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Continuing Education Self-Study Course

UNDERSTANDING ANNUITY PLANS

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PUBLISHER'S NOTE

Table of Contents

PART I: PLANNING WITH ANNUITIES

CHAPTER 1: THE CONCEPT OF ANNUITY

Overview of Annuities

An annuity is designed to liquidate an estate in a systematic stream of payments. There are annuities that pay out for a specified period of time, there are those that pay for life, some have beneficiaries, and some do not.

Unlike savings accounts where funds can be withdrawn at will, an annuity account is designed to convert a specific sum of money into a series of periodic payments. These may be guaranteed for a specified period of time or for the lifetime or longer of the individual.

The owner may make withdrawals if they choose unless they have chosen a life payout option. An owner may purchase an annuity without choosing the payout option at the time of purchase. The drawbacks to withdrawing money are the fees and taxes. We will discuss these later.

In the event an individual cannot start out with a large sum of money to draw from, annuity programs can be structured to accumulate a specified amount of money before periodic disbursements begin.

Risk Factors of an Annuity

For an individual, an annuity transfers some of the risk of outliving one's funds to an insurance company who, in turn for the premium, guarantees a specified payback over an agreed period of time or the life of the annuitant. The only risk to the annuitant then, is inflation.

As modern medicine expands the life expectancy of individuals, insurance companies can only estimate what this technology will do in extending the average life expectancy, and thus only estimate the risk of payout in any specific annuity contract.

The Structure of an Annuity

Like any other insurance contract, an annuity has an owner, an annuitant (instead of insured) who can be either the same individual or a different individual, and the contract may have a beneficiary.

The common feature of all annuities is an accumulation period and the annuity payout period. The accumulation period begins with the deposit of a premium either by lump sum deposit or monthly installments and such deposits earn interest tax deferred and are compounded within the annuity.

The interest is not taxed as it builds within the annuity, thus compounding the additional retained interest. It is because of this additional benefit that annuities make good sense over a savings account where the interest is taxed as it is earned.

During the payout period, the funds received by the individual are a combination or a "blend" of the deposits and interest which then creates a tax advantage. The premium portion is returned nontaxable as taxes were paid before the money was deposited, the interest is taxed at the client's normal rate. This is assuming the annuity was not in a retirement plan. If that is the case, all the money coming out is taxed since it was tax-deductible on deposit.

Mortality statistic tables help determine the payout for individuals depending on their age and sex at the time of the contract. Annuities, in essence, create a pool of individuals from which some individuals will die early, thus creating "uncollected benefits" and some will outlive the "average" and thus require "extra benefits."

The insurance company is the vehicle that organizes the annuity pool.

Life annuities programs are based on mortality factors and pay an individual for life, even beyond his/her life expectancy.

Fixed-period annuities expire at the end of a designated period, regardless of the life or death of the individual, and terminate when all the principal and interest are used up.

In the last twenty years, annuities have gained such popularity that they have increased in usage by fourteenfold.

The frequency of premiums varies, and there are several options depending on the needs and goals of the individual.

Level premiums, which were once immensely popular, have fallen to the wayside in favor of single premiums, periodic premiums, and flexible premium arrangements.

Although level premiums offer the security of what might be compared to a forced savings account, other options offered today are often more responsive to a variety of individuals' needs.

Annuities can be set up as single life coverage with or without a beneficiary, joint and survivor life coverage, or joint life coverage. Once again, today's annuities are geared to meet the growing needs of varying households.

What is an annuity? It is a legal contract between a person and an insurance company. An annuity is a savings plan that will pay out to the annuitant over a period of time or for the rest of their life, according to the payout option the owner has chosen. ***An annuity contract is different from a life insurance contract*** in that the purpose of an annuity is to provide an income to an individual (a.k.a. the annuitant) while they are alive, whereas a life insurance contract pays a death benefit to a beneficiary when the individual dies. ***Simply, life insurance creates an estate, an annuity liquidates an estate in a systematic stream of payments.*** The payments made to the deferred annuity are called premiums.

What riders can I add to this? A company offering annuities may have many riders that may be added to your plan. Each of these will have a fee. They range from a Cost-of-Living Rider to Guaranteed Minimum Income. A Long-Term Care rider may be added, which may increase the payment if needed for Long-Term Care costs.

Long-Term Care Rider is a rider that covers long-term care according to the amounts in the contract. It is paid for with a lump sum so, unlike a Long-Term Care policy, the premiums cannot increase. You may be able to access the benefit immediately. Conversely, if you do not use the benefit, the money is still there and can be passed down to an heir or beneficiary. You do need to qualify medically for the rider, and it is limited to a payout of a certain number of years. The payout can be your standard expected annuity payout with a multiple of 2 or 3 for up to 5 years.

Guaranteed Minimum Income Benefit is a rider that guarantees a minimum payment, as the name suggests. This could be important in a volatile market with a variable annuity. If a person is counting on a certain amount to cover expenses, they can purchase this rider to be certain they will receive at least that amount of income. This is used after the annuity has been annuitized and is making payments. This rider comes with a fee.

Guaranteed Minimum Withdrawal Benefit (GMWB) is a rider that allows you to withdraw a portion of your investment annually. Most annuities have that in place already, up to 10% of the investment amount annually. This rider guarantees the initial principal investment may be withdrawn over a number of years, even if the market has lowered the value of the account.

Withdrawing is different from receiving the annuitized income. Once an annuity has been annuitized, the control is turned over to the insurance company, and they make systematic income payments to the annuitant. Instead of annuitizing, a person may decide to withdraw a portion of the funds annually. In a volatile market, the value of the account could easily drop. This rider protects the client by guaranteeing that whatever the value is, the total amount that can be withdrawn will be equal to or greater than the amount in the account at the time of purchase.

- **Nonforfeiture options** are built into the plan. During the accumulation period, if a client stops paying in, they do not have the plan canceled, nor do they lose the funds already in there. During the annuity period, the plan pays out according to the payout option chosen. The only time a client could not fully withdraw the funds is if they have chosen a life payout option. The policy then cannot be surrendered and will be paid out according to the option chosen.

Why an annuity? There are lots of reasons to choose an annuity. The main point to remember is that there are other options to save money, and this is a long-term vehicle, not short-term savings.

- The ***interest is earned tax-deferred until withdrawn***.

- There are no limits as to how much you can fund it with, other than a company's guidelines.

- *A qualified retirement plan also has tax-deferred growth and may be funded with pretax dollars. However, there are requirements and limits. There will be an annual limit, the money must be earned income, and the required minimum distribution must start no later than the year you turn 73 (as of 2024).*

- It is your money, and you may access it at any time.

  - ** There is a **10% *early withdrawal penalty*** on the earned interest if the money is withdrawn before age **59½**. If money is withdrawn from an annuity, **interest accumulation is withdrawn first,** meaning it is taxed as it comes out and only that taxable amount is subject to a 10% penalty**.** The owner is fully vested, and they control their money.

  - ** The only exception is if you have chosen a life option at the contract date. The money is not accessible to you until payout. The contract may not be surrendered.

- There are no requirements to take it out, ever.

- It's not for everyone due to the fees, but if you have money to invest and your IRA and employee benefit plans are at the maximum, this type of plan is perfect for long-term tax deferred savings.

- It is a perfect vehicle to save for retirement or supplement any retirement savings.

- Lump sum settlements that you may not need access to immediately can grow tax deferred and be paid to you in an installment option.

- Will you outlive your retirement savings? You can roll your retirement to an annuity and let the insurer make regular payments to you. This can be a safety feature for retirees who may be worried about someone taking advantage of their savings. The regular payments will continue for life if you choose a Life option.

- Your college savings are ready; you can have them paid out over 4 years or more in a systematic stream of payments.

Taxes?

That depends: when putting money in the plan (the accumulation period), if the money is after-tax dollars, the principal will not be taxed on withdrawal or payout, but the tax-deferred growth is taxable upon withdrawal. If you choose to take a partial surrender, this product is last-in-first-out (LIFO), which means the interest or growth is paid out first and is all taxed.

- E.g., Miss Ginnette invested $100,000 in premiums over 20 years. The tax-deferred growth on the account is an additional $400,000 for a total account value of $500,000. Any distribution will be 20% premium and 80% growth so she will be taxed on 80% of the income. Any withdrawals will be taxable until she has taken out the $400,000.

- A withdrawal is different from a distribution. When a plan is annuitized, the insurance company takes over and makes regular payments to the annuitant. This could be considered a distribution. A withdrawal can be taken in any amount at any time.

If the annuity is inside an IRA or a qualified retirement plan, that will cause the premiums to be tax-deductible, and all the funds will be taxed as they are paid out.

When do I put it in versus when do I take it out? There are two time periods tied to an annuity: the accumulation phase, when you are putting money into the account or letting it grow (known as a deferred annuity) and the liquidation or payout phase when you are receiving benefits, known as the annuitization phase.

This starting point is the annuitization date, and the account may now be known as an immediate annuity. The payout or liquidation phase is when the annuity begins to generate regular income payments to the annuitant.

Single Payment, a.k.a. **Lump Sum…** the annuity is purchased with a single premium payment or a lump-sum payment. The annuity is paid in full. This is required for immediate annuities.

Level/Fixed Installment… the annuity is purchased in equal payments at regular intervals over a deferral period.

Flexible Premium Payments… the annuity is purchased, allowing the owner of the contract to vary premium payments from year to year. The application may state a flexible payment plan but can still use a fixed premium. The difference is if the owner wishes to increase or decrease the premium paid, they may do so.

- A person may use a combination of all the above. *E.g., $5,000 down with $300 per month but you may drop in extra money anytime.*

What happens if I stop paying? This plan is a savings plan during the accumulation period. If you stop paying in, the carrier does not keep the money. Similar to the nonforfeiture options in a whole life policy, you have choices. The owner will Not Forfeit or lose the funds already accumulated. The money can remain in the account growing tax deferred, you can withdraw all or some of it — fees will apply — a.k.a. a total or partial surrender, or you can annuitize the account. Annuitizing will not incur any fees.

What sorts of fees? They are built into the plan. Because the plan is intended to be long term there is generally a Contingent Deferred Sales Charge (CDSC). If you withdraw any funds during the first year, you may end up paying 10% in fees to the carrier. The second year the fee will be 9%, etc., until after 10 years the fees have vanished. These are insurance company fees, if you withdraw any money before age 59½ the IRS also want taxes on the portion that has been growing tax deferred that is taken out as well as a 10% penalty.

Payout Features

The Payout of annuities can be made either immediate or deferred. An immediate annuity is one where the payout starts within 1 year of the contract date. A deferred annuity payout starts after a year. Since a person does not need to choose which payout option at the time of purchase, they may never actually have a payout timeframe and may choose to leave the funds alone or take a withdrawal. As soon as a life option is chosen the funds belong to the insurance company. As long as that choice is not made the funds belong to the individual.

Immediate payouts usually begin after a lump sum premium has been made and are the results of an individual coming into a lump sum of money wishing to receive disbursement over an extended period of time to ensure lifetime income. This could be an inheritance, winnings, or a retirement plan rollover.

Deferred payouts are usually established by individuals who wish to accumulate additional principal and interest in their annuity and receive their compensation at a later date when there is more financial need. Deferred payouts are required if a person is making payments, but a lump sum from any of the above-mentioned reasons will fund a deferred plan, using the payout at a later date.

Accumulating Cash Values

A Fixed annuity has a ***fixed guaranteed*** rate of return; however, some may pay more than the stated guaranteed amount (current assumption). Under current assumption contracts, the *guarantee* (usually between 3 and 5%) is combined with the *excess* interest credited to the cash. This is called the *current* rate of interest. The excess interest is NOT guaranteed.

An (Equity) Index annuity is a ***hybrid product*** that offers guaranteed principal, a minimum guaranteed return (such as 1%), and the opportunity to participate in the ***upside potential of the equity markets*** by using indices such as the Standard & Poor's 500.

- If the index return is flat, the principal is guaranteed as well as a minimum rate of return.
- If the index drops the principal is guaranteed as well as a minimum rate of return.
- If the index rises? There is a higher rate of return, and the principal is still guaranteed.

An Index Annuity can use two or more indices for funding the Annuity. They first came to the market in 1995 and have been sold as insurance, without SEC or FINRA supervision, meaning you do not need a securities license to sell this product.

A Variable annuity is a securities product because the investment return depends on the performance of the separate account. A securities license is required to sell these, the annuitant assumes the investment risk, and there is ***no guarantee*** on the increase in value of the contract. The cash value will go up with the stock market gain but will also go down with a decrease in the stock market.

- Accumulation units are purchased, and annuity units are paid out.
- An interesting feature of variable annuities is if you annuitize the account after the market has dropped you will be paid out based on the current balance. However, if the market drops and the value of the account drops and the annuitant dies PRIOR to annuitizing the account, the beneficiary receives the higher value of the annuity at the time of death or the value of the annuity at the last anniversary date. This is a death benefit paid out and is one of the many costs associated with this product.

How do I get my money out? Life Payout (Settlement) Options vs. Certain Payout (Settlement) Options

Unless or until an annuitant chooses a life option, they can take out the money at any time**. You are always fully vested and may withdraw at any time. This is known as the Nonforfeiture value.** It is the balance of the account available to the owner. It is the premiums paid + interest – surrender charges (if applicable) – any prior withdrawals. Any money withdrawn comes out of the interest first, which is taxable. If the client is not yet 59½ there is also a 10% federal penalty tax on the taxable portion of the withdrawal. A person may purchase an annuity and not choose a payout option until they are ready, or they may choose the option immediately.

Annuities have a Contingent Deferred Sales Charge (CDSC) which usually runs for 8 years. If you withdraw (partial surrender) funds during the first year there is an 8% sales charge, if you withdraw (partial surrender) funds during the second year there is a 7% sales charge. As the years increase, the sales charge decreases until it is eliminated. Annuities are meant to be long-term policies.

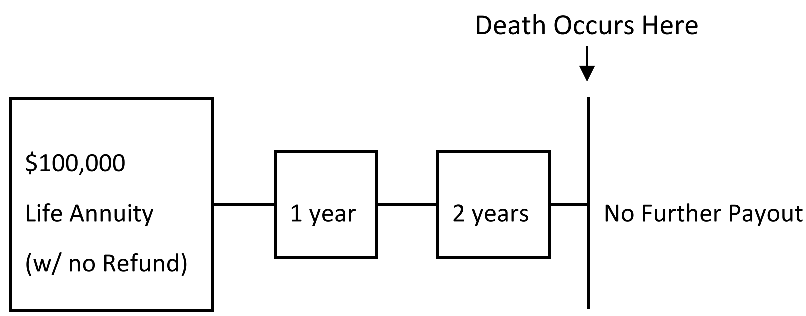
Life Annuity Options — the payout amount is determined by the annuitant's age, gender, amount in the account, and the option chosen. **Life annuities are ideal for retirement because their primary purpose is to provide an income that cannot be outlived.** Once the annuity payouts start, the insurance company guarantees that the payments will continue no matter how long the annuitant lives, thus giving a true lifetime guarantee of income. **Keep in mind that once a Life option is chosen, it cannot be canceled or surrendered.** Life options will continue to pay out the amount in the contract even if the account is down to zero, as long as the annuitant is alive it pays.

There are five life options:

If the word **LIFE is used, the annuitant is paid for **LIFE,** regardless of how long they live. A beneficiary only becomes part of the contract and is paid if the annuitant dies either prior to the balance of the principal being paid out or the annuitant dies prior to a period of time passing.

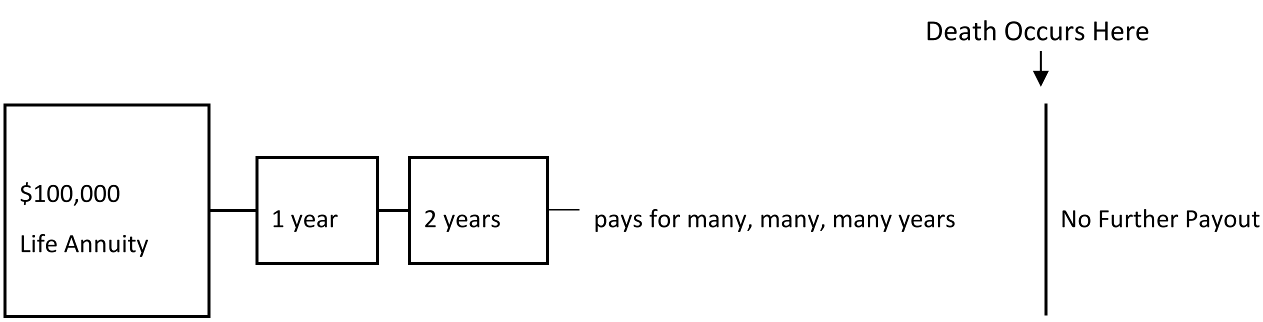
The first 3 life options are for individuals, 2 of the 3 have a beneficiary for either the money left in the account if the annuitant dies before all the money paid in has been paid out, or a period of time of payments should the annuitant die before a specified period of time has passed. The last two options are joint and are for two people.

Life (Straight/Pure) w/No Refund is one where the annuitant receives a specified amount for as long as they live. The insurance company's obligation ends upon death. There is no beneficiary.

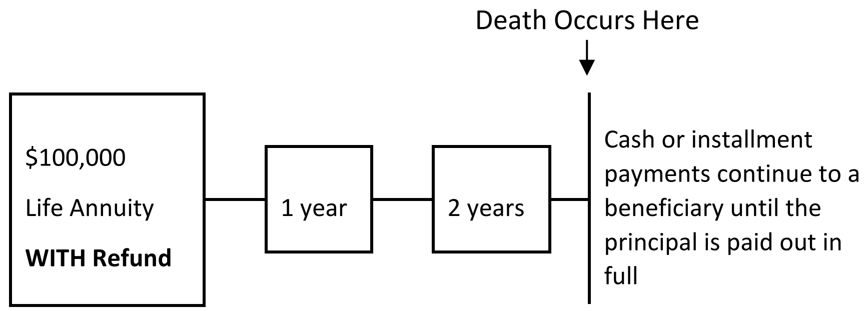


That scenario looks great for the insurance company but not so great for our client. This option however has the highest payout of all the options. Of course, if our client lives for 40 years, this will pay for 40 years.

Life (Straight/Pure) w/No Refund cont.:



Life with Refund provides income to the annuitant for life and payment to the ***beneficiary*** if the annuitant dies prior to receiving an amount equal to the full amount paid for the annuity (a.k.a. principal).

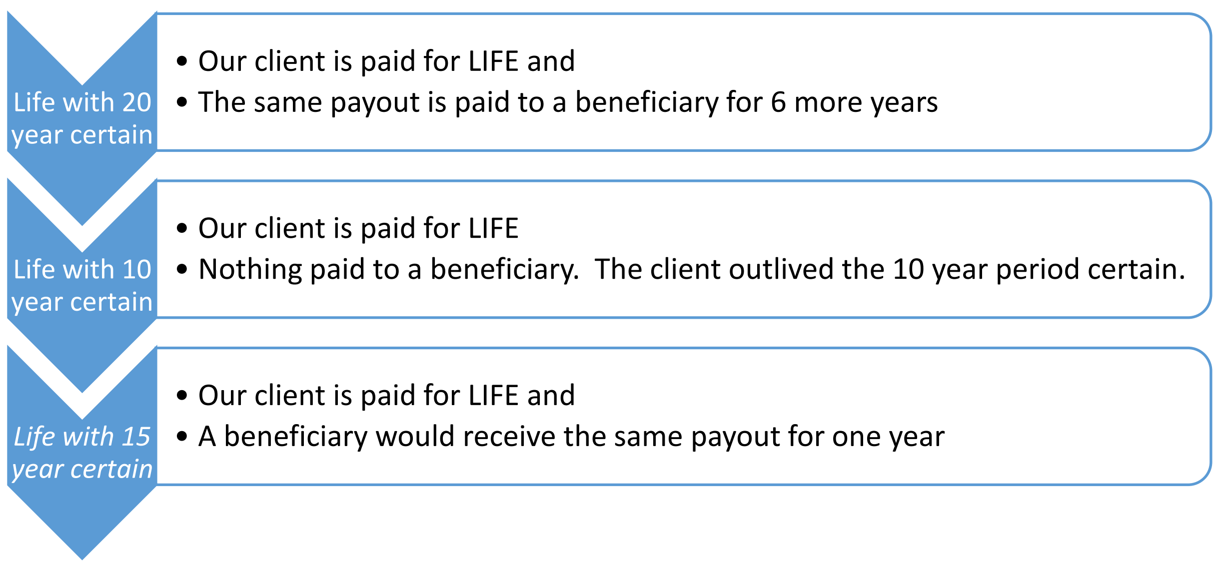


- a.k.a. ***Cash Refund*** or ***Installment Refund Annuity***

Although it is named "Life with refund," "Cash refund," or "Installment refund," think of it as life OR refund. This will pay the annuitant for life OR it will pay a beneficiary through the balance of the principal. ***Whichever pays out more***.

Life w/ Period Certain provides a life income for the annuitant. If the annuitant dies within a specified period (such as 5, 10, or 20 years), the same annuity payments will continue to the named ***beneficiary*** until the end of the stated period.

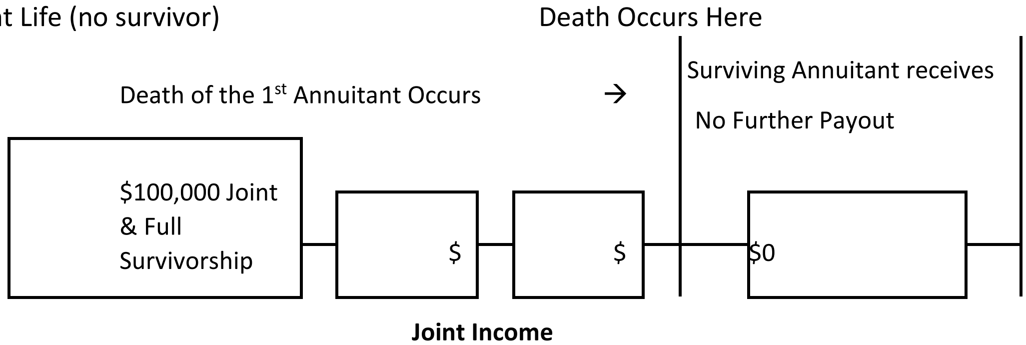
If our client lives for 14 years after annuitizing the account…



Although it is named "Life with Period certain," think of it as life OR period certain. Replace a number for the word 'period,' e.g., *life with 10-year certain.* This will pay the annuitant for life OR it will pay a beneficiary through the end of the certain period of time. ***Whichever pays out longer.***

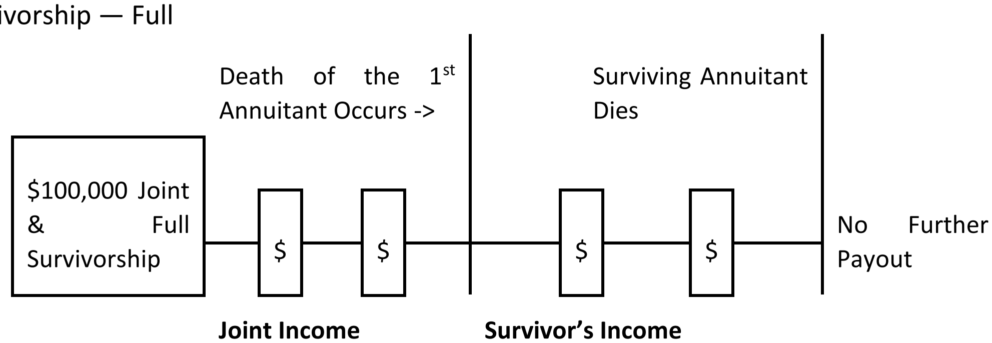
Joint Life Annuity pays an income to two annuitants (with one check) and terminates when the first annuitant dies. There is no beneficiary. This is a very risky option if this is to be the only income. It has the higher payout amount of the two joint options.

Joint Life (no survivor)



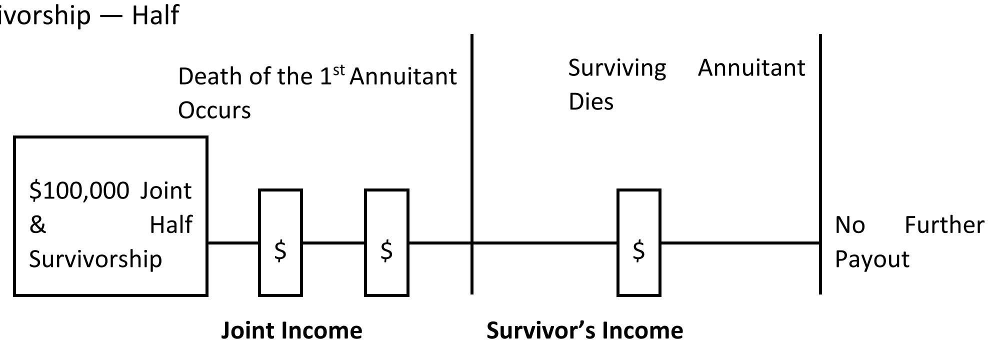
Joint Life w/ Survivorship pays an income to two annuitants (with one check) but will continue to pay the second annuitant when the first annuitant dies. The annuitant chooses the amount of the continued payout, such as 1/2, 2/3, etc., of the original payout, at the time the annuity contract is purchased. However, **when the survivor (annuitant) dies, all payouts stop.** The survivor is not a beneficiary; they are an annuitant.

Survivorship — Full



Payments: 100% (e.g., $854) 100% ($854)

Survivorship — Half



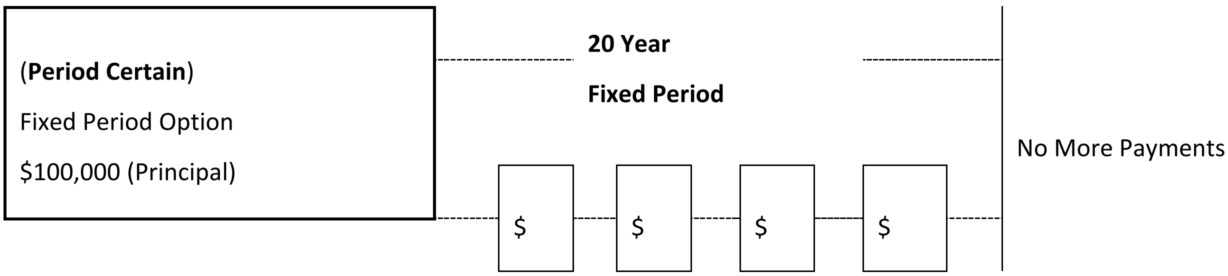
Payments: 100% ($944) 50% ($472)

The difference is the 100% with full survivorship will be a lower amount than 100% with partial survivorship for the same investment. Less later = More now.

Payout amounts are determined by the average age, sex, amount invested, and which option is chosen.

