still be viable if the employees:

- Are under the age of 21,
- Work less than 1,000 hours in a year,
- Are nonresident aliens, or
- Belong to a union.

Any of the above classifications render the employee ineligible for participation.

Owner-Only Defined Benefit Plan

These are defined benefit plans that have been packaged in such a way to substantially reduce the annual administrative costs, as well as actuarial fees, for small business with one to five employees.

Under the recent regulations, the deferral limits for defined benefit plan contributions have been increased to $165,000 in 2004. This provides great opportunity for successful business owners to shelter relatively substantial amounts of income, while greatly enhancing their retirement savings picture.

When calculating the amount of the employer contribution to the plan, the employer must take into consideration the employee's current age, age at retirement, and the average of the three highest years of income. Because of this, owner-only defined benefit plans tend to work best with individual business owners who are over age 45, relatively close to retirement age, have no more than five employees, and are interested in contributing more than $40,000 toward their retirement plan.

> **Example 7.** Simon is 55 years old, owns a small business, and plans to retire at age 65. He has an average annual income of $165,000. Simon may be able to contribute as much as $156,000 into a defined benefit plan. If Simon were younger and had the same compensation amount, his contribution amounts would be reduced as shown:[16]

Age	Maximum Contribution
50	$88,611
45	56,068
35	26,088

Commonly Asked Questions — Owner-Only Defined Benefit Plan

Question A. If the company employs more than the owner, what are the eligibility requirements for the "rank and file" employees?

Answer A. All employees are eligible if they work 1,000 hours and are age 21 or over.

Question B. If the employer wants to contribute the maximum $165,000 to benefit the owner-employee, how much must be contributed for the "rank and file" employees?

Answer B. Since the contribution calculation is based upon years to retirement and three years' highest salary, the plan cannot be created based upon a specific dollar amount to be contributed for the benefit of an employee. However, whatever formula is used to calculate the owner-employee's contribution must be consistent with the formula used to calculate contributions made on behalf of "rank and file" employees. Because of this, these types of plans tend to lose their attractiveness if the "rank and file" employees are closer to retirement than the owner-employee.

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16. Calculated on www.aliactuary.com

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Question C. What if the company cannot afford to make the calculated plan contribution?

Answer C. Subject to IRS rules, the contribution amount can be changed simply by amending the plan benefit formula.

Question D. What are the deadlines involved in creating and maintaining this type of plan?

Answer D. The plan must be established prior to the employer's fiscal year-end. Contributions must be made each year prior to the employer's tax filing deadline, plus extensions, not to exceed eight and one-half months from the fiscal year-end.

Question E. What are the fees associated with this type of plan?

Answer E. Because of the actuarial complexity of administering these types of plans, they tend to be at the high end of the administrative cost spectrum. One reason why these plans don't work as well as other plans is when the owner-employee is not likely to defer more than he could in the owner-only 401(k). However, there are several high quality mutual fund families that offer very competitively priced packages for small business owners where the benefits far outweigh the annual fees.

A BRIEF OVERVIEW OF KEY-EMPLOYEE LIFE INSURANCE

Andrew Carnegie once said "take away my factories, my equipment, my money…take everything I own…but leave me my key employees, and in less than five years I will have it all back again."

Business owners typically think of key-employee life insurance as a benefit to the company. However, it can also be used for a retirement benefit when the key-employee retires. The retirement aspect is discussed in **Question E.**

One of the biggest problems that small business owners face is how to protect themselves against the loss of one of their most valuable assets: their key employees. In order for these businesses to succeed in today's competitive marketplace, they must fill positions that encompass several skill sets. Some of the more common positions that are required to make a business viable are:

- An effective sales person, or sales staff,
- An effective administrative person, or staff,
- A research or product development person,
- Team leaders, who are good at motivating and encouraging people,
- Engineers, who are often used by manufacturers to help give them a competitive edge,
- Architects, medical specialists, trainers or educators, and so on.

Businesses may have the need for "key-employee" life insurance. This is a life insurance policy that is owned by and payable to the employer to indemnify the employer against the death of its key people so that the funds are available to find an adequate replacement. This can include any type of insurance, including whole life, universal life, or term.

Employers ask some of these questions when evaluating key-employee insurance:

Question A. Can the employer be a sole proprietor?

Answer A. The employer can be operating as a sole proprietor, a partnership, or a corporation. As long as he can evidence an insurable interest in the employee, the coverage is available.

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Question B. What are the tax ramifications to the employer?

Answer B. The answer to this question depends upon the current phase of the policy:

1. During the accumulation phase, cash value policies continue to accumulate tax-deferred. Currently the employer may access the cash value through policy withdrawals or loans without incurring a tax liability.

> **Note.** This is something that future legislation may change. At the time of this writing, there is talk of making the gains realized in corporate-owned life insurance taxable.

2. Premiums may **not** be deducted by the employer, but the cash surrender value may be shown as an asset of the corporation. This may help the company secure loans if needed.
3. Death proceeds are received tax-free by a sole proprietor, a partnership, or an S corporation, but death proceeds payable to a C corporation may be subject to the alternative minimum tax. Tax preparers should review the AMT guidelines for additional information on how this is calculated.

Question C. Are there any restrictions as to how the employer uses the death benefit once received?

Answer C. No. Presumably the funds are paid directly to the employer/company as a means to cover any shortfall that would occur due to the loss of the key individual. These expenses would include the cost of hiring and training a replacement, as well as revenue lost due to the key individuals absence. If the amount of proceeds received by the employer exceeds the need, the employer may use the balance for any other purpose.

Question D. How do you determine an appropriate amount of coverage?

Answer D. Determining the appropriate amount of coverage to purchase in order to protect a company against the financial hardship experienced after a key employee has died is really more an art than it is a science. There are several different factors that must be taken into consideration when attempting to calculate an appropriate amount of death benefit for each key employee. These areas include loss of:

- Service,
- Profits,
- Credit,
- Competitive edge,
- Customer confidence, and
- Morale.

Working with an experienced financial professional in this area is quite helpful.

Question E. What happens to the life insurance policy if the key employee lives to retire?

Answer E. Since the policy is an asset of the company, it will remain an asset of the company, and the owner or owners have the right to do with the policy as they please. Some choose to distribute the cash to the owners, some choose to retain the policy so that the company may still collect the death proceeds later on, and some use the policy cash values as an additional retirement benefit for the employee. If the cash values are distributed outright to the employee, this may be deductible to the corporation and taxable to the employee as a distribution. If the employer chooses to retain the policy, but make incremental payments to the employee, they may take tax-free withdrawals and loans as explained earlier, and deduct the amount that is paid to the employee as a distribution. The employee is then responsible for the income tax due. If this is structured properly, the employer may also receive the tax-free death benefit.

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