Annuity Certain Options (Fixed)… The fixed option ***guarantees*** the payout of all the principal and interest and allows the annuity owner to cash out the contract. ***The negative aspect of the fixed option is that the annuitant could outlive the annuity.***

The Fixed Time Annuity payout option ***guarantees*** all of the principal plus interest to the annuitant ***over a period of time*** (a.k.a. Period Certain). **The annuitant could, however, outlive the annuity payout.**



- ✓ This option will pay equal installments of an amount that will exhaust the principal and interest during the fixed period *(e.g., 20 years)*. If the annuitant dies before the 20 years is over, the ***beneficiary*** will receive the same installments for the balance of the 20 years.

Fixed Amount Annuity… Under this settlement option, the annuitant receives benefit payments of a ***set amount*** for as long as the ***annuity's accumulation value plus interest lasts.***

- ❖ If Ms. B has an accumulation value of $200,000, under this settlement option, she could elect to receive a monthly benefit payment of $3000 (or any other amount she prefers). The insurance company would send her a check each month for as long as the accumulation value and interest would support the benefit. After the funds in the annuity were exhausted, Ms. B would not receive any further benefits from the annuity contract. In the event of Ms. B's death before the funds in the annuity have been used up, the remainder generally is paid to her ***beneficiary***.

Sales and Administrative Charges

The premiums paid into annuity policies are all applied to the principal. The interest earned supplies funds to cover administrative costs.

Some of these costs include a level sales charge, an investment management group fee, a record maintenance, accounting, or reporting fee.

Taxes also play a part in fees and costs, and in some States, a "State Premium" tax is charged on annuities.

Most annuities have some form of withdrawal or surrender charge. In some states, the withdrawal or surrender charges are regulated by state law.

In the case of variable annuities, fees are regulated by the Securities and Exchange Commission.

Some annuities carry a withdrawal or surrender fee for a specified period of time, usually 8 years, after which the annuitant can move the contract to a different company or different plan within the same company where perhaps the interest earned or the benefits available are more to the annuitant's benefit.

Variable Annuities and the Law

The first variable annuity was issued in the United States in 1952. Because variable annuities pass the investment risk on to the contract owner both the Securities and Exchange Commission and some States consider variable annuities to be securities rather than life insurance products.

Variable Annuities and those individuals who sell them are subject to federal securities regulations as well as state insurance regulations.

Variable contracts must be registered with the Securities and Exchange Commission under the Securities and Exchange Act of 1933.

Under this law, a prospectus must be filed with the Security and Exchange Commission, and this prospectus must be presented to the consumer in connection with any sales effort.

The company selling the variable contract must be registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

Brokers/Dealers selling variable annuities must be members of FINRA in order to conduct business.

FINRA is a self-regulatory organization, and brokers/dealers must comply with extremely strict FINRA regulations regarding sales practices.

Individuals selling variable annuities must be licensed both by their state and must be securities licensed and registered with FINRA.

Net premium payments from variable contracts cannot be deposited in the insurance companies' general asset account but must be deposited in a separate account.

The gains and losses passed through to variable contract owners must represent only the investment experience of the separate account and not any part of the company's assets. In conclusion this chapter has attempted to bring you an overview of annuity concepts and principles and the rules and regulations that guide them.

FOCUS POINTS

- An Annuity, unlike a savings account, is designed to last the life of the individual.
- An Annuity is designed to convert a specific sum of money into a series of periodic payments.
- Annuities guarantee a contract holder's payments for life or longer.
- Annuity programs can be structured to start out with one lump sum of money.
- Annuity programs can be structured to accumulate a specified amount before disbursement begins.
- An annuity transfers some of the risk of outliving one's funds to an insurance company.
- In turn for the premium, an insurance company guarantees a specified payback.
- An Annuity is an insurance contract that has an owner, an annuitant, and a beneficiary.
- An owner and an annuitant can be the same person or different individuals.
- The accumulation period begins with the deposit of a premium.
- The difference between a savings account and an annuity is that the interest on the annuity is not taxed until disbursement.
- Annuities create a pool of individuals, some with "uncollected benefits" and some requiring "extra benefits."
- Life annuity programs are based on a mortality factor.
- Fixed period annuities terminate when all the principal and interest are used up.
- Annuities can be set up as single life, joint and survivor, or joint life coverage.
- The payout of annuities can be structured as immediate or as deferred.
- Immediate payouts usually begin after a lump sum premium has been made.
- Deferred payouts begin at a later date.
- Cash values in an annuity are accumulated either in a fixed or variable method.
- In the fixed method the insurance company returns the annuitant a minimum or pre-designated interest of the investment.
- In the variable method there is no minimum guarantee of return to the annuitant.
- Payout methods come in the form of Life or Fixed annuities.
- Fixed annuities come in the form of designated period contracts or designated amount contracts.
- Straight life contracts pay a benefit for the life of the annuitant.

- Life Annuity with period certain program pays for a period of time even if the annuitant dies prior to the agreed time.
- Cash Refund Annuities guarantee the beneficiary a refund of the unpaid principal if the annuitant dies prior to using up the paid-up premium.
- Installment Refund Annuities pay the beneficiary installment payments until all of the premium collected is paid out.
- Fixed Annuities provide income for a specified time period.
- Fixed Annuities payout in either fixed period or fixed amount.
- Some of the premiums paid into annuity policies are applied to sales and administrative charges.
- Some annuities have withdrawal or surrender fees or market value adjustment fees.
- Some annuities are subject to a "State Premium Tax."
- Most annuities have some form of withdrawal or surrender charges.
- In the case of variable annuities withdrawal or surrender fees are regulated by the Securities Exchange Commission.
- Some annuities carry a withdrawal or surrender fee for a specified period of time.
- Variable annuities pass the contract risk to the contract owner.
- Variable Annuities are subject to state regulations and federal securities regulations.
- Variable contracts must be registered with the Security Exchange Commission.
- Variable contract offerings must be presented to a consumer together with a prospectus.
- Companies selling variable contracts must be registered with the Securities Exchange Commission.
- Broker/Dealers selling variable contracts must be members of FINRA.
- Individuals selling variable contracts must be licensed with their state and must be FINRA registered.
- Net premium payments from variable contracts must be deposited in a separate account by the insurance company.

CHAPTER 2: ANNUITIES

What is an Annuity?

An annuity is an investment that is made through an insurance company. It is a contractual relationship between the contract owner (person covered by the annuity) and the particular insurance company. Its primary purpose is to liquidate an estate in a systematic stream of payments.

Annuities can be sold through insurance agencies, banks, savings and loans institutions, brokerage firms, investment advisors, and financial planners. Although annuities are sold only by the insurance industry, they do not have anything to do with life insurance or insurance coverage.

When an annuity is purchased the insurance company makes certain assurances. Guarantees vary according to the type of annuity.

There are three types of annuity investment options:

Fixed (this provides a set rate of return)

Variable (the contract owner chooses where the money goes. Investment options range from conservative to aggressive)

Equity Index (a guaranteed minimum and the opportunity to participate in the upside of the stock market)

Who Participates in the Annuity?

There are four parties to each annuity:

- The Insurer;
- Contract Owner;
- Annuitant; and
- Beneficiary.

The Insurer

There are more than 2,000 insurance companies doing business in the United States and the vast majority deal in annuities.

Regardless of the source providing the annuity for sale—banker, financial planner, brokerage firm, or any individual or business licensed to sell annuities—the annuity agreement is always between the contract owner and the insurance company.

The insurance company or the insurer invests money. The insurer also makes certain guarantees to the contract owner, and these guarantees are outlined in the annuity contract. The contract is the instrument the insurer uses to define the terms and conditions governing the use of the annuity and the annuity funds.

The annuity contract outlines rules governing:

- Additional Investing
- Withdrawals
- Cancellations
- Penalties
- Guarantees
- Agreements and Applications

An investor purchasing a certificate of deposit (CD) from a bank signs an agreement. For the purchase of a mutual fund, the investor fills out an application. In each case the relationships are between the investor and the financial institution. Investment in an annuity is structured the same way.

Contract Owner

An individual investing in an annuity is known as the contract owner. The contract owner chooses investment options. The contract owner has the right and ability to:

- Add additional funds to the annuity;
- Terminate the annuity;
- Withdraw all or part of the money; and
- Change parties named in the contract.

The contract owner can be any one of the following:

- Couple
- Trust
- Corporation
- Partnership
- If the contract owner is an individual, they must be a legal adult. Minors may be contract owners only if the policy lists the minor's custodian. The contract owner controls the investment and can gift or will part or all of the contract to anyone or any entity.

The Annuitant

A life insurance policy names the insured party. The life policy continues in force until:

- The owner terminates the contract;
- The owner fails to make premium payments; or
- The insured dies.

An annuity names the annuitant. With an annuity, the contract remains in force until:

- The contract owner makes a change; or

- The annuitant dies.

An annuitant is like an insured in a life policy. Although the annuitant must sign the annuity contract, the annuitant - who is not also the owner - is subject to the following restrictions:

- No control of the contract
- Cannot make withdrawals
- Cannot make deposits
- Cannot change the parties to the contract
- Cannot terminate the contract

The contract owner may name anyone as the annuitant—the contract owner, spouse, parent, child, relative, friend, or neighbor. The annuitant must be a natural person (not a living trust, corporation, partnership, etc.) currently living. This is the only qualification in naming an annuitant.

The maximum age allowed for the annuitant depends on the insurance company issuing the annuity contract. As a rule, the annuitant must be under age 75 at the date of signing. Some companies set a maximum age of 70 or 80. The contract may still be in force even though the annuitant has reached the maximum age limit.

Most annuities provide that the contract owner may change the annuitant at any time, with the stipulation that the new annuitant was alive when the original contract was executed.

Beneficiary

The beneficiary is considered a party to the contract because if they are due funds after the annuitant passes and the insurance company does not pay, the beneficiary may sue the insurance company. This fact means they are a party to the contract. The beneficiary of an annuity will only benefit or prosper from that annuity upon the death of the annuitant. The named beneficiary(s) can be children of the annuitant, friends, relatives, spouse, neighbors, trusts, a corporation, or a partnership.

The annuity application will allow multiple beneficiary designations of varying or similar proportions.

- *Example:* a beneficiary designation may read:
- 25% to Jane Smith
- 15% to John Smith
- 10% to Millie Smith
- 50% to the Smith Family Trust

Should the contract owner be a solitary individual, the contract owner may name themselves contract owner and annuitant, while listing a loved one or entity such as a living trust, charity, or corporation, as a beneficiary. This affords the individual complete control over the annuity investment during their lifetime.

The contract owner may change the beneficiary(ies) at any time, and consent of said beneficiary(ies) is not necessary.

Multiple Titles

The same person can hold *multiple titles* in the annuity contract. For example, the contract owner may also be — and usually is — the annuitant.

If the contract owner designates a living trust or a corporation as the beneficiary, the corporation or trust can only be the contract owner and/or beneficiary — a living *individual* meeting the insurer's age restrictions (couples excluded) must be named as the annuitant. The insurer is always the insurance company.

How an Annuity Works

Structuring the Annuity

A client's investment options may include:

- Certificates of deposit
- Government bonds
- Mutual funds
- Money market accounts
- Real estate
- Annuities

A client investing in an annuity must complete an application furnishing the following information:

- Name;
- Current address;
- Social Security of the contract owner;
- Risk tolerance;
- Name, Social Security number, address, sex, and date of birth of the annuitant;
- Investment options;
- Type of money used *(For example: Is it a rollover?)*;
- Signature of the contract owner; and
- Signature of the annuitant.

Following the submission of the application to the insurance company the contract owner receives the contract. The contract contains a cover sheet that summarizes the application, denotes the rate of expected return on the investment(s) and indicates type(s) of investments selected.

The contract owner has the right to gift all or part of the investment to someone else, change the beneficiary, or change the name of the annuitant.

FREQUENTLY ASKED QUESTIONS

Can Someone Invest Money in Different Ways?

Yes. Whether the contract owner opted for a fixed-rate, equity index, or a variable annuity, all have two stages:

1. The accumulation period; and
2. the annuitization (payout) period.

The accumulation period goes into effect the moment the investments are selected. During the accumulation phase, the account balance grows, tax-deferred, as either interest is credited by the insurance company (for a fixed annuity), or investment results are credited (for a variable annuity).

The payout or annuity period goes into effect the moment benefits (payments from the annuity) are disbursed.

A single-premium deferred annuity is structured so that the investment is made in one payment. The contract owner can make one or more payments of various amounts to a flexible-premium deferred annuity.

There is no requirement that a person have only one annuity if they want to have one of each.

Is an Annuity a New Type of Investment?

Annuities have been available in other countries for several hundred years. They have been available in the United States for more than one hundred years.

What Risk is involved?

As with any type of investment, caution should be used and investments carefully scrutinized. Annuities can be improperly sold or misused. Some types of annuities are not guaranteed and although the potential for long-term growth is exceptional, they depend upon the market and the investments chosen to retain their value.

What are the Advantages of an Annuity?

An annuity is a safe vehicle for investment.

Annuities offer tax-deferred growth on earnings. There are many options for tax-deferred growth, and an annuity should be considered after these are fully funded. An annuity does not have an upper limit as to how much money may be invested in it, whereas retirement plans all have annual maximums.

Life Annuities provide resources that last as long as the client needs them.

FOCUS POINTS

- An Annuity is an investment made through an insurance company. An Annuity is a contractual relationship between an owner {annuitant) and the insurance company.
- Annuities can be sold through insurance agencies, savings & loans, brokerage firms, investment advisors, and financial planners.
- In selling an annuity the insurance company makes certain assurances or guarantees that vary with the type of annuity.
- A Fixed annuity provides a set rate of return.
- A variable annuity allows the contract owner to choose where the money goes, and investment options range from conservative to aggressive.
- An equity index annuity offers a minimum guarantee and the opportunity to participate in the upside of the stock market.
- There are four parties to each annuity: the insurer, the contract owner, the annuitant, and the beneficiary.
- The annuity agreement is always between the contract owner and the insurance company.
- The annuity contract outlines rules governing additional investing, withdrawals, cancellations, penalties, and guarantees.
- An individual investing in an annuity is known as the contract owner.
- The contract owner can be a couple, a trust, a corporation, or a partnership.
- The contract owner controls the investment and can gift or will part or all of the contract to anyone or any entity.
- An annuity contract remains in force until the contract owner makes a change or the annuitant dies.
- An annuitant has no control of the contract, cannot make withdrawals, cannot make deposits, cannot change the parties to the contract, and cannot terminate the contract. These are the owners' rights.
- The contract owner can name anyone as the annuitant who is a living person.
- As a rule, most insurance companies require the annuitant to be under the age of 75.
- Most annuities provide that the contract owner may change the annuitant at any time.
- A beneficiary will only benefit upon the death of the annuitant.
- A contract owner may be an annuitant.
- In an annuity, a client's investment options can include certificates of deposit, government bonds, Mutual funds, money market accounts, real estate, and annuities.
- An annuity contract cover sheet summarizes the application, denotes the rate of expected return, and indicates the type or types of investments selected.

CHAPTER 3: ANNUITY BASICS

Renewal Rate

The renewal rate is the interest rate credited to an annuity in the years following the initial rate. This renewal rate is seldom identical to the new money rate, and with good reason. The new money rate reflects the investments that the insurance company is buying today. The renewal rate reflects what the insurance company bought when the annuity was initially purchased. Investigate the selected insurance company's renewal rate strategy for any differences to this standard. A fixed annuity has a guaranteed minimum set by the company and the account will never be paid less than the minimum, the company has the option to pay a higher rate depending on their experience in the stock market.

Lifetime Guaranteed Rate

The lifetime guaranteed rate is the minimum interest rate that is guaranteed for the life of the annuity. Each state department of insurance has jurisdiction over the many fixed annuities and mandates that annuities provide this lifetime guaranteed interest rate. Since the interest rate is for the life of the annuity, most insurance companies offer rates of three to five percent.

Settlement Options

When a contract owner elects a settlement option, the entire annuity value is applied for guaranteed income.

Settlement options specify the way the contract owner receives funds from the annuity. The contract owner has several options for receipt of guaranteed income. In fact, guaranteed income can be received on a monthly, quarterly, semi-annual, or annual basis.

Money Back Guarantee

The money back guarantee found in many annuity contracts is considered by some as a major selling feature since there is no market risk for the customer. The insurance company assumes the risk, and the customer receives protection.

If a contract owner is unhappy with their annuity 10, 20, or 30 days (depending on the insurance company) after the annuity is issued, they can get all of their money back.

In other words, the contract owner cannot get back less than their initial premium.

Surrender Charges

Surrender charges protect the insurance company just as guarantee of principal protects the customer. Surrender penalties with most annuities disappear over a five to ten year period. This is similar to the surrender charge in a Universal life insurance policy.

An annuity often has a CDSC or Contingent Deferred Sales Charge. 100% of the funds invested go to the account but if they are withdrawn (different than annuitized) before a certain time period there is a sales charge. An 8-year CDSC will keep 8% of the amount in the account if all funds are withdrawn in the first year, 7% if withdrawn in the second year, 6% if withdrawn in the third year and so on until the funds have been invested for 8 years.

Market Value Adjustment

Like the surrender charge, Market Value Adjustment (MVA) fees will apply if all the funds are withdrawn or if there is more withdrawn than the allowed amount during the surrender penalty period. Like the surrender fee, this generally disappears after the initial surrender period ends. These fees typically don't apply in the event of the annuitant's death.

Market Value Adjustment can work in favor of the owner or cost the owner, depending on where the market is at the time of withdrawal compared to where the market was at the time of purchase. As the annuitant retains higher risk during the surrender period, insurance companies may offer higher interest credit rates to discourage early surrender.

Bailout Clause

A bailout clause is an agreement by the insurance company to waive surrender charges under certain conditions. This most common example is an "interest rate" bailout clause (also known as an escape clause).

Simply put, the insurance company will waive surrender charges if the interest rate decreases below a certain level. Annuities have other bailouts. For example, some annuities waive surrender charges if the contract owner is confined to a nursing home, or charges could be waived if a terminal illness is diagnosed.

FOCUS POINTS

- The renewal rate is the interest rate credited to an annuity in the years following the initial rate.
- The lifetime guarantee rate is the minimum interest rate that is guaranteed for the life of the annuity.
- Settlement options specify the way the contract owner receives funds from the annuity.
- Guaranteed income from an annuity can be received on a monthly, quarterly, semi-annual, or annual basis.
- The money back guarantee provision found in many annuity contracts creates a no market risk scenario for the customer.
- Surrender charges protect the insurance company for a period of time (usually 5 to 10 years).
- A bailout clause is an agreement by the insurance company to waive surrender charges under certain conditions.

CHAPTER 4: TYPES OF ANNUITIES

Timeline

Annuities can be divided into two major applications for the client. Clients have two choices for income needs, depending on when the need for income occurs:

- an *immediate annuity*, or
- a *deferred annuity*.

Investment options include the *fixed-rate annuity, the equity index annuity,* and the *variable annuity*.

Immediate Annuity

An immediate annuity will provide income right away, in some cases just 31 days after purchase of the annuity. To be considered an immediate annuity payments must start within 1 year. Clients that need to receive a specific amount of money each month should investigate the immediate annuity. Money from an immediate annuity may be used as sole source of income or a supplement to other incomes. An immediate annuity must be fully funded from its inception. The funds can come from any legal source, for example: this can be a rollover from a retirement plan, an inheritance, or funds from closing out another annuity. There is no accumulation period since payouts begin immediately.

Annuity payments may be made monthly, quarterly, semi-annually, or annually. The amount of the check the client receives will not fluctuate from payment to payment in a fixed annuity. If this is a variable plan, the number of units paid will remain constant but the underlying value of the units will change with the market so the actual amount will vary. The actual dollar amount of the checks is in direct relationship to the total annuity investment, the type of payout chosen, the age of the annuitant at the time payments start, and the gender of the annuitant.

Most clients do not realize that insurance companies can become extremely competitive for annuity and large investments. Contact several insurance companies for rates and payouts, and ask for specific payout amounts for five, ten, 20 and 30 years on the intended amount of annuity investment. Use these figures to compare rates and payout amounts with other insurance companies.

Deferred Annuities

A deferred annuity is used for growth and offers flexibility for growth over a period of time. An annuity is considered deferred when the first payment occurs after a year from the date of the application. This can be funded with a single payment, with a series of fixed payments, or with a flexible payment option. The fixed payment plan will likely have flexible payments available. (The insurance company is not likely to say 'no, I don't want your money' if you have extra funds to drop in.)

Any growth in the accumulation period is tax deferred so the funds grow faster than they would if you had to withdraw money to pay taxes on them. The taxes are paid on withdrawal or annuitization.

Investment Options

Will vary from policy to policy and insurance company to insurance company. There are three types of investment options: fixed, index, and variable.

Fixed-Rate Annuities

A fixed-rate annuity affords the client a fixed guaranteed rate of return. The rate of return received from a fixed-rate annuity depends on the length of time the funds will be invested. The most common maturity periods for annuities are one, three and five years. The insurance company guarantees the rate of return for the contracted period. The money is deposited in the insurance company's general fund so they can and do guarantee the rates.

Typically, the longer the commitment, the higher the guaranteed rate.

With a fixed annuity, the rate is guaranteed rate regardless of:

- Stock market gains or losses;
- Rising or declining interest rates; and
- Insurance company performance (profits or losses).

The fixed-rate annuity assures the investor safety of the principal and the exact interest the money will earn. The fixed-rate annuity is especially attractive to conservative investors, or any investor who wants specific projections on their investment.

The fixed-rate annuity is not just for the timid or cautious. These investment vehicles have proven to be an excellent stabilizing force for the moderate or aggressive investor who needs balance in their overall portfolio.

With the fixed-rate annuity the diversified investor, with other investments in real estate, stocks, bonds, gold, or mutual funds, feels safe and secure with this aspect of their overall investment program guaranteed.

Variable Annuities

Not every investor seeks a guaranteed rate of return. Many investors subscribe to the investment adage that the bigger the risk, the bigger the return—the smaller the risk, the smaller the return.

The investor has total control of their investment choices with a variable annuity. The insurance company plays no part in directing the investments of a variable annuity. A producer with a security license can help guide the owner of the account towards good choices with a mix of funds.

The insurance company does not share in any profits earned on the annuity, nor will it absorb any losses. If an annuity earns 50 percent in one year, the contract owner keeps the entire amount. Conversely, if an annuity suffers a 60 percent loss in one year, there is no recourse.

Variable annuities increase in terms of <u>units</u>. A unit is the value of the mix of funds chosen by the owner. If a person paid $500 monthly and the unit value was $100, they purchased 5 units. If the unit value doubled overnight, they still only have 5 units, although they are worth more than the original purchase price. The next month the person purchased $500 worth of units but instead of getting 5 (at $100) they get 2.5 ($200 each). The payout works the same, they will receive a certain number of units, but the dollar amount will be different each month based on the unit price.

Equity Index Annuity

An equity index annuity has the contract owner's funds in the company general fund, just like a fixed annuity. Just like a fixed annuity, there is a minimum guarantee. This minimum guarantee may be low since the account has the ability to increase the rate of return dramatically. This return is tied to an equity index, or more than one index, If the index goes up the rate of return goes up. There are caps on how high the return will pay out, and the lower minimum may get a higher maximum. There are also adjustments according to which option you choose: quarterly, semiannually, or annually.

With an equity index product, a person can get the upside potential of the market without the downside.

- If the index stays flat, the minimum rate is paid.
- If the index drops, the minimum guaranteed rate is paid.
- If the index goes up, the rate of return on the annuity goes up.

Which Annuity is Best?

Billions of dollars are invested every year in both fixed-rate and variable annuities. Determine the type of annuity (fixed or variable) to recommend to a client based on their investment and income goals, and the 'time horizon' in which to achieve these goals.

Time Horizon

Clients willing to wait for investment returns should concentrate on equity instruments, such as stock. Over time, common stock and equities perform better than any other assets. A client with a time horizon of only one or two years should consider another type of investment. There are too many fees to justify saving money in an annuity unless you plan to annuitize it immediately.

An optimistic or *aggressive* investor with a time horizon of less than two years should not consider an annuity simply because the surrender charge will eat up any profit. The average investor should only consider variable annuities for a time horizon of three or more years. Most conservative investors consider stocks too risky.

Goals and Objectives

The common goals of an investor are to retire comfortably, provide children with a college education, and purchase a home or real estate.

Evaluate a client's goals and turn those goals into "dollar objectives." For example, if a client's goal is to retire comfortably, achieving that goal may require an investment that would generate a retirement income of $2,000.00 a month, or $1,000.00 every two weeks, depending on their expected standard of living.

A client desiring a $54,000.00 per year income would need at least $600,000 earning nine percent interest a year over 25 years. Your company will provide software to help you with these numbers.

FREQUENTLY ASKED QUESTIONS

Can risk be calculated in advance?

No. Advise every client to evaluate carefully investment choices.

Can someone hedge an investment in two annuities?

Yes. The best solution may be to structure a variable annuity by diversifying among several different sub-accounts. Some insurance companies offer a part fixed, part variable annuity that is often referred to as a hybrid annuity.

FOCUS POINTS

- Annuities provide two options for clients—the need for income and options for investment.
- Clients have two choices for income needs—immediate or deferred.
- Investment options include a fixed annuity and a variable annuity.
- An immediate annuity begins to provide income as quickly as within 31 days.
- Immediate annuity payments may be made monthly, quarterly, or annually.
- A deferred annuity offers flexibility for growth over a long or short period of time.
- A fixed rate annuity affords the client a guaranteed rate of return.
- The rate of return received from a fixed rate annuity depends on the length of time the funds will be invested.
- The most common maturity periods are one, three and five years.

- With a fixed annuity the rate is guaranteed regardless of stock market gain or loss, rising or declining interest rates or insurance company profit or loss.

CHAPTER 5: ANNUITY INVESTING ADVANTAGES

Features

There is no such thing as the perfect investment, however, an annuity provides more features than any other type of investment available, including:

- Safety
- Reserves
- Financial strength
- Ratings

Safety

By all investment standards the fixed-rate annuity investment is unequaled. In a fixed-rate annuity, principal is guaranteed every single day. In addition, the contract owner is permitted to terminate the contract at any time—after a day, month, or year, as long as they have not chosen a life payout option.

In addition to the principal guarantee the interest rate also is guaranteed. The interest rate is guaranteed for a specific period of time, depending on the contract. The only problem with this is time and inflation. If a person is guaranteed a 2% return and inflation is at 3%, the net return is actually -1%. Over time, this can be a problem.

Variable annuities are less safe because the investor decides the type of portfolio to enter into and the dollar amount that is going to be invested. Equity markets over time have always outpaced inflation.

Reserves

Banks must, by law, set aside a certain amount into reserves for every dollar deposited into the bank. That amount can range from zero cents to ten cents on the dollar. When a fixed-rate annuity is purchased the insurance company must also, by law, set aside reserves.

The insurance company can use the reserves for settling withdrawals and redeeming annuities. Insurance company reserve money *cannot* be used to pay claims, overhead, bad debts or any other non-related annuity items.

The insurance company accumulates the money to put into reserve from other profit centers. As a rule, the insurance carrier's annuity business represents the smallest source of its revenue, and the money can be obtained from the carrier selling life insurance and other forms of insurance.

Most states now require that the insurance company become part of the legal reserve pool. This pool protects the investor. Should an insurance company go out of business the reserve pool operates in a straightforward manner, and the remaining insurance companies must reserve the liabilities and the obligations of the carrier that went out of business.

Financial Strength

There are more than 2,000 life insurance companies in the United States, and they collectively own, manage or control more assets than all the banks in the world combined. Collectively they own, manage, or control more assets than all of the oil companies in the world combined. During the Depression the insurance companies, not the federal government, bailed out the banking industry.

Ratings

Annuities have a perfect track record, but consideration should be given to the insurance company providing the annuity. Some companies are safer than others.

The oldest rating company in the county is *A.M. Best*. They rate companies in the following manner:

- A+ Superior rating
- A Excellent rating
- B+ Great rating
- B Fair rating
- C+ Marginal rating
- C Weak rating
- D Poor rating

These may gain a Rating Notch of + or - to differentiate within the category. *E.g., A++ being the best, A- still being excellent.*

Most investors prefer to stick with the A+ or A rated companies for fixed-rate annuities. For variable annuities, the rating of the insurance carrier is of little importance because the earnings are not tied to the solvency of the insurer.

Performance

Fixed-rate annuities offer a specific rate of return for a specified time, and the rate is fully guaranteed for this period. The interest rate guaranteed depends on the company and the annuity.

Professional Management

Professional management plays a key role in the annuity field. The investment team or professional manager that oversees an annuity portfolio is in fact a specialist. These individuals are highly skilled and trained to focus on a certain segment of the marketplace. There are several independent sources that track the performance of fixed-rate and variable annuities. Some of these rating services are:

- Morningstar
- Lipper Analytical Services
- Standard & Poor's

In addition, *The Wall Street Journal* and *Barron's* publish articles from time to time related to annuities and annuity performance.

Withdrawal Options

All or part of the money invested in a fixed-rate or variable annuity may be withdrawn, however, that withdrawal may be subject to a penalty. As a rule, most insurance companies permit annuity withdrawals of up to ten percent per year without cost, penalty, or fees. The 10 percent withdrawal usually is based on a percentage of the principal, not the value of the annuity.

A few insurance companies will permit withdrawals of up to 15 percent per year, but it is important to note: annuities are last in first out (LIFO), which means the funds withdrawn are taken from the growth. Therefore, the money withdrawn will be taxed at the normal tax rate and if the owner is not 59½ then there is also a 10% federal tax penalty.

Note: an annuity does not ever need to be annuitized. A person could just withdraw 10% every year if that were enough to meet their needs. Living off the interest and not touching the principal is great, until there is a down year in the market and you start to dip in to the principal to meet your needs. The biggest difference between doing this and annuitizing is when the account is annuitized the money technically belongs to the insurance company. They then are responsible for paying out the funds and they will continue to do so even if you are 'out' of money in the account.

Variable Annuity—Guaranteed Death Benefit

A variable annuity automatically contains a guaranteed death benefit, which provides that upon the death of the annuitant, the beneficiary will receive:

- The greater of the principal, plus any ongoing additions, or
- The value of the account on the date of death, whichever is higher.

The variable annuity guaranteed death benefit makes it an ideal investment for an older person desiring a high-income stream. The variable annuity guaranteed death benefit is based on the sum of all investments made by the owner, or value on the date of death, whichever is greater.

The guaranteed death benefit will last until:

- The annuitant terminates the contract,
- The annuitant dies.

Avoidance of Probate

When an individual dies, a person is appointed as executor and the job they need to fulfill is to follow the terms of the will of the deceased and distribute all assets accordingly. Before any assets can be distributed, all debts must be paid. A notice to creditors is published in the newspaper, creditors are paid, inheritance taxes are paid, then assets are distributed.

The value of an annuity will not be included when the gross estate is valued, and the beneficiaries will start receiving payment as soon as a certified copy of the death certificate is received by the insurance company.

FREQUENTLY ASKED QUESTIONS

How Important are Rates?

Rates are extremely sensitive. Even a fraction of a percent can be critical in calculating the returns on an annuity. Rate shopping is a critical factor when choosing an annuity. The insurance company itself is of secondary importance.

How Important is Professional Management?

Investing in an annuity is like hiring a professional manager. By hiring professionals to manage the funds, the investor does not have to worry about the day-to-day fluctuations of stocks and bonds, or wonder if securities being purchased are about to be downgraded.

What Can Tax Deferral Mean to Me?

The investor pays no taxes on the interest earned so long as that interest remains in the contract. Money that normally would be paid to the federal government as tax works for the investor instead.

How Does an Annuity Compare to an Individual Retirement Account (IRA)?

There are some major differences between IRAs and annuities. For example, only those with earned income can open an IRA, but anyone can purchase an annuity.

An IRA limits the amount that can be contributed annually. An annuity has no limits on contribution. IRA contributions can be tax deductible. As a rule, there are no deductions allowed for payments into an annuity.

An IRA also requires a certain amount be taken out each year, the required minimum distribution (RMD). If that amount is not withdrawn and taxes paid on it, that amount is subject to a 50% penalty tax. You never have to withdraw the funds from an annuity.

An annuity can provide a guaranteed income for life—with an IRA, there is no such guarantee. It is possible to roll the IRA into an annuity for the payout.

FOCUS POINTS

- Annuities provide safety, reserves, financial strength, and ratings.
- A fixed rate annuity provides a guaranteed principle and the ability for the owner to terminate the contract at any time.
- A fixed rate annuity provides for a guaranteed interest rate for a specified period of time.
- When a fixed rate annuity is purchased the insurance company must, by law, set aside reserves.
- Insurance company reserves cannot be used to pay claims, overhead, bad debts or any other non-related annuity items.
- Most states require that insurance companies become part of a legal reserve pool to protect investors.
- Collectively insurance companies own, manage, or control more assets than banks.
- Collectively insurance companies own, manage, or control more assets than all the oil companies of the world.
- All or part of the money invested in a fixed or variable annuity may be withdrawn.
- Withdrawals may be subject to penalties.

CHAPTER 6: DISADVANTAGES OF ANNUITY INVESTING

Penalties and Expenses

There are very few disadvantages with respect to investing in annuities, and most of them will never affect the client. The three major disadvantages are: IRS penalties; Insurance company penalties; and Ongoing expenses of variable annuities.

IRS Penalties

Regardless of the type of annuity purchased, all annuities will be subjected to an IRS penalty of ten percent for withdrawals that are made prior to the annuitant attaining the age of $59^1/_2$ years. This is only on the taxable portion of the withdrawal. The principal has already been taxed so there are no more taxes taken on it. The growth, however, has been growing tax-deferred. These plans will always pay out the growth first on a withdrawal. When annuitized, the taxes are spread out over the life of the payments.

The ten percent penalty is not invoked if:

- The annuitant dies;
- The annuitant becomes disabled;
- Annuitization (when a portion of the annuity's assets are paid out as income on a regular basis);
- The annuitant reaches age 59½; or
- The principal is the payout (it has already been taxed).

Income Taxes

Money invested in an annuity will grow and compound tax- *deferred* not tax-*free.*

An annuity will pay out a mix of principal and interest so a payment of $5000 may result in a taxable income of $1000, depending on the amount of principal vs. growth.

The tax liability will be the value of the annuity at the time of death, less the amount invested, and then multiplied by the beneficiary's tax bracket percentage. The contract owner is wise to withdraw money from the annuity when in the lowest tax bracket.

Insurance Company Penalties

The proper terminology for an insurance company penalty is "surrender charge." The surrender charge only applies if a certain amount of money is withdrawn from the contract within a set number of years.

In an annuity, up to ten percent per year may be withdrawn without penalty, after the first year. The insurance company surrender charge occurs when amounts are withdrawn in excess of the free withdrawal privilege of ten percent.

Analyze the insurance company's penalty schedule prior to purchasing an annuity. Some companies' penalty periods last ten or more years, and the penalty can be as high as ten percent for the entire ten-year period.

Surrender charges do not apply if:

- The annuitant dies;
- The annuitant becomes disabled;
- Withdrawals are limited to those allowed under the free withdrawal privilege;
- The penalty period has lapsed;
- Systematic withdrawals of ten percent per year are made; or
- Annuitization.

Ongoing Expenses of the Variable Annuity

The ongoing expenses of a variable annuity consist of the mortality and expense fee and annual contract maintenance charges.

Mortality and Expense Fee

All variable annuities have a mortality or expense fee commonly referred to as guaranteed death benefit. This fee is levied against the account balance each year, and represents a source of the insurance company's profit. This fee funds the insurance company's payments of overhead, commissions, set up fees, and death benefit claims.

This fee can range from 1.1 percent to 1.5 percent. The most common mortality charge is 1.2 percent. The variable annuity contract specifies that this fee is "frozen" and can never be increased. The fee is usually described in a prospectus and will not appear on any quarterly or annual statements.

The mortality charge is used to pay commissions and overhead costs that the contract owner would normally have to pay in an up-front or continuing sales charge. It provides funds that allow the insurance company to hire the best money managers, and the mortality charge ensures the integrity of the guaranteed death benefit.

Annual Account Maintenance Charge

This charge is minor when compared to the mortality fee. The annual contract maintenance charge will range from $25 to $50. This charge will be noted in the fourth quarter statement issued by the insurance company, and will be deducted from the then-current value of the annuity.

This fee can never be increased during the life of the contract.

FREQUENTLY ASKED QUESTIONS

Can Someone Get to Their Money if They Need it?

Generally, annuity contracts do provide liquidity features. Withdrawals of fixed dollar amounts may be made without charge, depending on how the annuity has been in force. However, surrender charges may be incurred. When surrendering the contract, the surrender benefit generally is equal to the contract value (premiums plus interest) less any surrender charges.

$59^1/_2$ years of age and Older — Lump Sum or Annuitize?

Annuitization only subjects a portion of the amount withdrawn to taxation. Taking a lump sum, however, subjects the entire growth and interest to income taxes.

Are There Taxes or Penalties for Withdrawing the Entire Annuity and Then Putting the Entire Amount Back?

The IRS is not forgiving. Monies cannot flow in and out of annuities without a tax being imposed. However, most insurance companies provide a grace period for withdrawals.

What is the Insurance Company's Charge for Its Services?

While it is true that charges will vary from company to company the most common charge imposed by the insurance company is the surrender charge. The surrender charge comes into play only when withdrawals of all or part of the annuity are made after a certain number of years specified in the contract have passed.

FOCUS POINTS

- The three major disadvantages of annuities are IRS Penalties, insurance company penalties, and ongoing Expenses of variable annuities.
- Annuities are subject to a 10% penalty on withdrawals prior to age 59½.
- The 10% penalty is not invoked if the annuitant dies, becomes disabled, or annuitization occurs.
- Money invested in an annuity will compound tax deferred not tax free.
- The tax liability will be the value of the annuity at the time of death minus the amount invested and then multiplied by the beneficiary's tax bracket.
- The term for an insurance company penalty is a surrender charge.
- Surrender charges only apply if a certain amount of money is withdrawn from the contract within a set number of years.
- Up to 10% per year may be withdrawn without penalty, after the first year.
- Surrender charges do not apply if the annuitant dies or becomes disabled, annuitization occurs, or withdrawals are limited to the allowed free withdrawal privilege, period has lapsed, systematic 10% withdrawals are made.
- Variable annuity expenses consist of an annual contract fee and a mortality and expense fee.
- Mortality and expenses fees are levied against an account annually by an insurance company.
- To fund the company's payments of overhead, commissions, set up fees and death benefit claims.
- Mortality fees on a fixed contract range from 1.1 to 1.5%.
- Mortality fees on variable contracts are usually "frozen."

CHAPTER 7: MUTUAL FUNDS VS ANNUITIES

Common Features

Mutual funds and annuities share some common features. Each:

- Is easy in which to invest;
- Is easy to monitor;
- Has professional management;
- Has outstanding track records;
- Offer investment options;
- Provide options to increase the investment;
- Provide options to withdraw funds; and
- Offer Dollar-Cost averaging.

Notable Differences

Mutual funds and annuities differ in several areas, including:

- Commissions;
- Taxation;
- Performance;
- Withdrawal options;
- Investment choices; and
- Safety.

Commissions

Mutual fund commissions range from 1 to 8.5 percent and this commission usually is subtracted from the investment. Fixed and variable annuities do not charge the investor a commission. If additional contributions are made to the initial annuity investment, there are no commission charges taken out of the investment.

Taxation

Mutual funds are subject to income tax on certain earnings, including:

- The dividends or interest generated by the securities;
- Capital gains realized when stocks or bonds are sold; and
- Profits received upon the sale of shares or when changes are made within the mutual fund family.

The investor cannot control the amount of dividends or interest generated by the securities, or the capital gains realized when stock or bonds are sold. These returns are decided by the performance of the fund, and income tax will be determined accordingly.

The only income the investor can control is the profit received upon the sale of shares or when changes are made within the mutual fund family. The individual is not the investor, the company is.

Investments in a fixed-rate or variable annuity grow and compound tax-deferred indefinitely. The only time income tax enters the picture is when withdrawals are made. At that time taxes are only paid on that portion of the withdrawal that is considered accumulated growth and interest. Money received that is considered return of principal is not taxable.

Performance

Variable annuities often perform better than the top mutual funds in the best performing bracket. Most mutual funds, because of their size, are forced to buy stocks and bonds that are not the first choice. The Securities and Exchange Commission (SEC) requires that the mutual fund follow diversification rules.

In contrast, a variable annuity has investments in specifically selected stocks and bonds. This is especially true in the case of an initial public offering (IPO). An IPO is a stock offered by a company that is going public for the first time. All mutual funds keep a certain amount of assets in cash.

These assets in cash become reserves and are there to cover partial or complete liquidations. Fund managers do not like to sell off securities in order to settle partial or complete liquidations.

This problem is not encountered with annuities since withdrawals are much less frequent.

Both annuities and mutual funds provide professional management. For the most part, investors are not objective when it comes to making investment decisions. Professional money managers are excellent resources for the investor.

Withdrawal Options

Mutual funds and annuities permit withdrawals or complete liquidation at any time.

Investment Choices

A mutual fund family provides limited investment options and management styles from which to choose. Variable annuities offer a choice of many different management styles. However, mutual funds require investment money with the money managers within the mutual fund family.

Safety

Mutual funds are prohibited from guaranteeing the rate of return or even the safety of the principal. In a fixed-rate annuity the exact rate of return is known. No one has ever lost money in a fixed-rate annuity.

FREQUENTLY ASKED QUESTIONS

Why do mutual funds provide more information than annuities?

First, mutual funds are easier to understand. Popular publications emphasize the performance and features of mutual funds with much greater frequency.

Second, the brokerage industry can make more money selling mutual funds than annuities.

Third, the insurance industry does not spend as much money promoting annuities as fund executives spend promoting mutual funds.

Are there as many fund managers to choose from if I invest in an annuity rather than a mutual fund?

There are not as many portfolio managers under the annuity umbrella. However, it is possible to find a fund manager with a solid track record who manages according to your investment objective. Annuity managers enjoy a better overall performance record than mutual fund managers do.

How can someone compare mutual fund results to annuity results on a regular basis?

Financial publications such as The Wall Street Journal, Barron's, and specialty services such as VARDS and Morningstar all provide fund and subaccount performance results for comparing and contrasting specific fund and annuity accounts.

What protection does someone have against loss of their initial and/or ongoing investment?

Every variable annuity has inherent features that minimize risk and increase return, for example:

- Professional management:
  - All variable annuities and family of mutual funds are monitored by professional investment managers. The managers, backed by education, experience and research, strive to achieve the stated objective and to select the right investments.
- Diversification:
  - The risk is spread among many securities, reducing the possibility of losing a substantial amount of money due to any security. Investments are made in more than one portfolio.
- Separate accounts:
  - Variable annuity portfolios—other than fixed account option—are part of a separate account that is maintained and established aside from the insurance company's general investment portfolio. Only the performance of the separate account portfolio chosen will affect results.
- Switching privileges:
  - Providing money is not moved too often, most variable annuities money to be moved among the portfolios, usually without charge. When interest rates or market conditions change, transfers among portfolios keep earnings high.
- Guaranteed death benefit:
  - Variable annuities guarantee that in the event of death during the accumulation phase the beneficiary will receive the greater of the entire amount of the annuity premiums less withdrawals, or current value of the investment.

FOCUS POINTS

- Common features shared by annuities and mutual funds include easy to invest in and easy to monitor.
- Mutual funds and annuities have professional management and outstanding performance records.
- Annuities and Mutual funds provide investment options and opportunities to increase the investment.
- Both provide withdrawal options and offer dollar cost averaging.

- Mutual funds and Annuities differ in the area of commission, taxation, performance, withdraw options, investment choices, and safety.
- On Mutual funds commissions range from one to 8.5% and this commission is usually subtracted from the investment.
- Fixed and variable annuities do not charge the investor a commission.
- Mutual funds are subject to income tax generated by the securities.
- Mutual funds are subject to capital gains realized when stocks or bonds are sold.
- Mutual funds are subject to taxation upon the sale of shares.
- Investments in a fixed or variable annuity grow and compound tax deferred indefinitely.
- Variable annuities usually outperform mutual funds.
- Mutual funds and annuities permit withdrawals or complete liquidation at any time.
- A mutual fund family provides limited investment options and management styles.
- Variable annuities offer a choice of many different management styles.
- Mutual funds require investment money with the money managers within the mutual fund family.
- Mutual funds are prohibited from guaranteeing the rate of return or the safety of the principal.
- Fixed rate annuities guarantee an exact rate of return.

CHAPTER 8: UNDERSTANDING ANNUITY TAXATION

Basic Annuity Taxation

Always urge customers to seek advice from a personal tax advisor. Insurance agents are not trained or qualified to provide tax advice. There are gray areas where even tax attorneys disagree. It is not an agent's role to be a tax practitioner. An agent's role is to help people accumulate more money. Understanding basic annuity taxation allows an agent to perform that role.

Withdrawal

Withdrawals from annuities are taxed in one of two ways, depending upon when the annuity was issued.

Annuities issued prior to 8/14/82, were structured with FIFO accounting (first in, first out). Since principal was first in, it came out first, tax-free.

For annuities issued on 8/14/82 and thereafter, taxation changed to LIFO (last in, first out). Simply put, withdrawals are now taxable since interest is withdrawn first. Many customers will enjoy paying taxes only when interest is withdrawn since most are now paying taxes on interest even if they don't withdraw it.

Ten Percent Tax Penalty

The government extends tax advantages to the annuity for retirement purposes. To encourage people to not withdraw the funds too soon, the government has decided that the year you turn 59½ you can retire early or take what you need without an extra penalty. All interest withdrawn prior to the owner attaining the age of $59^1/_2$ will be subject to a ten percent tax penalty in addition to the regular tax paid on the funds. Any principal withdrawn will not be taxed since it was after tax dollars when it was paid into the plan.

Six Ways to Avoid the Ten Percent Excise Tax Penalty

There are certain circumstances where the ten percent excise penalty may be avoided:

- Disability of taxpayer;
- Distribution from a pre-8/14/82 annuity;
- Death of owner (but death of annuitant for annuities issued before 4/23/87);
- Payment from an immediate annuity where benefits commence within one year of purchase;
- Payment from a structured settlement; or
- Substantially equal payments over taxpayer's life expectancy.

Exclusion Ratio

When and if the owner annuitizes (applies their annuity value toward a settlement option), the annuitant will receive equal payments. The contract owner does not pay full taxes on the payments like those incurred with withdrawals.

An *exclusion ratio* is applied to each payment received. An exclusion ratio stipulates that a percentage of each payment is considered a return of the owner's cost basis and is tax-free. The balance is growth and is taxable.

Calculate the exclusion ratio by dividing the expected return into the total of all premiums paid into the contract.

Example:

Assume an annuity was purchased one year ago for $80,000. It is now worth $88,000. The total of all premiums paid in the contract equals $80,000. Further assume that the contract owner wants to annuitize and elects the settlement option of a 5-year Period Certain (60 months) where monthly payments will be $1,667.00 a month. The expected return is $100,000 ($1,667.00 multiplied by 60 months).

Therefore, 80 percent of all payments to the contract owner are income tax free ($80,000 of $100,000 = 80%). For annuities using a life contingency, calculate life expectancy using government tables to determine the expected return.

Note that, effective with all annuity starting dates after 12/31/86, payments become fully taxable after the owner recovers the total of all premiums paid into contract (determined by adding all dollars excluded from taxes). In other words, after they have lived beyond their expectancy (as calculated when payments began), payments then become fully taxable.

Important Tips for 1035(A) Exchanges

A 1035 exchange is money moving from one tax deferred account directly to another without any taxes being charged to the owner. It is for like-to-like exchanges: IRA to IRA, 401(k) to IRA, annuity to annuity, cash value insurance to cash value insurance, cash value insurance to annuity, (but NOT annuity to insurance), etc.

Transfers under Section 1035(a) should be carefully reviewed.

Assign the old annuity contract (if premiums are non-qualified) to the new insurance company;

Exchange the entire annuity (cannot transfer some of the money);

If there are loans outstanding, repay loans before exchanging;

Parties designated in the old contract as owner, annuitant, and beneficiary, should again be designated in the new contract; and

Customers should consult with their tax adviser before the exchange.

The basics of annuity taxation are:

- Taxes are only paid when interest is withdrawn.
- The 10 percent excise tax penalty exists just like another tax-advantaged vehicle, the IRA.
- The exclusion ratio allows clients to receive income partially income tax-free.
- Section 1035(a) exchanges are a way to move annuity money income tax-free.

FOCUS POINTS

- The government extends tax benefits to an annuity for retirement purposes.
- A 10% excise tax is imposed for withdrawal prior to age 59½.
- The excise tax is waived at the disability or death owner.
- Tax is waived when payment occurs from an immediate annuity with benefits commencing within one year of purchase.
- Tax is waived from a structured settlement payment on the principal, any interest earned will be taxable.
- Partial tax on the amount received is paid when an exclusion ratio formula is used because only the growth is taxed.
- Money transferred from one annuity to another is tax free under section 1035(a).

- To qualify under section 1035(a) the old annuity contract must be assigned to the new company.
- The entire annuity must be exchanged under a 1035(a).
- All loans must be fully paid back under a 1035(a) exchange.
- Parties in the first contract must be the designated parties in the second contract to qualify for a 1035(a).

CHAPTER 9: GROUP PLAN ANNUITIES

Tax Sheltered Annuities (TSA)

Whereas a 401(k) is a tax deferred qualified retirement savings plan for companies, a 403B is the same thing but for other types of groups. A 403B can be invested in a custodial account with mutual funds, a retirement income account set up for church employees, or an annuity contract provided through an insurance company. Because this is a qualified retirement plan the annuity funds will be pretax dollars. **This is why it is called a tax-sheltered annuity or TSA**. Certain groups of people are eligible for Tax-Sheltered Annuities (TSAs). These qualified programs are approved under Section 403(b) of the Internal Revenue Code (IRC).

Qualifying individuals are:

- School personnel;
- Hospital employees; and
- Members of non-profit organizations.

To qualify for a TSA the individual *must be* a member of one of the three groups described above.

Tax-sheltered annuities offer many advantages not found in any other type of retirement plan or annuity.

A tax-sheltered annuity has the following characteristics:

- It is purchased from an insurance company;
- The participant may choose either a variable or fixed account;
- Contracts are issued to either an individual or group;
- The insurance carrier receives deposits directly from the employer;
- The participant's contributions may vary yearly;
- Contributions are outlined in a salary reduction agreement;
- Contributions are made via payroll deductions on a pre-tax basis;
- Social Security tax (FICA) is withheld on the employee's salary deduction amounts; and
- Under certain circumstances, money may be withdrawn without penalty, such as:
    - Financial hardship
    - Disability
    - Death
    - Termination of employment

Individual vs Group Contracts

Under a group contract, the participant will receive an individual certificate verifying that they are in fact participating in the program. The actual contract is between the insurance company and the participant's employer. While individual contracts have certain guarantees that exist until that contract ends, group plans have guarantees that last for a certain period of time, such as five years.

Flexibility is the major difference between an individual and a group contract.

Individual contracts are portable. A participant who changes jobs under an individual contract has several options:

- Freeze the account;

- Transfer all or part of the program to one offered by a new employer, providing the new employer is eligible to participate in a TSA program; and
- All or part of the monies may be transferred to an IRA.
- If the changeover is properly made, there should be no tax consequences.

Variable Funds

In order for an insurance carrier to offer variable annuities it must be registered with the Securities and Exchange Commission (SEC). The insurance company is also required to provide the investor with a prospectus prior to the purchase. An employer may choose a fixed annuity of a variable annuity for this group plan.

Tax Benefits of a TSA

A TSA has attractive income tax implications, like any qualified retirement plan:

- Contributions made to a TSA by the employee reduce the participant's taxable income, dollar for dollar, and may result in a lower tax bracket for that person;
- Contributions made by the employer are not taxed to the employee and are tax-deductible for the employer;
- Once contributions are invested, the participant's money will grow and compound fully tax-deferred; and
- Participants making withdrawals when in a lower tax bracket can minimize tax consequences.

Accumulation Period

The accumulation period is the time in which the employer sets aside money into the TSA that has been deducted from the income of the participant.

The employer contributions are made with before-tax dollars by the following methods:

- Bi-weekly;
- Monthly; and
- Semimonthly

The monthly schedule is the one most commonly used. The insurance company then deposits most, if not all, of each contribution into the participant's account. The money is invested to conform to the options the participant has elected. As a rule, when deposits are made, a transaction charge may occur. There may also be a quarterly or annual maintenance fee.

Payout Period

When it comes time for the participant to receive money, usually at retirement, this is called the payout period. The participant may receive payout in a variety of ways:

- Receive a lump sum;
- Receive a partial payment;
- Roll the account into an IRA;
- Annuitize the contract and start receiving monthly, quarterly, or annual payments.

If the participant chooses to annuitize, the amount received will depend on:

- The rate the insurance company is offering,
- The annuity option selected,
- The actual amount being annuitized, and
- The age and gender of the participant, if relevant to the option chosen.

The rate the insurance company pays is based on a certain amount of monthly income per month for each $1,000.00 of cash invested in the annuity.

Crediting Interest

Two methods are used to determine the current interest rate credited to the participant's account:

1. The portfolio average; and
2. The banding method.

The portfolio average is a reflection of what the insurance company has earned on its entire portfolio of investments during the given year. From this, the insurance carrier forms a composite rate, and the policy owners are credited with that amount.

The banding approach uses a year-by-year method of crediting accounts. In other words, the participant's contributions are banded together for that particular year. When interest rates are rising the banding method is best. When interest rates are declining the portfolio method is best.

Two-tiered Interest Crediting

This method is often misleading. The two-tier approach credits the contract with a lower rate of interest should the participant make a partial or total liquidation of the account. There is also a substantial charge for withdrawals, and this charge may never disappear.

Under this method accounts are credited at an artificially low rate if a minimum payout or period is elected. Many states have outlawed two-tiered policies because they are considered to be unfair.

Current Trends in Crediting

Many companies have discontinued the use of a calendar-year approach in valuing the rate of interest credited to accounts.

Many companies use a quarterly, monthly and, in some cases, daily method. This permits the insurance companies to be more competitive and also gives them the ability to move quicker to change the credited rate in the event that it is too high in comparison to the actual yield of the insurance company's portfolio.

Some insurance companies have adopted a provision known as *market value adjustment*. This method adjusts the fund balance, not the yield, upward or downward. The adjustment will always be in the opposite direction of the movement in interest rates.

Variable Options

The variable TSA is a suitable alternative to the more conservative fixed-rate TSA. The variable account offers the participant a range of options from aggressive stock portfolios to money market funds. Over time the equity market has consistently outpaced inflation.

Contributions

The majority of all TSA contributions are made by the employee. The amount of the contribution is governed by parameters set by the insurance company. Additionally, total contributions cannot exceed the IRS annual limit.

The amount that may be deducted from the employee's paycheck is calculated by using a dollar figure based on a percentage of pay. The amounts deducted are sent to the insurance company biweekly, semimonthly, or monthly.

Transfers

Contributions may be made by transfer. Under this method the participant can move funds from one company to another, or from one subaccount to another offered by the same insurance company.

Transfers are made because:

- The participant is dissatisfied with the current company's portfolio performance; or
- The participant is changing employers; or
- The participant has experienced a change that affects their ability to take risks; or
- There is a change in the participant's retirement date; or
- The participant has changed employment and the new employer does not have a TSA.

Retirement Options

Retiring participants have several options:

- Leave the money in the account and let it continue to compound and grow until some future date;
- Withdraw part of the money;
- Withdraw all of the money;
- Receive payments over a fixed period of years;
- Select a fixed rate;
- Select a variable rate;
- Transfer the money to another insurance company; and
- Roll over the money into an IRA.

Loans

Some insurance companies will permit participants to borrow a portion from the TSA, however not all permit loans. The IRS governs loans from TSAs via a series of codes that state the following:

A loan is taxable if it exceeds 100% of the employee's account or $10,000.00, whichever is less, if the account is less than or equal to $10,000.00.

A $10,000.00, or greater, loan will be taxed if the participant's account is more than $10,000.00 but less than $20,000.00.

If the value of the account is over $20,000.00, a loan will be taxable if the amount of that loan is 50 percent of the value of the account, or $50,000.00, whichever is less.

The $50,000.00 amount referred to here is reduced by any net loan repayments made by the employee during the preceding 12 months.

Loans, with the exception of real estate-related loans, must be repaid within five years.

Should the loan not be repaid in time, any amount that is still outstanding will be immediately subject to taxation. It may also be subject to a 10 percent tax penalty.

If a loan is in default, the insurance company is required to notify the IRS and the participant.

Should the loan ever exceed the value of the employee's account, any excess is taxed.

Loan Protection

Since TSA loans do have the potential for adverse tax and penalty consequences, it is suggested the borrower contact their insurance company and discuss possible safeguards.

Protective measures should be taken to avoid a late payment, also known as a *technical default*.

Since the insurance company may deduct any payments that are due from funds in the account, the participant could find themselves in a withdrawal situation due to this forced payment.

Death Benefits

As a rule, most insurance companies do not charge a fee for liquidation of an account due to death. Upon the death of the participant most companies pay out the total value of the account.

The death benefit may be a lump sum, or it can be annuitized by the beneficiary. As a rule, the processing time for death claims once the death certificate has been received is about two weeks.

TSA Expenses

Virtually every tax-sheltered annuity has expenses. Insurance companies obtain fees as: Explicit; or Implicit.

Explicit charges are clearly spelled out and visible. These charges may be applied regularly throughout the year under the following circumstances:

- When the account is valued;
- When a contribution is received;
- When a loan is made; and
- When a withdrawal takes place.

Implicit charges are made indirectly and can often be much higher than their explicit counterparts. An implicit charge may be the difference between the returns the insurance company actually earns versus the amount credited to your account.

Insurance companies do have the right to alter or amend a TSA contract. As a rule, this privilege is broad and can affect:

- The amount of any charges made;
- Interest credited to the account in the future;
- Annuity rates per $1,000.00 annuitized; and
- Other provisions in the contract.

Note: TSAs cannot be changed without the permission of the participant.

FREQUENTLY ASKED QUESTIONS

Are contributions to both a TSA and a regular annuity permitted?

Yes, although it is suggested that the majority of the contribution be invested in the TSA. By doing expenses and fees are kept to a minimum. There is no law against investing in both.

Why are the rates of return are so different with TSA accounts?

TSAs are group annuities. Because of the number of plan participants involved, expense and rate of return calculations are more complex.

Do TSAs differ from regular annuities?

The TSA is a type of annuity that can be offered only to certain employment classifications. A major difference is that TSAs contribute before-tax dollars and other annuities are funded with after-tax dollars.

What if I don’t agree with a change in my group policy or contract?

When participating in a TSA the individual is subject to the decisions of the group as a whole. Although most changes are made with maximum input from individuals in a group plan, the final decision made by the group may not mesh with an individual’s financial plans. The alternative for the individual: terminate participation.

FOCUS POINTS

- Tax sheltered annuities are approved under Section 403(b) of the Internal Revenue Code.
- Qualifying individuals are school personnel, hospital employees, and members on non-profit organizations.
- Tax Sheltered annuities are purchased from an insurance company.
- TSA contracts are issued to either an individual or group.
- The insurance carrier receives deposits directly from the employer.
- Tin TSA's the participant's contributions may vary from year to year.
- In TSA's contributions are outlined in a salary reduction agreement and are made via payroll deduction on a pre-tax basis.
- FICA is withheld on the employee's salary deduction amounts.
- Money can be withdrawn without penalty under circumstances of financial hardship, disability, death, and termination of employment.
- Under a group contract the contract is between the insurance company and the participant's employer.
- Group contracts have guarantees that last a certain period of time, such as five years.
- Flexibility is the major difference between an individual and a group contract.
- Individual contracts are portable to another qualified employer, may be transferred to an IRA, or frozen.
- Contribution's made to a TSA reduce the participant's taxable income dollar for dollar.
- Employers may make contributions biweekly, semimonthly, or monthly.
- Payout can be made in a lump sum, partial payment, rolled into an IRA, rolled into another TSA, or annuitize the contract.
- Interest is credited by either the portfolio average or the banding approach.
- Crediting of interest is usually done either monthly or quarterly.
- Contributions are made by the employee through the employer.
- Contributions are limited by IRS regulations.
- Contributions may be made by transfer from one company to another.
- The IRS governs loans from TSAs.
- Loans with the exception of real estate related loans must be paid back within five years.
- If a loan is in default the insurance company is obligated to notify the IRS.
- A late payment or technical default could place a participant in a withdrawal situation.
- A death benefit can be a lump sum or can be annuitized.
- Charges on accounts are made either in an implicit or explicit manner.
- TSA's cannot be changed without the permission of the participant.

CHAPTER 10: EQUITY INDEXED ANNUITIES

An Overview of Equity Indexed Annuities

Equity indexed annuities were first introduced in 1995 and met with such enormous success that by 1996 received wide acceptance.

The Equity Indexed Annuity offers the consumer, in a single tax-advantaged annuity contract, a solution to balancing both risk and reward.

Since Equity Indexed Annuities are fixed annuities, today's products have not been registered as securities and may be sold by licensed life/annuity agents.

Equity Index Annuities returns are based on the performance of one or more market index returns, e.g., S & P 500

There is a minimum guaranteed rate of return offered by the insurance company. If the index the product follows increases, the rate of return (ROR) increases as well. If the index stays flat, the guaranteed minimum is paid out, and if the index drops, the guaranteed minimum is paid. Regarding the increase, if the S & P goes up 300 points the annuity will not. There will be a cap on what the ROR paid out will be.

There are options for the consumer when purchasing, for example if you choose a 0% minimum you may have a 10% cap, and if you choose a 3% minimum there may be a 7% cap. The principal is always guaranteed and the funds are kept in the company general account.

On January 8, 2009, the Securities and Exchange Commission ("SEC") issued a new rule that defines the terms "annuity contract" and "optional annuity contract" under the Securities Act of 1933 ("Securities Act"). The rule is intended to clarify the status under the federal securities laws of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index. The rule applies on a prospective basis to contracts issued on or after January 12, 2011.

Description of Indexed Annuities

An indexed annuity is a contract issued by a life insurance company that generally provides for accumulation of the purchaser's payments, followed by payment of the accumulated value to the purchaser either as a lump sum, upon death or withdrawal, or as a series of payments (an "annuity"). During the accumulation period, the insurer credits the purchaser with a return that is based on changes in a securities index, such as the Dow Jones Industrial Average, Lehman Brothers Aggregate U.S. Index, Nasdaq 100 Index, or Standard & Poor's 500 Composite Stock Price Index. The insurer also guarantees a minimum value to the purchaser. The specific features of indexed annuities vary from product to product.

Section 3(a)(8) Exemption

Section 3(a)(8) of the Securities Act provides an exemption for any "annuity contract" or "optional annuity contract" issued by a corporation that is subject to the supervision of the insurance commissioner, bank commissioner, or similar state regulatory authority. The exemption, however, is not available to all contracts that are considered annuities under state insurance law. For example, variable annuities, which pass through to the purchaser the investment performance of a pool of assets, are not exempt annuity contracts

Definition of Annuity Contract

Rule 151A, on a prospective basis, defines a class of indexed annuities that are *not* "annuity contracts" or "optional annuity contracts" for purposes of Section 3(a)(8) of the Securities Act; *i.e.*, that are outside the scope of Section 3(a)(8). With respect to these annuities, investors will be entitled to all the protections of the federal securities laws, including full and fair disclosure and antifraud and sales practice protections.

Under rule 151A, an annuity issued by an insurance company is *not* an "annuity contract" or an "optional annuity contract" under Section 3(a)(8) of the Securities Act if the annuity has two characteristics.

First, the contract specifies that amounts payable by the insurance company under the contract are calculated at or after the end of one or more specified crediting periods, in whole or in part, by reference to the performance during the crediting period or periods of a security, including a group or index of securities.

Second, amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract.

Rule 151A addresses the manner in which a determination will be made regarding whether amounts payable by the insurance company under a contract are more likely than not to exceed the amounts guaranteed under the contract. Rule 151A is principles-based, providing that a determination made by the insurer at or prior to issuance of a contract will be conclusive, provided that:

- both the insurer's methodology and the insurer's economic, actuarial, and other assumptions are reasonable;
- the insurer's computations are materially accurate; and

- the determination is made not earlier than six months prior to the date on which the form of contract is first offered.

Effective Date

The effective date of rule 151A is January 12, 2011. The new definition in rule 151A will apply prospectively — that is, only to indexed annuities issued on or after January 12, 2011.

Deferred Annuity Features

Interest is not taxed until withdrawn by the contract owner or beneficiary.

Retirement payout options include guaranteed life time payout or specified period payout to contract owner or beneficiary.

A long term retirement planning program as an option of the contact owner.

Availability of funds for emergency situations, should the need arise.

Except for variable annuities, the stability and consistency of earnings of both principal and interest.

Probate free death benefit as a result of the annuity.

A surrender charge for early withdrawal with some annuities and an excise tax penalty for the taxable portion of withdrawals made prior to age 59½

Comparing Annuities

In the case of fixed annuities the insurance carrier and the annuitant work with a specific interest rate and the annuitant is guaranteed both the rate of return and the principal amount of the contract. This type of contract normally carries the lowest risk and thus in most cases the lowest return.

In the case of variable annuities the contract owner enters into the risk factor by choosing the investment vehicles in which their principal and interest is invested. Thus by joining in the choice, they also join in the risk and could experience both an increase or decrease in the amounts accumulated.

The investment sources for variable annuities are usually a combination of mutual funds and equity funds.

This vehicle certainly represents an opportunity for higher gain over a fixed product but also an opportunity for greater losses.

Equity Indexed Annuities on the other hand have interest rates that are linked to growth in the equity market as measured by an index. The mostly commonly used index is the S & P 500.

Because the owner of the contract is guaranteed no exposure to the downside risk, the upside potential can represent great gain.

Features of Equity Indexed Annuities

Accumulations are taxed deferred until paid out to the contract owner or beneficiary.

They feature lifetime retirement income options and death benefits.

No market risk to the owner on the principal and the potential to earn more than the minimum guarantee.

Benefits of Equity Indexed Annuities

Both the principal and earnings are guaranteed.

A vehicle that permits both long term accumulation, as well as, retirement planning.

As time passes, Equity Indexed Annuities are predicted to gain stronger favor because historically Equities have outperformed fixed income investments and inflation.

"Safe Harbor Rules" of Equity Indexed Annuities

In order for an Equity Indexed Annuity to be outside the domain of the Security Exchange Commission regulations it must meet all the requirements which qualify it to be a fixed annuity.

(a) Any annuity contract shall be deemed to be within the provisions of section 3(a)(8) of the **(a)** Any annuity contract or optional annuity contract (a *contract*) shall be deemed to be within the provisions of section 3(a)(8) of the Securities Act of 1933), *Provided,* That

(1) The annuity or optional annuity contract is issued by a corporation (the *insurer*) subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

(2) The insurer assumes the investment risk under the contract as prescribed in paragraph b of this section; and

(3) The contract is not marketed primarily as an investment.

(b) The insurer shall be deemed to assume the investment risk under the contract if:

(1) The value of the contract does not vary according to the investment experience of a separate account;

(2) The contract for the life of the contract

(i) Guarantees the principal amount of purchase payments and interest credited thereto, less any deduction (without regard to its timing) for sales, administrative or other expenses or charges; and

(ii) Credits a specified rate of interest to net purchase payments and interest credited thereto; and

(3) The insurer guarantees that the rate of any interest to be credited in excess of that described in paragraph b of this section will not be modified more frequently than once per year.

(c) The term ***specified rate of interest,*** as used in paragraph b of this section, means a rate of interest under the contract that is at least equal to the minimum rate required to be credited by the relevant nonforfeiture law in the jurisdiction in which the contract is issued. If that jurisdiction does not have any applicable nonforfeiture law at the time the contract is issued (or if the minimum rate applicable to an existing contract is no longer mandated in that jurisdiction), the specified rate under the contract must at least be equal to the minimum rate then required for individual annuity contracts by the NAIC Standard Nonforfeiture Law.

(1) The annuity or optional annuity contract is issued by a corporation (the *insurer*) subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

(2) The insurer assumes the investment risk under the contract as prescribed in paragraph b of this section; and

(3) The contract is not marketed primarily as an investment.

Securities Regulation Organizations

The two major players in this arena are The Securities and Exchange Commission and FINRA –The Financial Industry Regulatory Authority.

The Securities and Exchange Commission is an agency of the federal government that regulates the offerings of securities to the consumer. The Commission establishes rules and also enforces the securities laws that have been enacted by congress.

The Financial Industry Regulatory Authority (FINRA) is a self-regulatory organization. FINRA oversees it's members activities, making sure that they are in compliance with federal laws and at the same time issues its own rules and regulations.

As the name implies, the organization comprises individuals from the security industry.

Also playing a part in this picture is the broker/dealer and the registered representative.

The broker/dealer is a company or individual who has registered with the Securities and Exchange Commission to buy and sell securities for its own account or for the accounts of others.

A registered representative is an agent for a broker or dealer and represents the interest of that broker or dealer in working with a consumer.

Pre-Requisites of Selling Variable Equity Indexed Annuities

A producer needs to have an insurance license in the LIFE line of authority as well as complete a 4-hour required Annuity Suitability with Best Interest Standards of Conduct certification course.

Some states also require an additional examination to sell registered contracts.

The necessity of these rules is for the purpose of providing prospects with accurate information before making a buying decision that involves risk.

An agent must use the highest ethics in presenting this type of product. It is important that no statements are made in regard to predicting losses or gains.

What is Indexing?

Indexing is the strategy that seeks to match the performance of a specified group of securities. The recognized market measure of this group is called an "index."

Most equity-linked products marketed in the United States are linked to the S&P 500.

The S&P 500 is used over other indexes because, for one, it is a United States Department of Commerce leading economic indicator.

It reflects the long-term growth potential of equity-linked returns. Normally, these types of equities outperform fixed-interest returns as well as inflation.

The 500 stocks in the index represent 70% of the total United States equity market. It is comprised of stocks from the New York Stock Exchange, the American Stock Exchange and FINRAAQ.

The S&P 500 includes industrial, utility, financial, and transportation stock and is "market-weighted". This means that each stock impacts the index in proportion to that stock's importance in the market.

The S&P 500 doesn't include dividends and is a widely used index in "passive investing".

"Diversified" Equity Indexed Annuities link their return to two or more indexes.

Foreign linked equity indexes include:

- The Dax which is compromised off an index of 30 stocks on the Deutsche Stock Exchange
- The Nikkei which is an index of 225 stocks on the Tokyo Stock Exchange
- The Financial Times Stock Exchange which is an index of 100 stocks on the London Stock Exchange

Since "indexing" is a strategy that basically buys and holds for a period of time it tends to outperform an active trading strategy which is a buy low sell high strategy over shorter periods of time. In an activity strategy of investing one is always trying to outguess the market for quick profit.

The major features of an indexed fund are low cost, consistent performance, predictability, proven success, and tax efficiency.

The Vocabulary of Equity Indexed Securities.

The Annual Reset Rate is an indexing method used to measure growth annually and re-established each year as a basis for the following year.

Averaging is a method wherein the index starting point is based on an average value over a pre-established period of time rather than on a specific day. Sometimes this is also known as the "Asian" method in comparison to the European method.

The Cape Rate is the maximum allowed percentage value increase in one year.

The Contract Value is the minimum guaranteed cash value minus applicable surrender fees.

The Deferred Annuity is a contract that accumulates value and pushes forward the distribution to an alternate pre-established date.

The Floor is the minimum credited rate applied to the account value regardless of the index changes.

A Free Withdrawal is a pre-established amount that can be taken out without suffering carrier imposed surrender charges.

The Index Benefit is the amount of earnings credited to an Equity Indexed Annuity.

The Index Growth is the change in the value of the index from beginning point to end measuring point.

Liquidity is the ease at which funds are available within a contract.

The Participation Rate is the percentage of increase in the index that will be credited to the account value.

Point to Point is an indexing method in which index growth is measured between two points in time. This can range anywhere between one year and some future point.

The Probate Free Death Benefit refers to the ability of a beneficiary to receive death benefits without having to go through the expense of probate.

The term Real Return is the return on the investment after the rate of inflation is deducted.

The Spread Yield is a flat percentage deduction from the growth to pay for administration costs.

The Surrender Charge is a fee that is imposed for early termination of a contract or for withdrawing funds from the contract.

The Term is that period of time in which a surrender penalty applies.

The Main Categories of Equity Indexed Annuities

The three main categories of Equity Indexed Annuities are annual reset, point to point, and high-water mark with look back.

Annual Reset

This format sets and resets the starting index point each year and credits and compounds interest annually.

Point To Point

This format determines a starting point and then measures to the ending point and credits the percentage increase to the account. An example of this might be a starting point of 1000 and at the ending point of five years 1600. This is a 600 point gain. This gain divided by the starting point index of 1000 would result in a 60% increase. This figure would then be multiplied by the participation rate to determine the contract credit at the end of five years.

Annual High-Water Mark with Look Back

This format is like the point to point except it does not deal with beginning point to end point, but deals with beginning point to a high point on an anniversary date. An example might be that starting point is 1000 year 2 it reaches 900 no credit and no loss to the account is incurred. Year three it reaches 1100.

Now credit is made to the account for the increase. This continues until the next high point is hit on an anniversary date. Basically a contract is credited at high points only and the owner of the contract suffers no losses if on an anniversary date a low is hit.

Average Format

Some Equity Indexed Annuities base their increases on the average over a predetermined period of time.

FOCUS POINTS

- Equity indexed annuities offer the consumer a solution to balancing both risk and reward.
- Equity indexed annuities are fixed annuities and can be sold by licensed annuity agents.
- Equity indexed annuities combine guarantee of principal, minimum cash values, free withdrawals, surrender charges and tax deferral with crediting rates that are linked to the equity market.
- Interest is not taxed until withdrawn by the contract owner or beneficiary.
- Retirement payout options include guaranteed life time payout or specified period payout to owner or beneficiary.
- Availability of funds for emergencies should the need arise.
- Probate free death benefit. Equity indexed annuities have rates that are linked to growth in the equity market as measured by an index.
- The most commonly used index is the S& P 500.
- Both the principal and minimum earnings are guaranteed.
- A vehicle that permits long term accumulation and retirement planning.
- Earnings have history and past market performance.
- In order for an equity indexed annuity to be outside the domain of the Security Exchange Commission it must meet "safe harbor requirements."
- In order to meet "safe harbor" the contract cannot be marketed primarily as an investment, interest credit is not modified more than once a year, the insurer must credit a specified rate of interest at least equal to the minimum non-forfeiture interest rate.
- Under "safe harbor" insurer must guarantee principal and prior earnings, as well as assume the investment risk.
- Other conditions of "safe harbor" are that the indexed annuity be issued by a regulated insurer and that the owner's account value is not based on a separate account.
- No statements should be made in predicting loss or gain.
- The prospect should not be led to believe that the product is sanctioned by the SEC.
- Indexing is the strategy that seeks to match the performance of a specified group of securities.
- The S&P 500 is used as the preferred index because it is a United States Department of Commerce leading economic indicator.
- The 500 stocks in the S&P represent 70% of the total United States equity market.
- The S&P 500 doesn't include dividends and is a widely used index in "passive investing".
- "Diversified" equity indexed annuities link their return to two or more indexes.
- Foreign linked equity indexes include the Dax, the Nikkei, and the Financial Times Stock Exchange.
- The major features of an indexed fund are low cost, consistent performance, predictability, proven success, and tax efficiency.
- The three main categories of Equity indexed annuities are annual reset, point to point, and high water mark with look back.

CHAPTER 11: TAX DEFERRED QUALIFIED PLANS LIMITS & CONTRIBUTIONS

The Economic Growth and Tax Relief Reconciliation Act, which went into effect on January 1, 2002, included major changes to the laws governing Individual Retirement Accounts (IRAs), providing for increases in contribution limits.

Traditional/Roth IRA

Contribution Limits

The contribution limit for both Traditional and Roth IRAs is $7000 per year for those under age 50 and $8000 for those age 50 and older.

IRAs: Technically, since qualified plans are employer-sponsored, an IRA or Individual Retirement Account, whether it is traditional or Roth, is not a qualified plan. A traditional IRA shares many of the limits of a qualified plan: limits on deposits, you must leave the funds in the plan until age 59½ or pay a penalty, and you must take distributions by age 73 or a tax penalty is imposed *(as of 2024)*. A Roth IRA does not have those restrictions, although there are income limits to be able to use this plan.

- A traditional IRA is generally, though not always tax-deductible.
- The growth is always tax-deferred, meaning it will be taxed on withdrawal.
- Anyone with earned income can put money into an IRA.
- A Roth IRA is not tax-deductible, but the growth is tax-free as long as the account has been established for 5 years. This means there are no taxes on the money taken out of the plan.
- There are income limits to qualify for a Roth IRA and the funding, as with a traditional IRA, must be from earned income.
- There is no such thing as a joint IRA; a married person may use the spouse's income to qualify to contribute to an IRA.
- Both have the same annual limit (in 2025 - $7000).
- The annual limit is the total for all IRAs for one person, e.g., $3500 in a traditional IRA and $3500 in a Roth IRA.
- A traditional IRA has a late withdrawal penalty of 50% if the funds have not started distribution by age 73, a Roth IRA has no such requirement.

Qualified Plans are savings plans that have tax advantages with the intent to have the individual save money for retirement. Qualified plans are offered by employers, must meet criteria set forth by the IRS, and are held to strict requirements according to ERISA (Employee Retirement Income Security Act).

A plan may be defined contribution or defined benefit:

- In a defined contribution plan (e.g., 401(k)), the individual knows how much is going in, but not how much will be there at retirement.

❖ In a defined benefit plan, the individual does not know what is going in, but knows what will be paid out (e.g., pension). We will focus on the defined contribution plans here.

- All employees who are eligible must be allowed to participate in the plan, minimum participation requirements must be in place.

- All employees must be informed of the plan.

- The plan must be nondiscriminatory regarding matching contributions, meaning everyone gets the same coverage (e.g., 50% match up to $2000).

- All participants in the plan have the same plan limits.

- Plans must satisfy specific vesting requirements.

    - The employee's contribution always belongs to the employee.

    - Vesting means, after a period of time, the amount the company puts in the employee's account belongs to the employee. Initially, the money is still owned by the employer, and gradually ownership transfers to the employee. With a 5-year vesting plan after the first year, the employee owns all their funds and 20% of what the employer has contributed, after 2 years they own 40% of the employer's contribution, and so on. This is to encourage employees to stay with a business for a length of time.

- There is an early withdrawal federal tax penalty of 10% of the taxable amount if the person is not 59½ in that year (in addition to the regular taxes on the income).

- If the person is age 59½ the withdrawal is taxed as regular income.

- There is a late withdrawal federal tax penalty or excise tax of 25% of the amount not withdrawn if the individual does not start withdrawing funds by a certain age, currently 73 (as of 2024).

Benefits of the plans are:

- Contributions are tax-deductible to both the employers and employees.
- Interest earned is tax-deferred until withdrawal.
- Plan types include 401(k), 403b (the 401(k) of the charitable organization employer), Simple IRAs, SEP IRAs, SARSEPs, and profit-sharing plans for employers.

Self-employed persons can set up a Keogh, HR10 plan, or an individual 401(k).

Two Annual Limits Apply to Contributions:

A limit on employee elective salary deferrals. Salary deferrals are contributions an employee makes, in lieu of salary, to certain retirement plans:

- 401(k) plans
- 403(b) plans
- SARSEP IRA plans (Salary Reduction Simplified Employee Pension Plans)
- SIMPLE IRA plans (Savings Incentive Match Plans for Employees)

An overall limit on contributions to a participant's account. The limit applies to the total of:

- elective deferrals (but not catch-up contributions)

- employer matching contributions
- employer nonelective contributions
- allocations of forfeitures

SEP IRA Contribution Limits

A SEP IRA owner may contribute up to 25% of compensation, as much as $70,000 for 2025.

The term "compensation" for self-employed individuals refers to earned income.

It should also be noted that the spouse and children may also participate in the plan and open their own SEP IRAs - as long as they are employees of the company.

Employees cannot make SEP IRA contributions on their own behalf, they are solely employer funded.

SIMPLE IRA Contribution Limits

SIMPLE is a Savings Incentive Match Plan for Employees. With a SIMPLE IRA, the employee can elect to have up to 100% of his/her annual compensation deferred into a SIMPLE IRA.

There is a maximum of $16,500 for 2025 if under age 50, and $20,000 if age 50 and over.

The employer must match each participant's contribution dollar-for-dollar, up to 3% of compensation or the employer must make contributions for ALL eligible employees.

A separate SIMPLE IRA is also available to the spouse and other family members - if they have received at least $5,000 in compensation during any two years preceding the current calendar year and are reasonably expected to earn at least $5,000 during the current calendar year they are eligible to participate in the plan.

Individual 401(k)(Contribution Limits

Two components comprise the maximum Individual(k) plan contribution: an employee salary deferral contribution and an employer contribution.

The employee is able to contribute up to $23,500 for 2025 through salary deferral, although this may not exceed 100% of pay.

Employees 50 and older may contribute $31,000 and employees 60-63 may contribute $34,750.

The employer profit sharing contribution limit is up to 25% of pay, or 20% for self-employed.

Also remember that spouses are eligible to open their own Individual(k) account provided they have separate income and are covered in the plan.

403(b) Annuity and Tax Sheltered or Tax Deferred Annuity

This program is available to charitable organizations, public schools, hospitals, and churches. 100% of pre-tax income can be directed to the plan, up to a maximum per year.

Section 457 Deferred Compensation

This program is available to employees of public bodies such as municipalities, counties, and states. The investments are owned by the employer. The employer satisfies the benefit to the employee.

HR-10 or Keogh Plans

These programs are available to self-employed individuals and sole proprietorships, S-Corporations, and partnerships.

A self-employed person can establish and make tax deductible contributions to a Keogh Plan even if the person additionally works as an employee and is covered by that employers tax-qualified retirement plan. An individual can also establish an IRA under the same tax rules as other taxpayers.

The two types of Keogh Plans are defined contribution plans and defined benefit plans.

Retirement benefits received from a defined contribution plan are based on the tax deductible contributions and accumulated interest and gains.

Retirement benefits received from a defined benefit plan are based on a benefit formula. Tax -deductible contributions are adjusted to provide the required benefit.

The maximum tax-deductible contribution to a defined contribution plan is the lesser of $42,000 or 100% of compensation.

The maximum tax-deductible contribution to a defined benefit plan is the amount needed to produce the required benefits under the formula.

For 2005 the maximum annual retirement benefit which may be funded may not exceed the lesser of 100% of the participant's average compensation for the highest three consecutive tax years as an active participant; or, $210,000.

Provided the Keogh Plan is established by the last day of the tax year, an individual can make tax deductible contributions up to the due date of your tax return.

Many other tax rules apply and individuals should seek the help of a qualified professional before establishing a tax deductible Keogh Plan.

Corporate Defined Benefit Plans …

…are sponsored by the corporation, and ERISA controlled. The policy is owned by a trustee. The employee looks to the pension fund to satisfy the benefit.

FOCUS POINTS

- SEP - Simplified Employee Pension Plan is designed for small businesses.
- Savings Incentive Match Plan for Employees (SIMPLE) can be set up either as an employer established IRA or 401(k).
- TSA OR TDA 403b Annuities are available to charitable organizations, public schools, hospitals, and churches.
- Section 457 Deferred Compensation programs are available to employees of public bodies such as municipalities, counties, and states.
- HR-10 or Keogh Plans are available to self-employed individuals and sole proprietorships, S-Corporations, and partnerships.

CHAPTER 12: SUMMING UP THE ANNUITY

QUICK QUESTIONS AND ANSWERS

What is a Tax-Deferred Annuity?

It is a tax-advantaged product issued by an insurance company where long term financial needs can be addressed more efficiently than with most other financial alternatives.

What is the Major Advantage with Annuities?

Interest (earnings) accumulates income tax-deferred until dollars are withdrawn. This helps the customer build a substantial fund for retirement and can provide the customer with an income that they cannot outlive.

Is the Annuity a Safe Alternative?

The general assets of the insurer, which issues the fixed and index annuity, back their annuity value.

Who Wants an Annuity?

Customers who want a safe way to reduce taxes; customers who want to decide when to pay taxes.

Clients who have disposable income after fully funding their retirement plans and want to save tax deferred.

Who is the Average Annuity Purchaser?

Average age is 55 years old with an average premium of $20,000. Typically, the annuity purchaser is not spending immediately the interest earned on their taxable alternative.

What Kind of Dollars are Invested in an Annuity?

Maturing CDs, passbook savings, money markets, and treasury bills.

Is the Annuity for Everyone?

No, Dollars earmarked for short-term needs should not be invested in an annuity. In addition, at least, six months' worth of income should be on deposit outside of the annuity. Those who need current income should not consider the deferred annuity. On the other hand, those looking for one of the safest ways "to accumulate" dollars on a tax advantaged basis will find the deferred annuity extremely beneficial.

Does the IRS Impose a Ceiling on Investments in a Tax-Deferred Annuity?

No, the government imposes no ceiling, nor does an individual need earned income to qualify for the annuity. However, since the tax-deferred annuity is designed as a retirement supplement, the government does impose a 10 percent excise tax penalty on "pre-tax dollars" withdrawn before age $59^1/_2$.

Since a Withdrawal of Principal is Tax-Free and IRS Penalty-Free, Can Principal be Withdrawn First and Then Interest?

No, the government considers interest earnings come out first. Naturally, any portion of a withdrawal exceeding interest earned would be a tax-free return on principal.

What if the Annuity is Paying an Interest Rate Less than Other Financial Alternatives?

Compare the virtually no-risk feature of the annuity to other alternatives. Note that the interest on many alternatives currently is taxable every year. And, Section 1035(a) of Internal Revenue Code allows annuity owners to transfer funds from one annuity to another annuity income tax-free.

How is the Interest Rate Declared After the Initial Guarantee Period of 1 to 3 Years?

Current market conditions and the insurance company's portfolio will dictate renewal rates.

How Does a Customer Know the Annuity Balance?

The insurance company will provide a statement of annuity value once a year.

When Does the Annuity Mature?

Although an annuity is similar to many safe taxable alternatives in many respects, an annuity does not mature after the initial interest rate guarantee period. Interest continues to accumulate on principal until the annuity is surrendered or when a settlement option is elected.

Will the Annuity be Tied Up in Probate Proceedings?

No, if a "named" beneficiary, other than the estate, is listed, annuity dollars will avoid the delay and expense of probate.

Will the Beneficiary be Taxed on the Interest That Accumulates in the Annuity?

Beneficiaries will be taxed on the tax-deferred interest when receiving those dollars. However, if a beneficiary is the spouse of the contract owner and the contract owner dies, the beneficiary may elect to continue the annuity and postpone taxes if the contract owner dies. Once again, the customer decides when to pay income taxes.

If the beneficiary is not the spouse and the owner dies, then dollars must be totally withdrawn within five years or they may be received over the beneficiary's life expectancy. However, this latter option must be elected during the first 12 months following the contract owner's death.

Is the Annuity Identical to an IRA?

Although the annuity can be used as a funding vehicle for an IRA, the purpose of an annuity is directed to after-tax dollars.

Therefore, dollars deposited into the annuity are not deductible. And because of this, there is no government imposed ceiling on how much premium can go into an annuity, nor do distributions have to begin at age 73. Some say that the annuity picks up where the IRA leaves off.

CHAPTER 13: THE LANGUAGE OF AN ANNUITY

Annuitant - One who receives an annuity payout.

Annuity - A contract that pays an income for life or for a specified period.

Beneficiary - A person who may become eligible to receive, or is receiving, benefits under an insurance plan, other than as an insured.

Beneficiary, Primary - The person first designated to receive the proceeds of a policy, as named in the policy.

Cancellation - Termination of the insurance contract by voluntary act of the insurer or insured, effected in accordance with provisions in the contract or by mutual agreement.

Claim - The demand of an insured or their representative or beneficiary for benefits as provided by an insurance policy.

Commission - The portion of the premium stipulated in the agency contract to be retained by the agent as compensation for sales, service, and distribution of insurance policies.

Contingent Annuity - Annuity structured so payments are contingent upon the occurrence of an uncertain event.

Contingent Beneficiary - Person or persons named to receive benefits if the primary beneficiary is not alive at the time the insured dies.

Death Benefit - The policy proceeds to be paid upon the death of the insured.

Death Claim - A formal request for payment of policy benefits occasioned by the death of the insured. Should be made through the agent, but may be made directly to the home office. Requires a copy of the death certificate as proof of death and is made by the beneficiary.

Deferred Annuity - An annuity for which payments to the annuitant are delayed until a specified future date.

Domestic Company - An insurer formed under the laws of the state in which the insurance is written.

Effective Date - The date on which an insurance policy goes into effect.

Estate - Assets of an individual comprising total worth. Includes any life insurance in force.

Expiration - The date upon which a policy's coverage ceases.

Fixed Amount Option - A settlement option under which the beneficiary receives a fixed amount for an unspecified period of time. Payments continue until the principal and interest are depleted.

Fixed Period Option - A settlement option under which the beneficiary receives a regular income for a specified period of time.

Flexible Premium Annuity - An annuity that allows the contract owner the option to pay or not pay the annuity premiums following the establishment of the annuity. Commonly used in conjunction with an Individual Retirement Account.

Fraud - An intentional misrepresentation made by a person with the intent to gain an advantage and relied upon by a second party which suffers a loss as a result.

Beneficiary, Irrevocable - A named beneficiary whose status as beneficiary cannot be changed without their permission.

Home Office - The place where an insurance company maintains its chief executives and general supervisory departments.

Immediate Annuity - An annuity in which the income payments to the annuitant are to begin almost immediately, within a year.

Insurance Department - A governmental bureau in each state or territory (and federal government in Canada) charged with administration of the insurance laws, including licensing, examination, and regulation of agents and insurers. In some jurisdictions, the department is a division of some other state department or bureau.

Interest - That which is paid for the use of money by the user.

Joint Life Annuity - An annuity under which payments are made to two annuitants for only as long as both live. When one dies, payments cease even if one remains living.

Lapsed Policies - A policy for which the policyholder has failed to make the premium payment during the grace period, causing the coverage to be terminated.

Life Annuity - An annuity that provides a periodic income to the annuitant during their lifetime.

Life Annuity with Period Certain - An annuity under which the annuitant receives payments for a specified number of years or for their lifetime, whichever is longer. If the annuitant dies before all the guaranteed payments have been made, the beneficiary receives the payments for the rest of the certain period.

Loan Value - The amount of cash value reposing in a policy which may be borrowed by the insured.

Mortality Rate - The average number of people who die each year.

Policy - The contract effecting insurance and including all clauses, riders, endorsements, and papers attached to and made a part of the contract.

Primary Beneficiary - The beneficiary named first to receive proceeds or benefits of a policy that provides death benefits.

Rebate - Giving or offering to give something of value other than the benefits of a policy as an inducement to buy insurance, an illegal practice.

Refund Life Annuity - Provides annuity payments for the annuitant's lifetime with the guarantee that in no event will total income be less than the purchase price of the contract. If the annuitant dies before receiving this amount, the difference is paid to a named beneficiary.

Retirement Annuity - Generally a deferred annuity under which payments are made by the annuitant until retirement age.

Rider - An amendment attached to a policy that modifies the conditions of the policy by expanding or decreasing its benefits or excluding certain conditions from coverage.

Settlement Option - A method of receiving life insurance proceeds other than in a lump sum.

Straight Life Annuity - (*See* Life Annuity).

Fixed Annuity Certain - The annuitant receives payments for a specified number of years. If the annuitant dies after the payments have started, the beneficiary receives the payments for the rest of the specified number of years.

Variable Annuity - Annuity whose payment varies with the fortunes of the investment.

Waiver of Premium Provision - When included, provides that premiums are waived and the policy remains in force if the insured becomes totally and permanently disabled.

CHAPTER 14: ETHICS ISSUES FOR ANNUITY AGENTS

Whether you are a Life and Health Agent or a Property and Casualty Agent, the ethics you employ in your sales approach reflects not only on you but also the companies you represent.

Although some ethical issues are personal issues of conduct or level of integrity, other issues become violation of state laws.

In selling annuities, it is critical that the highest standard of ethics be adhered to in making recommendations for products.

- Are you properly outlining the risk factors involved in some choices the client may make?
- Are you properly explaining the sales and administrative charges or are they being buried away in the fine print?
- Do you know enough about the products that you are marketing not to misrepresent to the consumer?
- Are you adhering to all Security Exchange Commission Rules regarding variable products?
- Are you making sure that a prospectus is being delivered, when required by law, to the consumer prior to their making a decision?
- Are you adhering to all FINRA rules and regulations?

In this chapter we will be reviewing the ethical issues that face all agents in the conflict of earning a living versus serving the customer's needs.

Ethical Perceptions

Ethics is "the discipline that deals with what is good and bad or right and wrong or with moral duty and obligation."

Ethics can be approached from two levels:

1. The philosophical level-dealing with the possibilities.
2. The practical level - dealing with the reality of everyday experiences.

Ethics is a person's perceptions or convictions about what is right or wrong.

Living by the Golden Rule is often the role model for sound religious ethics.

Society, through laws and accepted behavior patterns, imposes guidelines on how to deal with other people.

Insurance Agents and Ethics

An insurance agent is anyone who solicits insurance or who aids in the placing of risks, delivery of policies or collection of premiums on behalf of an insurance company.

There are four areas of ethical responsibility for an insurance agent:

Responsibilities to the agent's insurer are covered under the concept of agency. The agent owes their insurer the duties of good faith, honesty, and loyalty.

The agent's day-to-day activities are a direct reflection of the insurer's "image" within the community.

Responsibilities to policy owners require the agent to meet the needs of the client, provide quality service, maintain loyalty, confidentiality, timely submission of applications and prompt policy delivery.

Responsibilities to the public require the agent to maintain the highest level of professional conduct and integrity in all public contact in order to maintain a strong positive image of the industry.

Responsibilities to the state require the agent to adhere to the ethical standards mandated by their state.

Insurance Brokers & Ethics

A broker's primary responsibility is to their client, meaning that, the broker is charged with the responsibility of finding the appropriate insurance coverage and markets to meet a client's needs.

Brokers are held to the same standards of care as agents in terms of their responsibilities to the general public and the state.

Definition of a Professional

The word "profession" means an open or public declaration, but has come to mean any calling requiring academic training and specialized knowledge.

Insurance agents and real estate agents are considered professionals because their business meets the following six commonly accepted characteristics of a profession:

- Commitment to high ethical standards;
- Concern for the welfare of others;
- Mandatory licensing and training;
- Formal participation in an association or society;
- Acting with integrity and objectivity; and
- Public acknowledgement as a profession.

Fiduciary Responsibilities

The two fundamental principles of an agency relationship are power, authority, and the thorough standards of conduct expected of the agent as a fiduciary. A fiduciary is a person holding the funds of another in a position of trust.

The Concept of Agency

Agency is a legal term used to describe the relationship between two parties, in which the *principal* authorizes the *agent-to,* perform certain legally binding acts on the principal's behalf.

The main components of an agency relationship are:

- An agent is an agent of the principal, not the third party with whom the agent deals.
- An agent has the power to bind the principal to a legal contract and its terms.
- The acts of the agent, within the scope of authority, are the acts of the principal.

Agency can be created by:

- Appointment or
- Explicit contract;

Estoppel is the principal allows someone to act in a way that would induce a third party to believe that a person was an agent of the principal;

Ratification - the principal later sanctions the actions of an authorized principal.

Before an individual can act as an agent, they must have the *power* and *authority* to take action. There are three types of agency authority:

- **Express authority** is the authority the principal intentionally and expressly gives the agent.
- **Implied authority** is the authority that the principal intends for the agent to have, but does not expressly give.
- **Apparent authority** arises when principal permits an agent to perform acts neither expressly or implicitly authorized.

The limits to an insurance agent's authority are usually defined in their agency agreement and the agent must work within those perimeters.

The ethical significance of these limits to an insurance agent's authority is that an agent must serve the needs of the insurer, live up to the contract and operate within the scope of their authority. By entering into this contractual relationship with the insurer, the agent becomes a fiduciary of the insurer.

Agents as Fiduciaries

An individual whose position and responsibilities involve a high degree of trust and confidence is known as a fiduciary. An insurance producer has a fiduciary relationship with their insurer with regard to the following:

Loyalty to the insurer-A producer must at all times act in the insurer's best interest, not their interests of personal gain.

Skill and performance-An agent has the duty to carry out their actions with the care and skill because an agent represents the company to the public and must act in such a manner as not to create a tarnished image for the company.

Full Disclosure

An agent is obligated to fully disclose all information they have that may affect the insurer and its ability to do business. Full disclosure is critical during the application and claims handling processes.

Follow Up

An agent has the obligation to act promptly in all matters regarding the insurer's business, including the duties to forward completed applications as quickly as possible.

Handling of Premiums

By law, payment to an agent is payment to the insurer. The agent has a fiduciary duty to turn over all funds given to them as specified in the agency agreement.

Avoiding Conflicts of Interest

An insurance agent cannot serve two principals at the same time. An agent has the ethical duty to make full disclosure to an insurer in regard to any other related service they provide and receives compensation.

Responsible Solicitation

An agent has the duty to solicit only business that appears to be good and profitable to their employer.

Competitive Integrity

An agent cannot misrepresent or in any way defame a competitive agent or insurer. An agent must compete only on the basis of products and services they can provide.

The principal is responsible for the acts of its agents and owes the agent three duties:

1. Payment of compensation in the form of commissions or fees.
2. Employment in return for meeting production responsibilities.
3. Indemnification or reimbursement for damages or expenses incurred in defending claims for which the agent may be liable.

Legally, a *broker* acts as an agent and representative of the applicant. However, when an insurer gives a policy for delivery to an insured, the broker becomes the agent for the insurer. Should payment of a premium be involved, payment to the broker is considered payment to the insurer.

Although the broker technically represents the client, the ethical and fiduciary standards that apply to an agent also apply to a broker.

Employing sound ethical principles permits producers to serve both the insurer and client may consider serving both the insurer and the client without creating a conflict of interest.

Obligations to Consumers & Clients

Agents fulfill their ethical responsibilities to their insurers by providing the appropriate Products to meet their consumers' needs, as well as quality service. Making sure that the consumer understands both the products and underwriting process is a critical responsibility of the agent.

The insurance agent can serve the needs of the prospect by providing the prospect with the types of policies that best fit their needs, in the amounts they can afford. In order to accomplish these goals, the agent should:

Obtain the required knowledge and skills to accomplish the needed objectives.

Educate the prospect or policy owner about the products and plans being recommended by the agent.

Additionally, the agent should be committed to not only selling the product, but to quality service both before, during and after the sale. This means:

- Educating the prospect about insurance products and the underwriting process;
- Treating all information obtained with confidentiality;
- Disclosing all necessary information so that an informed decision can be made by both the insurer and the prospect.
- Keeping the prospect informed throughout their application.
- Showing loyalty to prospects, clients, and insurer.

Service begins with the application.

It is the agent's duty to see to it that the application is completed both accurately and completely. To properly explain why required information is necessary. How the information will be evaluated by the underwriter. That accuracy and honesty are imperative in the application.

A prospect should be informed that failure to disclose information could result in denial of claims or policy cancellation.

It should be explained that a *binder* provides Fixed protection while the policy is being underwritten and is not a guarantee that the policy will be issued.

The agent or broker is responsible for service before and after the sale, which includes:

- Maintaining accurate client records;
- Maintaining complete and accurate records of all business transactions;
- Knowledge of new coverage and products;
- Availability and changes in products offered in the marketplace;
- Assistance with claims processing;
- Reviewing clients' existing policies;
- Suggestions on updating coverage on existing policies.

Ethically an agent or broker must respect the confidential information provided by the client and must assist the client in the following areas:

- Selecting the most appropriate policy;
- Understanding the basic features of the policy; and
- Evaluating the costs and features of similar plans.

Ethical standards must be used in evaluating risk management.

Risk management is the process of decision making that protects assets and income against accidental or unintended loss by identifying, measuring, controlling, and treating the elements that contribute to the risk.

Two basic risk management rules are:

- The size of the potential loss must be within the scope of the resources available to the insurer.
- The possible benefit must exceed the costs of the potential loss.

The risk manager, agent or broker should:

- Identify and measure the loss exposures and hazard.
- Determine the amount of money available to pay for the potential loss; and
- Identify various risk management techniques to deal with potential losses.

Risk management techniques include:

- Avoidance-averting a loss by refusing to take part in something that could cause a loss.
- Transfer-shifting risk to another entity through a contract or hold-harmless agreement;
- Loss control-reducing the frequency or probability of loss through loss prevention or lowering the severity of loss through loss reduction.
- Retention-holding part of the risk through deductibles or all of the risk through self-insurance.
- Insurance-transferring risk to an insurance company.

Obligations to the General Public

Because unethical behavior by agents and brokers can affect the whole industry, the integrity and professionalism of their conduct is of utmost concern to all.

The public's perception of the insurance industry is gagged by the behavior of both insurance agents and brokers and their commitment to professionalism is the key to the public's trust of the industry.

Insurance is something that is used by many, but yet, many are unaware of how insurance works and benefits them.

The ethical agent has a duty to provide the consumer with fair and honest information of the policies and services they have to offer.

The Insurance Industry is regulated by both the state and federal governments with the state departments of insurance issuing rules and regulations, licensing insurers, agents, and brokers, suggesting laws to legislators, examining insurers' financial operations, approving policy forms, and overseeing marketing practices.

A code of ethics is employed by the industry to guide corporations, agents, and brokers.

Insurance producers continuously face complex issues dealing with skill, competence, and levels of knowledge required of professionals.

Professional conduct often dictates that the client's need be put ahead of the agent's needs, be dedicated to the insurance industry and offer quality plans from quality insurance companies. The agent should develop high ethical standards, adhere to integrity, and serve the interests of the client.

The public's perception of the activities of an individual agent or broker shapes the perception of the industry as a whole.

Skill, competence, professionalism, and moral integrity shape public perceptions.

Enforcing Ethical Standards

Each state regulates the ethical conduct of insurance producers by creating rules, regulations, and legislation to protect the consumer.

States through an Insurance Commissioner or Director to oversee the marketing activities of agents regulates the Insurance industry.

The National Association of Insurance Commissioners (NAIC) proposes model legislation to:

- Encourage uniformity in state insurance laws and regulations;
- Assist officials in administering laws and regulations, help protect the interest of policy owners; and
- Preserve state regulation of insurance.

Most states have laws that protect consumers against unfair trade practices such as:

- Misrepresentation and/or false advertising,
- Coercion,
- Improper placement, or
- Rebating.

States also prohibit unfair claims methods and practices, such as:

- Misrepresenting policy provisions to claimants or insured's;
- Failing to deliver a determination on a claim within a reasonable time;
- Failing to settle claims promptly and fairly;
- Attempting to settle a claim for less than could be reasonably expected;
- Engaging in activities that result in a disproportionate number of complaints;
- Failing to provide necessary claims forms; or
- Unfair claims practices.
- Insurers are prohibited from engaging in underwriting or rating that is based on race, religion, and national origin or redlined areas.

In most states, the punishment for unethical practices ranges from fines to license suspension and revocation.

Once a license is revoked, normally a one-year waiting period is required for re-application. And in most states a bond will also be required.

People who set high personal and professional goals of honesty, integrity, loyalty, fairness, and truthfulness will never have to deal with the penalties set by state governing bodies.

Making Decisions Ethically

When trying to make decisions ethically, ask yourself the following questions:

- To whom do I have obligations?
- Whose rights must I protect?
- What rules apply to this situation and should be observed?
- Would I be proud of my decision and advocate this action again?

Even the most ethical producers are often time confronted with unhappy clients who feel their claim was improperly handled. Producers can help to protect themselves by:

- Maintaining high standards of personal ethics;
- Having errors and omissions insurance;
- Being diligent when recommending policies and placing business; and
- Being committed to continuing education.

Competition and production quotas often encourage producers to look to an increased bottom line, regardless of what it takes.

An agent's moral values and standards should help to resolve this inner conflict and guide them to the right decision.

PROFESSIONAL CODE OF ETHICS Independent Insurance Agents of America

I believe in the insurance business and its future, and that the Independent Insurance Agent is The instrument through which insurance reaches its maximum benefit to society and attains its most effective distribution.

I will do my part to uphold and build the Independent Agency System, which has developed insurance to its present fundamental place in the economic fabric of our nation. To my fellow members of the Independent Insurance Agents of America, I pledge myself always to support right principles and oppose bad practices in the business.

I believe that these three have their distinct rights in our business: first, the Public; second, the Insurance Companies, and third the Independent Insurance Agents, and that the rights of the Public are paramount.

To the public

- I regard the insurance business as an honorable occupation and believe that it affords me a distinct opportunity to serve society.
- I will strive to render the full measure of service that would be expected from an Independent Insurance Agent.
- I will analyze the insurance needs of my clients, and to the best of my ability, recommend the coverage to suit those needs.
- I will endeavor to provide the public with a better understanding of insurance.
- I will work with the national, state, and local authorities to heighten safety and reduce loss in my community.
- I will take an active part in the recognized civic, charitable, and philanthropic movements, which contribute, to the public good of my community.

To the companies

- I will respect the authority vested in me to act on their behalf.
- I will use care in the selection of risky, and do my utmost to merit the confidence of my companies by providing them with the fullest creditable information for effective underwriting, nor will withhold information that may be detrimental to my companies' sound risk taking.
- I will expect my companies to give to me the same fair treatment that I give to them.

To fellow members

- I pledge myself to maintain friendly relations with other agencies in my community. I will compete with them on an honorable and fair basis, make no false statements, or any misrepresentation or emission of facts.
- I will adhere to a strict observance of all insurance laws relative to the conduct of my business.
- I will work with my fellow Independent Insurance Agents for the betterment of the insurance business.

Realizing that only by unselfish service can the insurance industry have the public confidence it merits, I will at all times seek to elevate the standards of my occupation by governing all my business and community relations in accordance with the provisions of this Code and by inspiring others to do likewise.

American Institute for Chartered Property and Casualty Underwriters Code of Professional Ethics

Canons and Rules

Canon 1

CPCUs Should Endeavor at All Times to Place the Public Interest Above Their Own.

Rules of Professional Conduct

R1.1 A CPCU has a duty to understand and abide by all *Rules* of conduct, which are prescribed in the Code of Professional Ethics of the American Institute.

R 1.2 A CPCU shall not advocate, sanction, participate in, cause to be accomplished, otherwise carry out through another, or condone any act which the CPCU is prohibited from performing by the *Rules* of this *Code.*

Canon 2

CPCUs Should Seek Continually to Maintain and Improve Their Professional Knowledge, Skills, and Competence.

Rules of Professional Conduct

R2.1 A CPCU shall keep informed on those technical matters that are essential to the maintenance of the CPCU's professional competence in insurance, risk management, or related fields.

Canon 3

CPCUs Should Obey All Laws and Regulations, and Should Avoid Any Conduct or Activity Which Would Cause Unjust Harm to Others.

Rules of Professional Conduct

R3.1 In the conduct of business or professional activities, a CPCU shall not engage in any act or omission of a dishonest, deceitful, or fraudulent nature.

R3.2 A CPCU shall not allow the pursuit of financial gain or other personal benefit to interfere with the exercise of sound professional judgment and skills.

R3.3 A CPCU will be subject to disciplinary action for the violation of any law or regulation, to the extent that such violation suggests the likelihood of professional misconduct in the future.

Canon 4

CPCUs Should Be Diligent in the Performance of Their Occupational Duties and Should Continually Strive to Improve the Functioning of the Insurance Mechanism.

Rules of Professional Conduct

R4.1 A CPCU shall competently and consistently discharge their occupational duties.

R4.2 A CPCU shall support efforts to effect such improvements in claims settlement, contract design, investment, marketing, pricing, reinsurance, safety engineering, underwriting, and other insurance operations as will both inure to the benefit of the public and improve the overall efficiency with which the insurance mechanism functions.

Canon 5

CPCUs Should Assist in Maintaining and Raising Professional Standards in the Insurance Business.

Rules of Professional Conduct

R5.1 A CPCU shall support personnel policies and practices which will attract qualified individuals to the insurance business, provide them with ample and equal opportunities for advancement, and encourage them to aspire to the highest levels of professional competence and achievement.

R5.2 A CPCU shall encourage and assist qualified individuals who wish to pursue CPCU or other studies, which will enhance their professional competence.

R5.3 A CPCU shall support the development, improvement, and enforcement of such laws, regulations, and codes as will foster competence and ethical conduct on the part of all insurance practitioners and inure to the benefit of the public.

R5.4 A CPCU shall not withhold information or assistance officially requested by appropriate regulatory authorities who are investigating or prosecuting any alleged violation of the laws or regulations governing the qualifications or conduct of insurance practitioners.

Canon 6

CPCUs Should Strive to Establish and Maintain Dignified and Honorable Relationships with Those Whom They Serve, with Fellow Insurance Practitioners, and with Members of Other Professions.

Rules of Professional Conduct

R6.1 A CPCU shall keep informed on the legal limitations imposed upon the scope of their professional activities.

R6.2 A CPCU shall not disclose to another persona any confidential information entrusted to, or obtained by, the CPCU in the course of the CPCU's business or professional activities, unless a disclosure of such information is required by law or is made to a person who necessarily must have the information in order to discharge legitimate occupational or professional duties.

R6.3 In rendering or proposing to render professional services for others, a CPCU shall not knowingly misrepresent or conceal any limitations on the CPCU's ability to provide the quantity or quality of professional services required by the circumstances.

Canon 7

CPCUs Should Assist in Improving the Public Understanding of Insurance and Risk Management.

Rules of Professional Conduct

R7.1 A CPCU shall support efforts to provide members of the public with objective information concerning their risk management and insurance needs, and the products, services, and techniques which are available to meet their needs.

R7.2 A CPCU shall not misrepresent the benefits, costs, or limitations of any risk management technique or any product or service of an insurer.

Canon 8

CPCUs Should Honor the Integrity and Respect the Limitations Placed upon the Use of the CPCU Designation.

Rules of Professional Conduct

R8.1 A CPCU shall use the CPCU designation and the CPCU key only in accordance with the relevant GUIDELINES promulgated by the American Institute.

R8.2 A CPCU shall not attribute to the mere possession of the designation depth or scope of knowledge, skills, and professional capabilities greater than those demonstrated by successful completion of the CPCU program.

R8.3 A CPCU shall not make unfair comparisons between a person who holds the CPCU designation and one who does not.

R8.4 A CPCU shall not write, speak, or act in such a way as to lead another reasonably to believe the CPCU is officially representing the American Institute, unless the CPCU has been duly authorized to do so by the American Institute.

Canon 9

CPCUs Should Assist in Maintaining the Integrity of the Code of Professional Ethics.

Rules of Professional Conduct

R9.1 A CPCU shall not initiate or support the CPCU candidacy of any individual known by the CPCU to engage in business practices which violate the ethical standards prescribed by this Code.

R9.2 A CPCU possessing unprivileged information concerning an alleged violation of this Code shall, upon request, reveal such information to the tribunal or other authority empowered by the American Institute to investigate or act upon the alleged violation.

R9.3 A CPCU shall report promptly to the American Institute any information concerning the use of the CPCU designation by an unauthorized person.

PART II: OTHER RETIREMENT PLANNING

CHAPTER 1: THE NATURE OF RETIREMENT

What it means to be Retired

Two or three decades ago, the mention of retirement conjured images of the "golden years" when one could finally reap the harvest of the seeds sewn in youth and nurtured through middle age engaging in those activities that one always wanted to do while constrained by employment and child rearing.

The stereotypical images were pleasurable yet diverse — playing golf with life-long friends and retired business acquaintances, fishing with grandchildren, escaping the dreaded January blizzards to visit relatives in Florida, or in some cases, simply doing nothing.

The American worker, through dedication and perseverance, was presented with an opportunity to climb the corporate ladder, and in turn was rewarded with regular pay increases, promotions, and in many cases, substantial contributions to a company pension plan, which upon retirement afforded the loyal employee a comfortable monthly payment for life and a reasonable amount of health care coverage. The corporate paternalistic attitude resulted in a rather simple approach to planning for retirement — the making of a will and securing a family burial plot.

The average modern worker retires earlier, lives longer and is more affluent than those of preceding generations. Thus, while the notion of retirement remains diverse, it is a more active one. Frequently, retirement means departure from a long-established job so that one can become involved in another career.

Where one may have formerly gone fishing with a grandchild, a retired worker is just as likely to take a trip with a grandchild down the rapids through the Grand Canyon. Other forms of travel are more rigorous and involve mountain climbing, hiking, or kayaking.

Generally, present-day retirees can attribute their comfortable lifestyles to a variety of sources of income. In addition to the company-sponsored pension plan, Social Security provides another monthly source of income to a retiree or to their survivor. A number of retired workers who served an extended period in the military were provided with an additional pension.

A large number of companies have programs which are designed to boost the morale of former employees, such as including them in company social functions, sponsoring group trips and providing visual and dental preventive care.

History of Company-Sponsored Retirement Plans

The company-sponsored retirement plan is a phenomenon in the American work force, gaining particular popularity after World War II.

At the end of the nineteenth century, companies established pensions as a method of keeping their most experienced and valued workers, usually middle-aged men, from being lured away by the competition. However, the majority of workers received no pension, and retirement for many was the gateway to instant poverty since there was no Social Security.

By 1929, just prior to the establishment of the Social Security system, almost 40 percent of retired workers received some form of charity from private or state programs. Social Security was designed to eliminate older workers from the labor force to keep the numbers of unemployed low.

With the outbreak of World War II, many young men were diverted from the labor force to military service. Suddenly, the stereotypical image of the older worker as forgetful, clumsy, and physically inept gave way to one who was a mature, experienced, dedicated and willing worker. Along with women, retired workers by the thousands were pressed into the manufacturing sector of the economy. When the war was over and the younger men returned home, there was no longer any pressing need for the services of women and older workers.

Thus, a number of practices were adopted to encourage the more mature members of the labor force to seek retirement once more. The Social Security system was expanded along with private pension programs and early retirement was rewarded.

Once again, the older worker was perceived as a poor performer, incapable of engaging in labor, and terribly slow to adapt. Retirement was no longer associated with poverty and pensions were characterized as deferred wages.

Mandatory retirement at the age of 65 was adopted by the federal government and by a number of states.

Since there was an elevated level of productivity in the 1950s and '60s, businesses could afford retirement benefits. Pension plans were promoted as a significant reward for years of loyalty, perseverance, and excellent performance.

In truth, the private pension plan was also a method of keeping workers in monotonous and repetitive jobs that they grew to dread after a number of years.

Contemporary technology and global competition have changed the face of the American workplace and the standard of living for those beginning their careers and those confronting retirement. American businesses are also faced with unprecedented problems that affect profitability, and in many instances, survivability.

In an era when retirement was the equivalent of the "Golden Years," most workers retired at age 65, whether they wanted to or not. Early retirement was an anomaly. The years to enjoy the fruits of retirement were less than at present, for the life expectancy of the average male rarely exceeded the age of 70, and for a woman was only a few years longer.

With advancements in pharmaceutical and medical technology, life expectancy began to increase. People were living longer and generally in better states of health. The percentage of Americans who retired or faced imminent retirement swelled considerably.

How Retirement Plans and Expectations Have Changed in the Past Several Decades

In the last several decades, with the increase in the number of people losing jobs long before retirement, the rise in the numbers of Americans living well into their late seventies and eighties, spiraling medical costs and a trend toward decreases in business profits, the number of people who had once been taken care of in retirement by the private sector have had to look to the federal government for retirement benefits.

Early retirement, once a privilege afforded to a select few, has become a reality for many. Frequently, early retirement is offered as an alternative to a pending layoff, and the employee who accepts it is provided with severance pay and medical benefits for a prescribed period.

The alternative is a forced layoff — termination with little or no pension or health care coverage. Since many older workers are more expensive to a business, companies frequently force the pre-retiree out the door under the guise of insubordination, poor performance, tardiness or simply a bad attitude, notwithstanding the fact that none of those terms may have ever been used to describe the employee in prior annual performance reviews.

In spite of laws that forbid discrimination against older workers, the legal system offers little redress because of the expense and duration of litigation. The dream home becomes a nightmarish mortgage and increased stress can lead to psychological and health problems.

Retirement savings may be depleted rapidly just to meet ongoing expenses of living, leaving extraordinarily little or nothing to bridge the gap between layoff and the time when meager Social Security benefits will be forthcoming.

Federal and state governments have not been able to close the gap left by private industry. When the labor force decreases and the nonproductive segment of society increases, the burden on those contributing to governmental resources increases significantly.

Combined with the rising costs of food, medication, clothing, and shelter, there simply are not enough national and state resources to sustain the comfort level of the retired segment of the population. High taxes and deficit spending, so prevalent in the 1990s, also serve as a restraint on productivity. An increase in both would be necessary to provide more benefits to retired persons. Since that is not likely, an increasing number of retirees can expect their standards of living to fall and many will slip into poverty for the first time in their lives.

For that matter, retirement may become a fading social phenomena for many older persons. Since Americans are living longer, they may be expected, or required because of economic necessity, to work past the normal or early retirement age.

This trend became partial reality when the federal government increased the eligibility age for Social Security benefits recently.

Persons in their fifties and early sixties can look forward to a time in the near future when it may be necessary to take part-time jobs to supplement their income. Older workers will, by necessity, have to become more flexible and diverse so as to secure a place in the workforce. It may be necessary to undergo job training.

As medical and retirement benefits continue to shrink, and the failure to contain medical costs continues, an increasing number of aging Americans will be required to live with and be dependent upon their grown children.

Unless legislation is forthcoming which prevents older persons without health coverage from losing all of their life savings as a result of a medical catastrophe, the number of older persons living in poverty will increase significantly.

How Will Retirement Change in the Future for Baby Boomers and Those Who Follow?

Americans born between 1946 and 1960 are commonly referred to as “baby boomers.” Many are the children of a generation of Americans who were adversely affected by the Great Depression and who in many cases deferred having children until after World War II. In 1946, the birth rate increased 20 percent over the previous year in the United States.

The birth rate peaked in 1957 when more than 4.3 million babies were born. While parents of the baby boomers sacrificed considerably for their children’s education and well-being, the boomers may very well be the last generation of children who succeeded in establishing a better lifestyle for themselves than that enjoyed by their parents.

Those on the leading edge of the baby boomer generation will soon be in their retirement years. Because of their growing numbers, they have created a class of middle-aged citizens that is almost four times greater than during any other period in American history. Thus, the cultural emphasis is no longer primarily on the young.

Significant numbers of baby boomers remained in college longer than their older siblings or parents and in many instances delayed parenthood well past the age of 30. Two-income families are the norm for boomers who, having more purchasing power, take on larger mortgages and drive more expensive cars.

With the more recent decline in earnings power, deferment of the more expensive costs of child rearing such as education, and a tendency toward materialism, the amount of baby boomers’ disposable income available for savings has declined significantly. The value of homes, which were purchased in their younger years, has not increased materially.

As the number of boomers age and the years until retirement decrease, a growing number are finding that, like some of the “Silent Generation” before them, it is becoming necessary to incur additional expenses relating to the care of an aging parent.

More young adult children are living at home longer now than in recent generations, resulting in an extended time for the parents to assume financial responsibility for their offspring. Frequently, one spouse, usually the wife, may have to abandon career aspirations because of dual demands of caring both for elderly parents and children.

Boomers are finding it necessary to switch jobs more frequently than those of succeeding generations just to remain employed, sometimes resulting in lower wages, reduced health care coverage, and diminished retirement benefits.

Many boomers start their own businesses, often working out of their houses, or become associated with much smaller enterprises that may offer limited or no employee benefits.

Private industry has been contributing substantial amounts of funds to pension plans because of the increase in the number of employees taking early retirement. It is possible that a number of such businesses will become bankrupt when it is time to make such contributions.

Presently, a growing number of companies have ceased making automatic contributions out of earnings to pension plans. Employer contributions may be based upon matching employee contributions.

Many businesses contribute only company stock to retirement plans, creating a constant fluctuation in value of the underlying assets. Workers who earn incredibly low wages typically do not contribute anything to pension plans.

Thus, many workers may retire with no pension funds whatsoever.

What can Boomers look forward to in Retirement?

Less discretionary income will be available because of reduced retirement funds and exorbitant medical expenses. An extended family consisting of elderly parents, roommates or other relatives all living under the same roof will be more common.

Others will live in elderly housing or managed-care facilities. As boomers-age in their seventies and eighties, they may be cared for on a daily basis in elderly-care facilities.

The generation, which followed the baby boomers, commonly referred to as the "Reagan generation," the "baby bust" generation and more recently as "Generation X," is considerably smaller due to a sustained trend to postpone childbearing and a decision to have smaller families.

The shrinking numbers of younger people between the ages of 16 and 24 entering the labor force for the first time has led the U.S. Department of Labor to estimate that by the end of this century there will be more than one million fewer workers than in 1990.

As a result, a trend, which has started presently, will continue well into the beginning of the next century. More and more older workers will fill the gap left by the shrinking numbers of qualified younger persons, taking jobs in every segment of commerce from fast-food franchises to consulting on the professional level.

CHAPTER 2: GOVERNMENT

Laws that affect Retirees

The degree of responsibility that society believes is owed toward any particular group is reflected to a certain degree in the types of laws which are adopted by its government. In that regard, retirees are a protected class for a number of purposes.

Cognizant of the fact that many older persons are unable to work throughout their entire lives but have contributed to society for many years through employment and child rearing, laws have been adopted by the federal government, which provide for a source of income and health care coverage for older persons. In addition, there are federal and state laws, rules, and regulations, which, while they do not provide preferential treatment for retirees, do have a profound effect on the quality of life during retirement.

The Age Discrimination in Employment Act (ADEA) Congress adopted the ADEA in 1967. It prohibits employers with more than 20 employees who do business in interstate commerce from engaging in the following discriminatory acts:

- Refusing to hire or fire a person solely on the basis of age except under limited circumstances.
- Refusal by an employment agency to refer a client to a prospective employer on the basis of age.
- Directly or indirectly referring to age in advertisements for employment.
- Denying union membership based upon age.

Thus, mandatory retirement in the private sector has been eliminated except in the event of:

- An executive or other employee who has been in a position of high policy making for no more than two years and is entitled to non-forfeitable retirement benefits in excess of $44,000 per year.
- A company-sponsored retirement plan or system, which includes a mandatory retirement age.
- Employment where age is a bona fide occupational qualification reasonably necessary to the business of an employer.

Under the ADEA, discrimination is illegal in every aspect of employment including hiring, firing, recruitment, evaluations, health benefits, insurance, and promotions. Employees who file age discrimination claims cannot be fired or otherwise penalized. The Equal Employment Opportunity Commission enforces the ADEA.

There are a number of states that have adopted similar age discrimination laws.

Social Security Act

The Social Security Act, adopted by Congress in 1936, includes a network of programs, which affect retirees and certain disabled persons through the provision of retirement and disability income, Medicare, Supplementary Security Income and dependent and workers' benefits.

The Older Americans Act

The Older Americans Act was adopted by Congress to provide for the social and financial needs of millions of low-income retirees in this country through the implementation of programs and services that permit senior citizens to avoid institutionalization and to maintain their dignity.

Under federal law, Medicaid was established to provide health care assistance to the poor who are blind, aged, or disabled, or families with dependent children through state-operated programs, which are federally assisted.

Employee Retirement Income Security Act

Commonly known as ERISA, Congress passed this legislation in 1974 to establish minimum standards for private pension plans including when such funds can be accrued by an employee and granting a right to a surviving spouse to receive part of a deceased retiree's pension.

Laws that affect the Quality of Life During Retirement

Unemployment Insurance

Older workers who are forced to retire prematurely because of layoffs or consolidation of a business may be able to qualify for unemployment insurance. Generally, an employee must have lost their job due to circumstances beyond their control or in a situation where no misconduct was involved. One who quits voluntarily and not for good cause is usually not eligible for unemployment compensation.

The Internal Revenue Code

Under the Internal Revenue Code, there are a number of tax-deferral devices that are designed to encourage a taxpayer to save for retirement, such as an IRA and a 401(k) plan. Funds in the plan are not taxed until such time when a participant actually withdraws funds.

There are other features of the Internal Revenue Code which are favorable to an older worker anticipating retirement.

Property Tax

Some state, county or city property tax laws contain provisions that permit persons over the age of 65 to avoid payment of property taxes by allowing the taxes to accrue and in effect become a lien against such person's real property. The taxes are then recouped from the estate upon the death of the taxpayer.

Disabilities

Under the Americans with Disabilities Act, it is illegal for private businesses to exclude, refuse to serve or otherwise discriminate against a disabled person by limiting or denying access to services or goods. The prohibition against such discriminatory conduct extends to virtually every kind of business establishment, including elderly day care centers, hotels, shopping centers, theaters, restaurants, professional offices, parks, banks, museums, and grocery stores.

Also, operators of public transportation, whether public or private, are required to satisfy standards of accessibility for disabled passengers. This requirement also extends to both the vehicles and the terminal or lounge facilities.

A person under age 65 who has been a disabled beneficiary under the Railroad Retirement Board or under Social Security for more than 24 months, can get premium-free Part A benefits under Medicare to help pay for certain medical expenses.

Social Security Disability Income (SSDI) is available to a person who has a mental or physical impairment that prevents them from working at substantial gainful employment on a 12-month continual basis or who has a fatal condition.

Deceptive Trade Practices

There are a number of federal and state laws, which protect consumers from commercial fraud. They require adequate disclosure in a number of commercial transactions and offer a procedure whereby complaints can be filed, and investigations are conducted with referral to the appropriate law enforcement agencies.

Federal Laws

- Consumer Leasing Act
- Electronic Fund Transfer Act
- Equal Credit Opportunity Act
- Fair Credit and Charge Card Disclosure Act
- Fair Credit Billing Act
- Fair Credit Practices Act
- Fair Debt Collection Practices Act
- Fair Housing Act
- Federal Trade Commission Act
- Home Equity Loan Consumer Protection Act
- Home Mortgage Disclosure Act
- National Flood Insurance Act
- Real Estate Settlement Procedures Act
- Right to Financial Privacy Act
- Truth-in-Lending Act

Many states have adopted laws similar to those federal statutes set forth above. One of the more effective is the Deceptive Trade Practices Act. This provides a remedy to a consumer for an "unconscionable act," which includes taking advantage of a person's ignorance, lack of ability or conducts which results in a gross difference in the price and quality of the service rendered or purchased.

Many states also have laws, which prohibit charging interest rates, which are so high as to constitute usury.

Patient Self-Determination Act

The Patient Self-Determination Act, which is a federal statute, provides that hospitals or nursing homes receiving funds from Medicaid or Medicare must explain to a patient upon admission of their right to refuse medical treatment in the event that their condition becomes virtually hopeless. If state law allows for a durable power of attorney and a living will, those facts must also be disclosed.

Disinheritance Laws

Under the laws of most states, a spouse cannot be disinherited or deprived of their interest in the other spouse's marital property unless such right has been waived in a premarital or inter-spousal agreement.

Right-to-Die Laws

The Uniform Rights of the Terminally Ill Act, a model state law adopted in 1985, allows a person who is a legal adult to control in advance of a terminal medical condition any decisions which would be made about their welfare.

The act applies only to situations involving treatment that is merely life prolonging, and to patients whose terminal conditions are incurable or irreversible, and who are unable to participate in treatment decisions.

Marital Property Laws

Virtually every state has adopted legislation that requires an equitable distribution of marital property to each party in a divorce. Before the adoption of such legislation, a disproportionate amount of community or marital property was frequently awarded to the spouse with the higher earning, leaving the other spouse in poverty.

A number of states have adopted laws allowing prospective spouses to enter into premarital agreements. Thus, a person who has accumulated substantial assets for retirement prior to a marriage can protect such assets in the event of a divorce.

Model Unfair Claim Settlement Practices Act

This act has been adopted by many states and provides protection for consumers who have purchased insurance by specifying what unfair claims practices are considered to be illegal.

Trust Laws

Almost every state has adopted laws, which allow persons to use a living trust to have access to their assets during later years in life and to enable such assets to pass directly to heirs without having to go through probate.

Plant Closing Laws

Under federal law, an employer who has a full-time labor force in excess of 100 workers cannot force workers into early retirement by closing a plant or engaging in massive layoffs unless they have given employees at least 60 days' prior notice of either an impending job loss because of a plant closing or a large staff reduction that will last longer than six months. Employees who work less than 20 hours a week or who have been employed for less than 6 of the preceding 12 months need not be given notice.

Government Programs for the Elderly

There are numerous federal and state programs that provide a variety of services to retired persons. Some programs are mandated by the federal government and are available in every state. A number are sponsored entirely by states, and others are optional federal and state programs.

Programs Sponsored by the Federal Government

Administration on Aging

There are more than nine million Americans who avail themselves of programs set up under the Older Americans Act. Such programs are administered by the Administration on Aging, an arm of the Department of Health and Human Services. Under such law, the federal government provides programs that must be implemented by the states to assist in meeting the financial needs of the elderly through a state-sponsored department of aging.

The federal government provides most of the funds. Some states have established local agencies that work directly with private nonprofit entities to carry out the programs and services. Some of the more significant programs, which are provided by a number of states through the Administration on Aging, include the following.

Adult Day Care

Adult day care centers have been established for elderly persons who are ambulatory and who need minimal care during the day. The advantage of adult day care is that an elderly person can continue to live at home under the supervision of their family on nights, weekends, and holidays.

Adult day care centers are licensed by the state and provide therapeutic, social, and medical services. Recreational activities, transportation to and from the center and psychological services may also be available.

Alzheimer's Day Care Centers

In states where Alzheimer's day care centers are available, the services vary, but generally include counseling support to families, medical care, and training for family members, and recreational and social functions for the patients and their families. The centers are generally available for those patients whose conditions have advanced to such degrees that full-time, in-home care is no longer possible.

Brown Bag Network Program

Some states maintain a program for the elderly, which provides fruits, vegetables, and other surplus foods to persons near or over retirement age who live on fixed incomes. The programs are usually intended as a dietary supplementary program.

Abuse Prevention Activities

Under the laws of most states, citizens are required to report situations involving abuse or neglect of the elderly to the appropriate law enforcement authorities. A few states have social agencies that offer support services to those caring for the elderly, including training for elderly care and the elimination of abuse.

Foster Grandparent Program

This is a governmental-sponsored agency that provides persons over 60 years of age with an opportunity to participate in a program that provides special assistance and care to low-income children.

Health Insurance Advocacy/Counseling

Trained volunteers assist the elderly and their families with health-related problems and with the application of Medicare and Medicaid to their individual circumstances. Counseling and advocacy services involving claims with Medicare and Medicaid may also be available. Such counselors may be found at various sites such as public libraries, senior day-care centers, public health centers, and hospitals.

In-Home Services

In-home services may be available to assist those caring for the elderly with long-term health problems. Such services may include counseling, assistance in nutrition planning and preparing meals, assistance with personal and daily care and related supportive services.

Legal Assistance

A number of state and local governments maintain legal aid centers to assist the low income elderly and their families in legal matters which affect the elderly, such as age discrimination, contested filings under Social Security, Medicare and Medicaid, disputes with nursing homes and elderly day care facilities, wills, conservator ships and other matters.

Long-Term Care

States are required by federal laws to adopt a long-term care ombudsman program where individuals are certified by the state to investigate and solve problems that elderly persons or their families have with long-term care facilities. Ombudsmen are guaranteed access to such centers and must strictly adhere to confidentiality requirements.

The nature of activities that may be investigated by an ombudsman includes neglect, abuse, insufficient staffing, and any other activities that may adversely impact the social, physical, spiritual, and medical well-being of a resident of a long-term care facility.

Outreach Service

These programs search for senior citizens who may be eligible for, but who are not currently participating in, federal- and state-assisted plans, such as Social Security Disability Income, Medicare, Medicaid, and the food stamp program.

Senior Centers

A number of state and local governments have centers for senior citizens which provide a variety of activities, such as counseling, recreational activities, arrangements for in-home care by participants in a senior-companion program, guidance about the availability of social and health care programs, nutrition programs and other activities.

Senior Discount Programs

A number of states have developed a network of discount programs for persons over the age of 60 which enables such persons to purchase services and goods at a significant discount from merchants or other businesses participating in the programs.

Transportation

Various public transportation facilities, such as train and bus lines, offer discounted fares to older persons.

Social Security Office

Questions about the application and coverage of Medicare and Social Security payments can be directed to any local Social Security office or by calling the toll-free number listed in the government section of the business pages.

Pension Benefit Guaranty Corporation

This is one of several federal offices that provide assistance in resolving disputes involving private pension plans. The other is the National Senior Citizens' Law Center.

Internal Revenue Service Offices

Retired workers can obtain assistance in filing their federal income tax returns or in resolving problems involving federal income, gift, and estate tax matters by contacting the local office of the Internal Revenue Service.

Legal Services Corporation

This federal agency provides funds for legal offices to serve retired persons with incomes that do not exceed 125 percent of the poverty level.

House Document Room

Copies of bills and committee reports of the U.S. House of Representatives can be obtained from the House Bills Room in Washington, D.C.

Programs Sponsored by State Governments

State Tax Offices

Here, retired workers can obtain assistance in filing state tax returns or in resolving problems involving income, gift, estate, and inheritance tax matters.

Property Tax Offices

State and local property tax offices may be consulted to determine if one's primary residence qualifies for a homestead exemption. Homestead exemptions protect a property owner in some instances from having their residence seized by legal authorities to satisfy payment of a lien. The exemption may also result in significant property tax savings.

State Department of Health Services

In many states the maintenance, operation, and licensing of nursing homes, including facilities that offer intermediate care and skilled nursing care, are regulated by the state department of health or similar governmental agency.

Legal Assistance Programs

A number of state and local governments provide legal services to retirees who meet low-income standards.

State Attorney General's Office

Many states have an agency such as a consumer fraud division of the attorney general's office whose function is to protect consumers against commercial fraud. Personal experiences with fraud should be reported to such offices. The agencies also act as a quasi-clearing house by gathering, storing, and disseminating information about fraudulent schemes.

FOCUS POINTS

- ADEA was enacted in 1967 and regulates employers, with more than 20 employees, who do business in interstate commerce from engaging in discriminatory acts based on age.
- ADEA makes discrimination illegal in every aspect of employment including hiring, firing, recruitment, evaluations, health benefits, insurance, and promotions.
- The Equal Employment Opportunity Commission enforces the ADEA.
- Congress adopted the Social Security Act in 1936.

- The Older Americans Act helps provide for the social and financial needs of low-income retirees through the implementation of programs and services.
- Medicaid was established to provide health care assistance to the poor who are blind, aged, or disabled, or families with dependent children through state-operated programs.
- ERISA legislation was passed in 1974 to establish minimum standards for private pension plans.
- Under the Internal Revenue Code, a person over age 55 may sell a primary residence and pay no capital gains taxes on profits up to $125,000.
- Federal income tax laws allow taxpayers over the age of 65 to take an additional deduction on their income tax returns.
- The ADA makes it illegal for private businesses to exclude, refuse to serve or otherwise discriminate against a disabled person.
- Operators of public transportation are required to satisfy standards of accessibility for disabled passengers.
- Social Security Disability Income is available to a person who has a mental or physical impairment that prevents them from working at substantial gainful employment.
- The Patient Self-Determination Act is a federal statute requiring hospitals or nursing homes that receive funds from Medicaid or Medicare to explain to a patient, upon admission, of their right to refuse medical treatment in the event that their condition becomes virtually hopeless.
- The Uniform Rights of the Terminally Ill Act was enacted in 1985 and applies only to situations involving treatment that is merely life prolonging, and to patients whose terminal conditions are incurable or irreversible.
- Under the laws of most states, a spouse cannot be disinherited or deprived of their interest in the other spouse's marital property.
- Employers who have a full-time labor force of 100 workers or more cannot force workers into early retirement by closing a plant or engaging in massive layoffs unless they have given employees at least 60 days' prior notice.

CHAPTER 3: EMPLOYER-EMPLOYEE RELATIONSHIPS IN RETIREMENT

How Employers Can Help Employees Plan for Retirement

Two of the most significant benefits that an employer can provide for employees are health care coverage and retirement plans. Many employers have done a laudable job in providing both for employees, but as companies continue to trim expenses, future retirees will find an increasing need to look at other investment vehicles to provide a source of income during retirement.

Employers may have to assume a greater responsibility in educating employees to plan for retirement. Educational programs, which employers can sponsor, include seminars given by retirement-planning experts, such as accountants, insurance agents, financial planners, attorneys, and stockbrokers.

Employees should also be educated about Social Security, Medicare, and Medicaid and how each can be supplemented with private health care and retirement plans, such as IRAs, life insurance, mutual funds, Medi-gap, and similar programs. Other programs, which might be offered by employers, include budgetary planning and the use of credit.

Retirement Benefit Plans

Federal laws have been adopted that encourage individual participation in employer-sponsored retirement plans that qualify for special tax treatment under the Internal Revenue Code.

Participation is encouraged for both employers and employees by affording preferred tax treatment for both parties. Employers who contribute to qualified profit sharing and retirement plans can deduct such contributions as an ordinary business expense for federal income tax purposes.

For an employee, contributions generally are excluded from gross income, thus reducing the amount of income that is taxable. Distributions to employees are not taxed until such time as employees actually withdraw funds from the plan, during which time a retiree may be in a lower tax bracket than while employed. Retirement plans are sometimes referred to as pension plans, profit-sharing plans, defined benefit plans, 401(k) plans and Keogh plans.

Some of the more common employer-sponsored qualified retirement plans are covered below.

401(k) and 403(b) Plans

401(k) and 403(b) are two types of savings plans named after two sections of the Internal Revenue Code. Both plans are two of the most popular retirement plans currently offered by employers to their employees. The 401(k) plan is available to a profit-making business, whereas a 403(b) plan is limited to not-for-profit companies.

401(k) plans are similar to other plans such as salary reduction plans, thrift plans, profit-sharing plans, or pension plans. Whatever the designation, 401(k) plans are popular with employees because of several features:

The amount of current income, which is contributed by an employee, can be sheltered from federal income taxes.

The current amount of federal income taxes can be reduced. Employers can make matching contributions.

In the case of a hardship, funds can be borrowed to help defray costs related to health care and education.

For an employee, participating in a 401(k) plan is relatively painless. All an employee must do when they are eligible to participate is sign up for the plan and indicate just how much of their salary they want to set aside for the plan. Generally, 401(k) plans provide for employee contributions ranging from 1 to 15 percent of their earnings, and are subject to an annual limitation imposed by the Internal Revenue Code.

Many employees have common concerns, some of them misplaced, about investing in a 401(k) plan. These concerns include locking up money for an extended period of time, an eventual reduction in the amount of Social Security benefits, shifting the responsibility for their investments to others or not being able to afford to set aside a specific amount of money to invest on a regular basis.

The ultimate amount of Social Security benefits is not affected by contributions to a 401(k) plan since the amounts paid by a company and employer to Social Security are based on gross salary and do not take the amount of contributions to a 401(k) plan into consideration.

Employees who withdraw funds from a 401(k) plan before the age of 59½ must pay income tax on such distribution and a 10 percent penalty, except in the event of distributions made to an IRA rollover or another qualified plan or a hardship loan.

In many instances, professionals who are independent of the employer manage 401(k) plans. Employees may be provided several options as to how their funds are invested.

A 401(k) plan, according to the ERISA definition is a “stock bonus or profit-sharing plan, which allows the employee to elect to be paid in cash or to have the money placed in a trust under the plan.”

With the implementation of Section 401(k), an employer, even a small business, can invest employee contributions in a qualified cash or deferred plan. In this plan, participants have an option — they may have part of their salary contributed to a profit sharing or stock bonus plan up the (up to the maximum amount that may be contributed by the employee).

These contributions to the 401(k) are not taxable until the funds are withdrawn. The other option means they may receive the wages as taxable income, as no employees can be forced to join a profit-sharing plan.

A 401(k) plan can be funded entirely by employee salary reductions. That way, the plan costs the employer only the installment and administration costs. The plan’s effectiveness, however, is enhanced by the employer’s direct contribution in addition to the salary reductions.

Qualified vs. Nonqualified Plans

A 401(k) is considered a qualified plan because it adheres to the rules established by the IRS and is described in sections 401 through 405 of the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA).

In addition, every major tax bill since the implementation of ERISA gives more definition to qualified retirement plans. To be "qualified," the savings plan must adhere to ERISA's nondiscrimination rules, reporting and disclosure guidelines, strict fiduciary responsibility to the plan, its funding, and its participants.

The company establishes the qualified plan only. The employer's contribution to the plan must not discriminate between highly compensated employees and others. For example, an executive employee who earns more than $100,000 annually is considered highly compensated. The employer may not contribute a higher percentage to this highly compensated employee's pension or profit-sharing account than to a non-highly compensated employee's account — an employee who earns under $40,000 per year.

Another qualification includes making 70 percent of all employees eligible to join the plan. Thus, the qualified plan is nondiscriminatory. In addition, the employer using a qualified plan may take an immediate deduction for contributions to the plan, while the employee does not have to include the contribution as part of gross income until the funds are distributed. Lastly, with a qualified CODA plan, the employee may use five-year forward income averaging to avoid paying increased taxes.

In contrast, the nonqualified plan (one not described in sections 401 through 405 of the Internal Revenue Code) differs from the qualified plan in several ways. Nonqualified profit sharing may also be discriminatory by benefiting highly compensated employees more than non-highly compensated employees. The nonqualified plan may benefit only a certain group of employees.

The employer may not claim contributions to the nonqualified account as tax exempt until the employee claims the contribution as income. Another difference between the plans is that the nonqualified profit-sharing plan is exempt from the ERISA reporting, vesting and fiduciary responsibilities. Finally, the employee may not use five-year or ten-year averaging in order to reduce taxes if they receives all their contributions in a lump sum.

Government Regulations of 401(k) Plans

Internal Revenue Code ("the Code")

Tax laws governing deductibility and taxation of pension and employee benefit programs are strict and protective of the employee. As stated earlier, these laws for a qualified plan generally are described in Sections 401 through 405 of the Internal Revenue Code. Other important provisions concerning pensions and 401(k) can be found in sections 72, 83 and other sections of the Code.

ERISA

Another regulation which governs the direction of a 401(k) plan has been mentioned — ERISA (Employee Retirement Income Security Act of 1974). ERISA imposed extensive reporting and disclosure requirements on a broad range of employee benefit plans. Because many employees are covered by these employer-sponsored plans, labor laws such as ERISA govern the non-tax aspects of federal regulations similar to the Code.

These labor laws involve plan participation requirements, notice to participants, reporting to the federal government and a variety designed to safeguard any funds that are set aside to pay benefits in the future. There is some overlap between ERISA and the Code in the areas of plan participation, vesting, prohibited transactions and others.

The Pension Benefit Guaranty Corporation was set up by ERISA in 1974 to provide termination insurance for participants in pension plans like the 401(k). The PBGC regulates plan termination and guides certain reporting requirements on covered plans that are in financial difficulty or are in a state of contraction.

Securities Laws

The federal securities laws protect the investor. Since benefit plans such as the 401(k) usually involve investing the employee's money, the securities laws may apply. Qualified plans described in the Code are generally exempt from the full impact of the securities laws. However, if the plan involves investing and holding employer stock, a federal registration statement may be required.

State Legislation

ERISA regulations displace any state laws relating to employee benefit plans. Only in instances in which ERISA does not deal with a certain issue will state regulations come into effect.

These regulations interpret laws published by a government agency. The most important regulations governing pension plans are those published by the Treasury Department (which governs the IRS), the Labor Department and the PBGC.

Plan Contributions

Employees and employers both must follow federal rules in contributing to the individual's 401(k) plan. The employee usually chooses an amount they feel they can contribute to the pension plan and voluntarily takes a salary reduction in that amount. By law, an inflation adjustment factor is built into the plan, which raises the maximum contribution limit.

The advantages of the 401(k) profit-sharing plan are numerous. For instance, the employee has a choice in the amount of savings, all or part of which can be salary reduction. In addition, the amounts contributed are nontaxable to the employee who enjoys tax-free accumulation of funds in the plan. The employee can take 5-year or 10-year income averaging once they receive the funds, which reduces the amount of tax paid.

Under a qualified plan, the participant must at all times be 100 percent vested in their accumulated benefits derived from the salary reduction contributions to the 401(k) plan. In other words, the money contributed to the plan is available and may be distributed in full at all times (although penalties apply, as discussed earlier).

In comparison, the employer establishes "up front" in writing the amount to be contributed by the company to the individual's amount. The employee alone may make all the contributions, the employer may establish a percentage contribution, or the company may match the employee's contributions.

Matching the employee's contribution is one attractive quality about 401(k) plans. This is a legally binding commitment by the company to make the promised contributions.

Therefore, the employer's costs in the 401(k) plan are dependent on the employee decision and out of the employer's control, but, overall, the employer may not contribute more than 6 percent of the employee's annual gross salary.

The employer's deduction limit is 15 percent of payroll expenses.

Plan Investment Direction

Participant-Directed Plans

A plan's choice of investment should be guided by the needs of both employer and employee. In the participant-directed plans, the employee chooses from a menu of possible investments for their salary reduction. For example, the company may offer life insurance, group annuity, equity investment, mutual funds, trust funds, stock options, or a choice of two or three of these options. This cafeteria-style plan gives the employee a measure of control over salary reduction investments and may create a positive feeling toward the employer's interest in their needs.

Many plans use a "directed investment" or "earmarking" provision that allows participants some degree of choice in the investment of their plan account. Directed investment provisions increase administration costs of the plan but may be attractive to the employee. If the directed investment provision meets the standards of the Labor Department's regulation (DOL Reg. 2550.404c-1), the employer is relieved of fiduciary responsibility for an investment directed by the participant.

Employer-Directed Plans

The employer-directed plan gives the company more control over where money received through salary reductions may be invested. While the employee makes the decision to participate in a cash or deferred arrangement by receiving the wages as taxable income or accepting a salary reduction, their choices are limited in the employer-directed plan. The employer's responsibilities to the employee are the same, but the company now directs the investing. Plans directed by the employer probably work well in smaller companies.

Components of a 401(k) Plan

Communication

Both before and after the employee decides to fund the 401(k) *(a.k.a. 401k)* plan with a salary reduction, the company must communicate clearly to all plan participants. Generally, the company would print an employee benefits handbook, which describes the health insurance, life insurance and retirement plan offered.

While employers should try to simplify the benefits as much as possible, government regulations often make the plan rather complicated. However, with the advent of ERISA, "summary plan descriptions" are mandatory. Special efforts by the employer to inform the employee of the retirement plan features must meet legal requirements as well as being clear and useful.

In addition, ERISA requires that an "individual benefit statement" be provided to the employee on request. If an employee makes such a request, the employer then has 30 days in which to provide the information. Even though there are minimum individual information statements required by law, the employer may elect to provide a statement of the full value of the employee's investment.

Many employers choose to provide individual benefit statements annually, whether requested or not. The summary annual report must be provided to the participant within nine months of the end of the plan year. This statement lets the employee see the full value of the employer's benefit program.

For instance, an individual benefit statement would tell the employee how much they will receive monthly from the corporation's retirement along with Social Security at age 65. It would also inform the employee that their spouse would receive benefits at retirement age as well.

Additionally, the statement tells the employee how much of their accumulated benefits are available at an earlier retirement age. In order to remind the employee that there is more to their paycheck than that which they take home, the individual benefit statement would indicate how much they have accumulated currently and the amount of their vested benefit.

Investment

Generally, investments used in qualified profit-sharing plans are also used in 401(k) plans. Employee accounts in the plan are usually pooled for investment purposes. These investments tend toward bonds, money market accounts and liquid, cash-type investments.

Smaller plans often use a family of mutual funds for plan investments. The level of equity investment in a 401(k) is usually lower than in defined benefit plans.

Life insurance is often provided in 401(k) plans in much the same way as it is used in regular profit-sharing plans. Investing in life insurance adds to the limit on deductible employer contributions. It also combines the advantages of an insured death benefit and the investment security of policy cash values, together with the opportunity to invest more aggressively using side funds.

In the end, a 401(k) plan is like any other investment. Before the employee chooses among the options offered by the company, they should consider their current investment outside the company and decide what goals the 401(k) can help attain. Investing in stocks has the potential for large gain, but the ability to move the money easily and quickly would be necessary.

If moving the money is restricted, the employee may opt for the investment that grows steadily like a money market fund or the life insurance annuity already discussed. Taking the time to understand the investments available and how they perform in different economic conditions is the responsibility of the participant.

Knowing the answers to certain questions (how the employee feels about investing; what the investment choices are; how well each choice is performing; how often investments can be changed; how much each employee knows about investments; how much time will be spent keeping current on the investment status; what other investments the employee has; length of time until retirement) can aid the employee's decision in how to invest in a 401(k) plan. Answers will differ from individual to individual.

Record Keeping

During the time an employee works for a company, record keeping in an employer-sponsored retirement plan is primarily the responsibility of the employer. The retirement plan administrator should see to it that all the proper forms are filed on the employees' behalf. The amounts the employee contributes through salary reductions must be carefully recorded.

Interest earned, vesting schedules and the individual benefit statement are calculated, compiled, and reported to the employee. Once funds are distributed either at retirement, end of employment, or for other reasons, the employee must report the taxable portion to the IRS.

Plan Set-Up and Administration

Examining the Plan Options — Eligibility Requirements and Vesting Rules

Since a 401(k) is a qualified plan under the Code, eligibility requirements and vesting rules must be met in order for contributors to enjoy the cash or deferred arrangement. The employer solely for the benefit of the employees must set up this plan.

As stated earlier, 70 percent of the employees must be offered participation in a 401(k) or it does not qualify for tax-deferred status. Not every employee is eligible to participate in the 401(k) plan.

Generally, though, if the employer establishes a 401(k) plan, and the employee is at least 21 years old and works a minimum of 1,000 hours in a 12-month period, they may participate.

Vesting means accrued benefits are non-forfeitable — the funds cannot be taken from the employee. The employee contribution to the 401(k) plan is always 100 percent vested. The company's contributions, on the other hand, may vest over a number of years.

According to ERISA terms, the employer may practice "cliff" vesting or "graded" vesting. With cliff vesting, all accrued benefits become non-forfeitable at a specified length of service by the employee, such as five years.

A graded vesting schedule means an increasing percentage of accrued benefits become vested each year, until 100 percent has been reached. Each year the employee works increases their "ownership," or they vest themselves in increasing percentages, in the employer's retirement plan. The employer chooses the length of time for vesting. Tax laws shortened the maximum vesting period from 10 years to between 5 to 7 years. Sometimes, the vesting period is shorter than 5 years. An exception would be an employee working under a collective bargaining agreement. Then the vesting schedule may legally be up to 10 or 11 years.

Distribution

An employee may request distribution of funds deposited in a 401(k) plan at any time. The rules allow for receiving funds before retirement, even though the circumstances must be right and the administrator's policies governing taking money out early determine if the request is possible. Usually, the only way to take out money from a 401(k) while the employee is still working is in the event of a hardship.

A hardship is defined by the plan as "an immediate and heavy financial need" due to education costs, medical expenses, or purchase of a principal residence. The employee must prove that all other assets are exhausted before they qualify for a hardship distribution. Once this hardship is established, the money comes to the employee only from their contributions, not from any of the growth or interest and none of the employer's matching amount. The plan may also call for withdrawing only enough money to cover the emergency.

An alternative in emergency situations could be to borrow from the account. Most 401(k) plans allow the participant to "borrow" up to 50 percent of their vested interest, but not more than $50,000. The loan money is not taxed as income, and the employee may choose from several options for repaying the loan.

Another scenario in which the employee may receive early distributions from the 401(k) plan would be leaving the employment of the company. The total lump sum of the employee's contributions, along with any matching by the employer and interest earned, would be given to her. The sum may be distributed over a period of years.

Of course, if the employee has not reached the age of 59½, early distribution penalties would apply.

To avoid these penalties, a participant under 59½ years of age must be separated from service and either roll the entire amount over to an IRA or take the distribution from the 401(k) as a series of payments. These payments are based on the life expectancy of the participant or the life expectancy of the participant and spouse.

Overall, the 401(k) plan is designed to help most those employees who contribute funds to a company pension plan over an extended period and retire at the age of 59½ or older. At that time, the account is fully vested.

The participant may leave the funds with the employer, take the funds as a lump sum, roll the funds into an IRA, or accept other options offered by the company.

The distributions may be taxed as ordinary income, unless withdrawn as a lump sum. The lump sum is eligible for special tax averaging over a five- or 10-year period. The distributions must start at age 70½. If the employee continues to work, they may still contribute to the 401(k) plan.

Who Directs the Plan — Participant or Employer?

No employer-sponsored pension plan is entirely within the control of the employee. In the employee-directed plan, though, the participant may choose among investments offered by the employer. These choices truly make the participant an investor.

If the employee reads about business and economic trends and decides to change investments within the 401(k), the company may comply. In some cases, within the guidelines devised by the retirement plan administrator, the participant may switch from one investment to another.

Sometimes this switching is allowed only twice a year. The administrative delays and paperwork involved in switching investments could make the change take longer than planned. This is one drawback to 401(k) plans. Over the years, no one investment will be best; sometimes one investment will do better than others, which calls for the employee to watch such trends.

The employee must decide if the time and effort of following the stock market and understanding investing is practical for them personally. While employee-directed plans increase administrative costs, these plans are usually attractive to employees.

As mentioned, if the investment provision meets Department of Labor rules, the employer no longer has fiduciary responsibility for any investment directed by the participant. (A fiduciary is the person or corporation such as a trustee, executor or guardian who manages property for another person.) Still, the advantage to the employee in a participant-directed plan may be a feeling of control over investing and, therefore, generate positive feelings about the company and saving for the future in general.

Employer-directed plans direct the employees' voluntary contributions to specific investments. Usually, the investments in this case would benefit the employer, give the employer control over where the employees' money and the matched company portion go, and still help the employees invest in their retirement.

With the employer-directed plan, the company decides beforehand the investments and the proportions of contributions to each investment. This directive is communicated to the employee upon becoming eligible for participation. The employee chooses only whether or not to join the plan.

The employer-directed 401(k) has advantages in that the employer has more control over investing and can project future contributions based on the percentage of personnel participating in the plan and turnover and hiring rates. Since the employee is always assured of receiving their own contributions and the employer's matched portion at any time (with penalties, if applicable), it may also be to the employee's benefit to let investing experts direct the funds. This directed plan saves the employee from having to closely watch the investments.

In the event that the stock market falls, and the company has heavily invested 401(k) funds in stocks, then the value of the contributions will fall as well. The employee still receives the shares bought with their salary reduction and matched portions, but the value fluctuates with the market. While the same problem occurs when employees direct the investing, feelings of distrust could result from employer-directed plans.

If the plan is employer-directed, the employee chooses only between joining the plan or not joining the plan.

Whether the employer directs the investing or the participant does so, only certain options yield stable results (such as money market funds) while others may offer higher returns (such as stock options). With clear communication from company to employee, the plan should be successful for all involved.

Plan Administration

The administrator of the 401(k) plan in a company is the person (or committee of persons) who runs the plan. The employer's goal in selecting a benefit plan usually includes providing the greatest pension benefits for employees and the company at the lowest cost.

Designing such a plan requires an actuary. An actuary is an outside person who should be capable of estimating the funds needed to provide the promised benefits. If the plan is funded by insurance, however, the actuarial work will have been done when determining the premiums.

Working with the company's financial advisor, the actuary must estimate investment income, employee turnover, vesting, mortality, wage inflation, retirement age, disabilities, etc. The company's financial advisor keeps the company's goals in mind when setting up the benefit program.

Once the program is in place, the sponsoring employer normally assumes the administrative costs, including trustee's fees, actuarial costs, attorney's fees, clerical costs, bank charges, and brokerage and agents' fees. These costs may be deducted from profits as normal business expenses.

Depending on the size of the company, a trustee investment committee may be appointed to administer the investments in the pension plan. This committee may appoint one or more professional money managers to manage the plan's investments. The corporate trustee holds the assets of the plan.

The administration of the plan involves keeping up with economic trends and managing the plan's investments.

The employer is responsible for administration and record keeping.

Record keeping differs from administration in that it is done after the fact. The administrators perform the investing while the recorders keep track of contributions, matching, interest earned and communication of gains (or losses) to the employees. Record keepers do not handle the investment of the funds.

Tax Considerations

How and When Plans Are Taxed

Employee elective deferrals, including salary reductions, are not taxable within the annual limit. However, even though these amounts are deferred by federal income tax rules, Social Security taxes must be paid. While the salary reduction may be exempt from income taxes, it is treated as received for Social Security tax purposes.

The employer's contributions to the plan are deductible for federal income tax purposes up to a limit of 15 percent of the total taxable payroll of all the employees covered by the plan. State payroll taxes depend on the particular state's law. Elective deferred wages and non-elective employer contributions may be exempt by state income taxes in some states.

With a cash or deferred arrangement such as a 401(k) plan calls for, funds contributed to the plan are not taxed until distributed. The salary reduction does not appear on the employee's W-2 form at all. Ideally, the funds are saved over an extended period and distributed upon retirement at age 59½ or later. Whatever the choice of distribution, it is important to plan carefully in choosing payment options since rules are complicated.

At retirement, the funds may be distributed as a lump sum. If the retiree receives a lump sum, they may benefit from a tax-free rollover to an IRA or another qualified company plan.

To avoid the mandatory 20 percent withholding tax, the plan funds must be directly rolled over by the company. However, the employer must provide written notice about the rollover options and withholding tax rules.

If the retiree was born before 1936 and was involved in a qualified company retirement plan for five or more years, then they may be eligible for averaging on a lump-sum distribution. The recipient would file form IRS 4972 for such distributions meeting three tests.

First, the sum must come from a qualified pension, profit sharing, or stock bonus plan.

Second, the employee under 59½ years old receives the funds due to quitting, retiring, being laid off or fired. After age 59½, the distribution may be made for any reason.

Finally, the balance of what is due to the employee must be paid within one of the taxable years. If the distribution meets these three requirements, then the recipient follows the instructions for 5- or 10-year averaging provided with IRS form 4972. Usually, 10-year averaging calls for lower taxes.

Distributions other than lump sum may be subject to regular income taxes. The recipient should receive full instructions from the employer for taking payments over the span of years. Funds will also be taxed if received before retirement and if they do not meet the requirements for hardships, separation from employment or death distributions.

After-Tax Contributions

An after-tax contribution to a pension plan is allowable. This is a contribution to the plan on which the participant paid taxes. This money will come to the employee tax-free upon distribution of the funds.

All interest, dividends, or capital gains, however, will be taxable. Since they are already taxed, the participant may withdraw them at any time.

The employee's benefit statement should show both before- and after-tax contributions. Upon retirement, the recipient should be provided with a record of both before- and after-tax contributions.

Defined Contribution Plans

In a defined contribution plan, an employer sets aside specific sums of money every year and such funds are placed in accounts, which are earmarked for each employee. Upon retirement, an employee receives payment of the amount of funds in the plan, which has actually been contributed by the employer.

A plan manager may invest the funds, which may be the employer or a third-party professional. Some employers permit an employee to participate in the direction of the investment of their funds. Defined contribution plans may come in one of two forms - a money purchase pension plan or a profit-sharing plan.

In a profit-sharing plan, an employer has the option of determining how much to contribute to each employee's account, and that amount is usually a certain percentage of an employee's salary.

A profit-sharing plan may be funded with employer securities. The disadvantage of a profit-sharing plan is that contributions depend upon the profitability of the company. Thus, in years when there is little or no profit, contributions to a plan may be nonexistent.

In a money purchase pension plan, an employer contributes a specific amount each year such as a certain number of dollars for every hour worked. That same formula must be applied every year that the plan is in effect.

Investors who have self-employment income in addition to other employment wages and can afford to contribute larger sums to their Keogh plans, or who expect to continue funding their funds over a period of several years, will probably be interested in a money purchase plan.

This plan earned its name from the way it works — investors contribute for a number of years, and at retirement, they may opt to "purchase" a financial instrument (such as an annuity) with the worth of their investment.

What an Investor May Contribute

Each year investors commit to contributing a specific percentage of their self-employment earnings. Once they decide on that percentage, they are bound to it. This, however, can be an advantage in that it forces investors to have fiscal discipline. They know what percentage they will contribute, so they are prepared to accept that responsibility.

Money Purchase Plan

Those who opt for a money purchase pension plan's total contributions (but not the percentage of contributions) will vary from year to year because of the fluctuation of earnings. Also, as with any type of investment, the earnings of the investment fluctuate because of the variance of contribution and investment climate, which changes from year to year.

Unlike a defined benefit pension plan, which pays a specified annuity upon retirement, a money purchase plan does not define the annuity in advance. Rather, it pays whatever annuity the funds will buy, or what the money will purchase, when the person is ready to retire. However, one who invests in this type of plan does not have to buy an annuity.

Defined Benefit Plans

Defined benefit pension plans cover millions of employees in the American work force. An employer who usually invests money in mutual funds, stocks or bonds funds such plans. A retiree is guaranteed a specific amount of pension funds when they retire based upon salary, age, and years of employment.

It is the hope of most employers that a defined benefit plan, together with Social Security payments, will provide a retiree 60 to 70 percent of pre-retirement income. The Pension Benefit Guarantee Corporation, a government insurance agency, backs defined benefit plans.

Defined benefit pension plans can be problematic in that many do not adjust future benefits for inflation. Thus, a retiree may find their monthly benefits substantially eroded. Participants are entitled to a fixed monthly benefit until death. Upon the death of a participant, the surviving spouse will continue to receive half of the benefits to which the participant was entitled. Some plans allow surviving spouses to receive 100 percent of monthly benefits in return for an agreement of a participant to reduce the amount of the monthly payments.

Simplified Employee Pension Plan

Commonly referred to as a "business IRA," the Simplified Employee Pension Plan (SEP) allows anyone with income from self-employment to open an SEP account.

A SEP IRA owner may contribute up to the limits outlined in limits and contributions section of this book.

The term "compensation" for self-employed individuals refers to earned income.

It should also be noted that the spouse and children may also participate in the plan and open their own SEP IRAs - as long as they are employees of the company.

Contributions made to the SEP are deducted from an employee's gross income. In many cases, companies offer SEP's in addition to defined benefit pension plans. If the total plans have excess contributions, the employee must withdraw the excess amount before filing a tax return. The amount must be reported as income, or the IRS may assess a penalty.

Distribution of an SEP is just like distribution of an IRA. In most cases, a penalty is faced for making withdrawals before the age of 59½ years, withdrawals must be started by age 70½ and money can be taken in a lump sum or by setting up an annuitized payment schedule.

SEP's have been called "pension plans without the drawbacks." Because they are IRAs, they are taxed as such. SEP's offer a large degree of flexibility — the individual or the employer designs the plan, including such options as salary deductions, which are a way of deferring taxes. SEP's are portable and can be rolled into another plan.

Keogh Plans

In the early 1960s, Eugene Keogh, a former New York Congressman, sponsored legislation that produced a retirement plan for the self-employed — called a Keogh plan. Although the early version of the Keogh plan was hindered by participation and contribution rules, the modern Keogh, also known as the HR-10 plan (again, a reference to the legislation number), gives self-employed workers retirement savings much like those that corporations offer their employees through 401(k) or profit-sharing plans.

Basic Characteristics

For employees who have a business on the side, a Keogh plan may be advisable. Contributions to a Keogh plan are fully deductible and there is no tax on earnings until a participant withdraws the funds. Participation is available to anyone who is an owner of a small business on a full- or part-time basis, a self-employed professional, or engaged in moonlighting, contract work, or free-lancing.

Contributions are limited to a percentage of earnings up to a yearly maximum. If a participant has any employees, they must be included in the Keogh plan and contributions must be made in the same percentage of income as that of the plan sponsor.

Investors put in money (a contribution) each year, which is meant to grow into a sizable sum that the contributors may use a retirement income, as an investment, as a way to procure a financially secure future or as a means of establishing an estate for their families.

Generally, those who are interested in short-term financial success (such as savings for a down payment on a house) should consider other investments such as stocks or bonds because withdrawing Keogh funds early results in penalties, which defeats the purpose of having a tax-sheltered investment.

Basically, to invest in a Keogh, a person must be self-employed and must be earning a net profit from that self-employment activity. Until retirement, they contribute a percentage of their earnings, and, depending on the Keogh plan chosen, receive as a retirement pension the contributions in the Keogh. These contributions are tax-deductible, so the investor pays no taxes on those earnings until they withdraw the funds at retirement.

The terms "employee" and "employer" are often used in discussions of Keogh plans. According to Keogh law, a self-employed person is an employee; therefore, they must also have an employer. Legally, they are also the employer because they work for themselves. If the self-employed person is a partner in a business, then the partnership (not the partner) is the employer. There also exists a third party: the trustee or the company where the Keogh is established. The self-employed names themselves the trustee, therefore they could fulfill three roles.

A written Keogh plan is a legal document, so the relationship established between employee and employer is similar to a contract. Although it might sound strange to say, Bill, a full-time accountant with a sideline tax preparation business with themselves as trustee, is simultaneously the employer, the employee, and the trustee of the tax preparation business.

This relationship must be handled as carefully as if it were actually between three different people.

Keoghs and Inflation

A common concern of investors interested in Keogh plans is inflation. They worry that their contribution will be worth less in the future because of inflation — will their $300,000 contribution be worth that in 30 years?

Also, an investor should realize that as inflation rises, their earnings and the amount that they might contribute to their Keogh rise proportionately with the increase in inflation. Therefore, their pension collection will rise in response to the rise in inflation. There are, of course, no guarantees that money will be worth tomorrow what it is worth today, but this is true of any investment.

Keoghs and the Underground Economy

Obviously, a person may only qualify for a Keogh when they report the earnings from their sideline business. Not reporting could result in severe tax penalties and perhaps even jail since withholding earned income from the IRS is a crime.

Sometimes people do not report money that they make on their moonlighting activities because they are attempting to shelter it from taxation. This results in what is called the underground economy. Participating in a Keogh also protects the money from taxation but, unlike hiding the money, the Keogh offers long-term financial regard.

Remember, money invested in a Keogh is tax-deductible.

Keogh money can also be invested anywhere, and all income on the investment is tax-free as long as it remains invested. The person who hides their moonlighting income has few opportunities to invest it in a way that will not eventually reveal their crime of not reporting the income.

Keogh versus IRA

A Keogh plan is like an Individual Retirement Account (IRA) in that participants set up an account or related arrangement and make tax-deductible contributions. Also, like an IRA, any investment profit is tax-free until the investor begins to withdraw it.

Finally, a Keogh and an IRA are similar in that investors may begin to withdraw funds from their accounts when they retire at age 59½ and must begin to withdraw by age 70½. On the other hand, if an investor must withdraw funds early, the amount would be penalized under both the IRA and the Keogh.

When investors reach 73 years of age, however, they will see the differences between the Keogh and the IRA. Investors, although they must begin withdrawing their funds by April 1 of the year in which they reach 73, may contribute to a Keogh as long as they are earning income from self-employment, even after they reach 73.

On the other hand, investors may not continue contributing to an IRA after that age (although they might contribute to a spousal IRA for a mate who is less than 73 and has no earnings). Also, unlike an IRA, investors may contribute far more than a year to a Keogh.

IRAs also do not share the privilege of forward averaging, which is where a person may withdraw a lump sum in one calendar year and be taxed as if they have taken the sum out over five years; they pay all their taxes up front.

Who Is Eligible?

Investors must qualify for a Keogh in two ways - they must be self-employed, and that self-employment must be profitable.

Self-Employed

There are three ways that a person may be considered self-employed:

The most obvious example is a person who is self-employed full-time; perhaps they own a local grocery store or are an artist who works out of their home.

The second way a person may be considered self-employed is that they work for someone else full-time but own a sideline business. For instance, a police officer who works during the day as traffic officer and as a security guard at night would fall into this category.

The third way a person may be called self-employed is that a person is a homemaker and has a sideline business.

- ❖ E.g., A woman who does not work full time but tutors neighborhood children may call herself self-employed for the purposes of qualifying for a Keogh plan.

If a person is not sure whether they are self-employed, the test is easy. If the person or business they work for withholds taxes on their earnings, they are an employee. If, on the other hand, no tax is withheld, then they are self-employed.

Before one makes the determination of their status, though, they should check with the person or business that pays them to make sure that a mutual understanding of their status exists. This is important at tax time, but it is equally important when a person is trying to qualify for a retirement plan such as a Keogh. If they disagree with the status their employer grants them, they may appeal to the IRS.

Employees of the Self-Employed

If a self-employed person decides to invest in a Keogh, they must also cover employees who want to participate. These employees must be at least 21 years old or have worked for the company for three years.

The self-employed may not exclude contributions to their own Keogh from taxable income unless appropriate contributions are made to the employees' accounts. If the self-employed contributes 20 percent to their Keogh, they must be prepared to contribute 20 percent of their employees' salaries to their Keoghs as well.

The contributions to the employees' accounts are tax deductible as business expenses, but it still may make too much of a financial demand on the self-employed to commit money in such a way.

For the purposes of this manual, whenever benefits or options of the self-employed as employees are discussed, this information applies to the self-employed individual's employees as well.

Income from Self-Employment

The second qualification for a Keogh plan is that a person must have net income from the self-employment activity, but the source of the income doesn't matter. It could be fees, hourly, weekly, or monthly charges, retainers, royalties from writing or inventions or other income, as long as it is not investment income such as wages or dividends as an employee.

To have income, the self-employment must be profitable, and in technical terms this means that there are "net earnings from self-employment." If a person is a writer, but they do not sell their manuscript, they are self-employed, but they do not qualify for a Keogh because they did not make a profit from their self-employment. If a person has income from their self-employment work, but they spend more on the activity than they take in, they, like the writer, are not entitled to participate in a Keogh plan.

Setting Up a Keogh Plan

After an investor selects the type of plan that is best suited to their goals, they must commit this to paper, and must have a written Keogh plan, which is referred to as a "plan document." A written trust agreement must also be obtained. Since both of these documents are fairly complex legal documents, most Keogh professionals suggest that investors seek professional help in completing these forms.

The Plan Document

In the plan document, the investor states in detail what they as an employer will provide, and then states the conditions that, as an employee, they will meet in order to belong to the plan and to benefit from it. They say exactly when and how much they will collect, and they specify any options, such as the option to take benefits as a lump sum or to purchase an annuity.

The Trust Agreement

In the trust agreement, the investor as employer sets forth what the trustee (the investor may name themselves trustee) should do about trust investments and payments to employees (again, this term applies to the investor). If an investor does not want to fulfill this role, they may have a person knowledgeable about pensions (such as a bank official or an insurance agent) do this for them.

Master Plans

A master plan consists of forms where the investor simply fills in the blanks on the form. More than one master plan exists, so an investor should investigate as many master plans as possible so that they might find one that best suits their retirement needs. Some investors select master plans rather than tailor-made plans because they may have already been pre-approved by the IRS.

Employee Savings Plans

Many employers sponsor employee savings plans under which a specific amount of earnings is deducted from payroll on a regular basis and is placed in a savings account for the benefit of an employee. There is no tax deferral as in the case of the 401(k) plan. The funds may be pooled and invested in certificates of deposit or in mutual funds.

Disability Plans

Although a long-term disability plan is not a retirement plan, nevertheless it is a method for an employee to preserve other funds for retirement in the event of incurring a disability while employed. Many businesses have plans which offer coverage to an employee in the event of short- or long-term disability. Some plans cover intermediate disability.

The features differ from one plan to another, but every plan has as its goal protection to an employee and their family in the event of a prolonged disability caused by a physical or mental condition. Following are some of the more substantial provisions of an employee-sponsored disability plan. Eligibility. Disability plans are generally available to regular, salaried, or hourly, non-bargaining employees located in the United States who work a minimum of 20 hours a week and who contribute a nominal amount to the plan through payroll deductions.

Disability. Many plans do not contain a list of those conditions, which may cause a person to be considered disabled. Disability plans typically cover conditions that arise both on and off the job. The determination as to whether a qualifying disability exists is left in most cases to the results of a thorough medical examination.

Pre-existing conditions may disqualify an employee. Additionally, employees may be excluded from coverage if a disability was caused by intentional self-infliction of an illness or injury, act of war, insurrection, terrorism, riot or during the commission of a felony.

Types of coverage. Participants are usually covered automatically under short-term disability provisions of a plan and further enrollment may be required for long-term disability coverage.

Short-term disability. Usually covers a disability that endures for up to a six-month period.

Long-term disability. After an employee has been totally disabled for an extended period, typically six months, they become eligible for benefits under the long-term disability provisions of a plan. Often, an employee and their employer share the costs of the premium for long-term coverage, usually a small percentage of an employee's base earnings. Long-term disability benefits customarily consist of payment of 60 percent of an employee's base salary for as long as the disabling condition exists.

Application for Social Security benefits. Some plans require an employee who seeks long-term disability benefits to apply for Social Security Disability Income (SSDI) at the same time. If an employee receives SSDI, long-term disability benefits will be reduced by the amount of SSDI payments.

Continuation of other benefits. A number of disability plans allow an employee to participate in other employee benefits, such as medical and dental plans and personal accident insurance, provided the employee pays the premiums for such plans. Personal accident insurance coverage may be available for several years after the date of disability if an employee pays the premiums.

Insurance Benefits

Many companies offer a variety of insurance benefits to active employees and retirees. Such coverage may include group term-life, accident, medical and dental. In some cases, group coverage may terminate upon retirement, and it may be possible for a retiree to convert such policies to individual policies and in other instances the company may continue group coverage for certain retirees.

Stock Option and Purchase Plans

A number of companies afford employees opportunities to invest through regular payroll deductions in their own stock. Dividends may be automatically reinvested in the plan. The employer usually pays administrative costs, including commissions on the purchase and sale of stock.

Some companies grant stock options to key employees after a number of years of service or as an inducement to hiring a valuable employee. If the stock has long-term growth potential and the price goes beyond the option price, an employee will be able to build an investment portfolio for considerably less than acquiring the stock in the open market.

Another vehicle for the acquisition of company stock is an employees' stock ownership plan (ESOP). An ESOP must invest primarily in the stock of the company which sponsors it. Typically, a company makes an annual contribution to the plan by buying its stock in the market or by contributing treasury stock to the ESOP.

The shares are then apportioned among employees according to what percentage of total salaries an individual's salary represents. Employees do not contribute any of their salaries to an ESOP. Actual shares of stock are not issued to an employee until termination of employment or retirement. An ESOP automatically covers most employees without signing up for the plan.

FOCUS POINTS

- 401(k) plans are available to a profit-making business, whereas a 403(b) plan is limited to not-for-profit companies.
- 401(k) plans provide for employee contributions ranging from 1 to 15 percent of the employee's earnings and are subject to an annual limitation imposed by the Internal Revenue Code.
- Employees who withdraw funds from a 401(k) plan before the age of 59½ must pay income tax on such distribution and a 10 percent penalty.
- Contributions to the 401(k) plan are not taxable until the funds are withdrawn.
- A 401(k) is considered a qualified plan because it adheres to the rules established by the IRS and is described in sections 401 through 405 of the Internal Revenue Code.
- ERISA was enacted in 1974 and imposed extensive reporting and disclosure requirements of employee benefit plans.
- The PBGC regulates plan termination and guides certain reporting requirements on covered plans that are in financial difficulty or are in a state of contraction.
- The employer-directed plan gives the company more control over where money received through salary reductions may be invested.

- Investments used in qualified profit-sharing plans are bonds, money market accounts and liquid, cash-type investments.
- Investing in life insurance combines the advantages of an insured death benefit and the investment security of policy cash values.
- In order for a plan to qualify for tax-deferred status 70 percent of the employees must be offered participation.
- Under ERISA employers may practice “cliff” vesting or “graded” vesting.
- Cliff vesting can be defined as all accrued benefits becoming non-forfeitable at a specified length of service by the employee.
- A graded vesting schedule means an increasing percentage of accrued benefits become vested each year, until 100 percent has been reached.
- A hardship is defined as an immediate and heavy financial need due to education costs, medical expenses, or purchase of a principal residence.
- Most 401(k) plans allow the participant to borrow up to 50 percent of their vested interest, but not more than $50,000.
- When an employee leaves a company, he/she may leave the 401(k) funds with the employer, take the funds as a lump sum, or roll the funds into an IRA.
- No employer-sponsored pension plan is entirely within the control of the employee.
- If the investment provision meets Department of Labor rules, the employer has no fiduciary responsibility for any investment directed by the participant.
- With the employer-directed plan, the company decides the investments and the proportions of contributions to each investment. The employee only chooses the employee whether or not to join the plan.
- If a company has heavily invested 401(k) funds in stocks and the market falls, the value of the 401(k) will fall as well.
- The administrator of the 401(k) plan in a company is the person or committee who runs the plan.
- With a money purchase pension plan, total contributions will vary from year to year because of the fluctuation of earnings.
- Defined benefit pension plans do not adjust future benefits for inflation.
- All contributions made to the SEP are deducted from an employee’s gross income.
- The Keogh plan can be thought of as a retirement plan for the self-employed.
- Contributions to a Keogh plan are fully tax deductible and there is no tax on earnings until a participant withdraws the funds.
- In the event a participant in a Keogh plan has any employees, the employees must be included in the plan and contributions must be made in the same percentage of income as that of the plan sponsor.
- Contributions to the employees’ accounts are tax deductible as business expenses.
- Keogh contributions can be invested anywhere and all income on the investment is tax-free as long as it remains invested.
- Investors may not continue contributing to an IRA after age 70½.
- An ESOP must invest primarily in the stock of the company which sponsors it.

CHAPTER 4: OTHER RETIREMENT INCOME

Planning for retirement must take into account not only those sources of income, which may be derived from employer-sponsored programs but also from other sources. Some investment vehicles also provided a method of deferring payment of income taxes until funds are actually distributed to a participant. A discussion of some of the more common sources of additional retirement income follows.

Annuities

A variable annuity, a type of investment sold mostly by life insurance companies, is a convenient way to combine the features of a mutual fund with life insurance and tax-sheltered retirement funds.

If the purchaser of an annuity dies before taking out any money, the funds which they have invested are paid to any heirs. This is true for all plans except the straight or pure life annuity. The money stays with the insurance company. There is no limitation on the amount of money which can be invested in an annuity.

Funds in a variable annuity account can be invested in one or more mutual funds. Perhaps the most attractive aspect of a variable annuity is the tax-deferral feature. Funds in a variable annuity are not taxed until withdrawal. Also, an investor can switch back and forth from one mutual fund to another without incurring any tax liability.

There are penalties for early withdrawal of annuity funds. Regular income taxes plus a 10 percent penalty must be paid on all withdrawals made before the person is 59½ years old. Generally, there is an annual contract maintenance fee and a management fee ranging from 0.3 percent to 2.5 percent of the annual investment. Additionally, there may be a fee of 1.25 percent per year to cover mortality and expense risk.

Traditional Investment Portfolios

Once an individual has prepared for their retirement using the more traditional and conservative investment vehicles, they may consider assembling a portfolio of equity and debt securities if sufficient discretionary funds remain. A mutual fund should be the first consideration.

The History of Mutual Funds

Mutual funds are, in some ways, similar to insurance. With insurance, a group of people contribute to a pool of funds to protect themselves against financial disaster. If one of them suffers a calamity (such as premature death, disability, disease, or loss of a major asset), that unfortunate one will receive some of the money contributed by the others.

With mutual funds, a group of people band together to make a greater profit than they might individually. Because their collective investment is so large, they are able to invest in a wide variety of investments, thereby reducing overall risk.

The person attributed with first creating the group (or trust) investment concept was King William of the Netherlands in 1822. His ideas were so well received that it wasn't long before people in Belgium, Great Britain and Scotland were putting their monies into investment trusts.

By the mid-1920s, professionally managed investment trusts began popping up in America. The first open-end U.S. trust was the Massachusetts Investors Trust (MIT), founded on March 21, 1924. At that time, its net assets, $50,000, were fully invested in 45 stocks, including 50 shares of General Motors.

At the end of its first year, the fund had more than 200 shareholders. Today that fund is one of the largest stock funds with more than $1 billion in assets and 85,000 shareholders.

Since its American inception in 1924, mutual funds have grown to be the third largest financial industry in the country (after commercial banks and insurance companies).

Basic Terminology

Mutual Fund Families

All funds of the mutual fund family are organized under a general umbrella name, and each individual fund falls under that umbrella. In many ways, it is analogous to a real family; the umbrella name is the general name of the family, and all the family members, while they share the same general name, all have different specific names and distinctive characteristics.

Mutual Funds and Their Management

A mutual fund (a term often used interchangeably with investment company) is a corporation, trust or partnership that makes investments on behalf of individuals and institutions who share common financial goals and objectives.

Investment companies hire investment advisers to buy an assortment of stocks, bonds, money-market instruments, or other securities that — in their judgment — will help the fund and its investors meet their investment objectives.

Similarly, a portfolio manager is an individual or team of individuals employed by a mutual fund to manage all the securities within the fund's portfolio. The idea behind a portfolio is to assemble a varied collection of securities, reducing the risk inherent in any investing practices.

A Mutual Fund's Prospectus

A prospectus, an official booklet required by the Securities and Exchange Commission (SEC) and given to all investors by a mutual fund, must be in the possession of an investor before they can purchase fund shares. Essentially, it tells investors all the necessary facts surrounding the securities they are interested in buying. It contains information such as:

- The exact objective of that mutual fund.
- The kinds of investments the fund plans to make to meet its objectives.
- The fund's fees, expenses, and services.
- How to open an account (the bookkeeping relationship established between a mutual fund and its investor) with that fund.
- The investor's rights and privileges as an investor into that fund.

After an investor reads the prospectus and establishes an account, they may receive a certificate — a printed record showing ownership of mutual fund shares, similar to a stock certificate. However, because of computerized account record keeping, certificates are seldom issued unless the shares are going to be pledged for a loan or margin account.

Determining Net Asset Value and Performance The bottom line of a mutual fund from a per share point of view is called the Net Asset Value (NAV). This value is the market worth of a mutual fund's total assets, minus its liabilities, divided by the total number of outstanding shares in the fund. *For example, if a fund's assets are $10 million, and there are 500,000 shares held by investors, the NAV is $20.*

With no-load funds (funds for which an investor is not assessed a sales charge), an investor pays the NAV when they buy shares. If they invest $1,000 in a typical no-load stock fund with an NAV of $15, they will own 66.67 shares ($1,000 divided by $15).

With load funds, the sales commission determines how many shares the investor ends up with.

For instance, if the investor wants to invest $1,000 and the load is 8.5 percent, $85 of the investment goes for sales commissions. If the NAV is $15, the offering price would be $16.393 ($15 divided by 91.5 percent - 100 percent less 8.5 percent, the commission fee). The investor would own 61 shares ($1,000 divided by 16.393). Another way to figure it would be to divide $915 ($1,000 less the $85 commission fee) by $15 to get 61.

The NAV fluctuates from day to day depending on how the securities the fund owns performed on the previous day. It also changes because of withdrawals to pay fund expenses, and periodically because of distributions when the fund passes along capital gains, dividends, and interest to its shareholders.

The total performance, usually stated as a percentage increase or decrease of the NAV, takes into consideration all income dividends, capital gains distribution and the unrealized capital gains of securities still held by the fund.

Capital Gains and Dividends

Simply put, capital gains are earned when investors sell shares in the fund for more than they paid for them. Net realized capital gains are the profits from assets that grew in value before being sold, minus losses from assets that declined in value before being sold. (Realized means that the securities were sold, but investors do not owe capital gains taxes on securities that have not been sold even if their value has grown.)

Sometimes, in exceedingly rare instances, a fund pays taxes on its gains even before selling the securities. This is called undistributed capital gains because investors must pay taxes on the gains the fund dispersed to them even though they did not collect them.

In capital gains distribution, shareholders receive their payments of capital gains, which are usually paid out annually near the end of the calendar year. For tax purposes, these are kept separate from income dividends.

Dividends distribution is the distribution of dividends (a share of earnings paid to a shareholder by a corporation) and interest from investments to the mutual fund shareholders. The distribution methods are the same as with capital gains distributions.

The ex-dividend date is the date on which declared distributions are deducted from the fund's assets. On that day, the share price drops, but since each shareholder receives more shares, the amount in the shareholder's account remains the same until the price per share changes.

The Ask and Bid Price

The ask, or offering price, is the price at which a mutual fund's shares can be purchased. It consists only of the NAV for no-load funds, or funds with no sales charge. For funds with sales charges (load funds), it is the NAV plus the sales charge (load), if any.

On the other hand, the bid price (or the redemption price) is the price at which a mutual fund will buy back its shares, which is the NAV.

A fund's cash position refers to its present cash assets; that is, the money available to pay off investors who decide to redeem or sell their fund shares. If the redemptions of a fund are greater than the cash monies the fund has, some of the securities in that fund's portfolio would be sold to cover those redemptions.

Mutual Funds Services and Fees

It is particularly important for investors to read the fund's prospectus for many reasons, but perhaps two of the most important are to determine the fund's services and fees. This way, the investor may compare funds using this information and can choose that fund which will give the best return and service less expenses for their investment dollar.

Mutual Fund Services

Probably one reason why mutual funds are the choice of many investors is the wide variety of services, many of which are free, that these funds offer.

24-Hour Information Numbers

Through voice-response and touch-telephone phones, investors can get answers to their questions about account balances, yields and other information on a 24-hour basis.

Automatic Reinvestment

When investors open their accounts, they can elect to have their dividends and capital gains distributions automatically reinvested. In fact, 80 percent of all mutual fund investors opt to do this. Fractional shares are purchased when the amount of the dividend does not equal a whole number of shares. If investors do not need the income, the compounding of automatic reinvestment enables the investment to grow maximally.

Automatic Withdrawal

With certain funds, especially income funds, investors can arrange to have checks sent to them monthly or quarterly. Such payments may be from their dividends, or they may be made up of dividends and principal.

Check Writing

Many funds, particularly money-market funds, offer this service at no fee or a low per-check service charge. Minimums usually apply, like $250 or $500, so such a service realistically cannot replace a checking account. There may also be a monthly limit on the number of checks that one may write.

If investors invest in a family of funds and can write checks only on a money-market account, they may want to request telephone switching so that they can switch money needed for checking out of other funds and into that account. A statement will be sent to them confirming all checks, and sometimes the cancelled checks will be returned.

On-Line Computer Services

This is a new service offered by some funds. Information about their funds (portfolio holdings or net asset value, for example) and information on their own accounts is available on personal computers through a modem. Limited account transactions, like switching funds, are also possible.

Payroll Deduction Plan

Payroll deduction plans can be arranged for regular contributions to most funds. Many investors take advantage of payroll deduction because then they do not have to pay income taxes on that money; their investment is deducted from gross pay before federal or state income taxes are levied.

Protection against Fraud

There is no doubt that some of the services offered by mutual funds offer easy access to accounts. The SEC has begun to investigate the management of these services, and particularly access to accounts by telephone. Some funds protect themselves by taping all calls. Some ask callers to give an identifying piece of information such as their mother's birth name.

Redemption of Shares

This is not usually thought of as a service of mutual funds, but in fact mutual funds make it easy for investors to withdraw their money. It is the law that funds must redeem all shares presented by shareholders on the day the redemptions is requested (by 3:30 p.m., usually), whether by telephone, wire, or check.

Retirement Accounts

Investors may purchase mutual funds in their Individual Retirement Account (IRA), their self-employed account (Keogh), or their salary reduction plan (401(k) plans).

Telephone Exchanges

This service allows investors to switch all or a part of their investment among the funds within a particular family of funds. For example, an investor could switch their funds from a stock fund to a bond fund. Investors will need to request this service on their application. Several exchanges a year may be permitted without payment of a fee. A statement will always be sent to confirm telephone transactions.

Wire Transfers

This service is an efficient way to transfer money both in and out of mutual funds. A wire transfer always results in a purchase or redemption of shares, but the money can only be wired to a bank. This service must be requested on the investor's application and will require a statement of the bank account number into which the investor will be wiring money. A wire transfer may be requested by telephone or mail.

Mutual Fund Fees

Although a mutual fund offers many free services for the convenience of the investor, it must also make money to meet its own operating costs. As with any business, a mutual fund has overhead, salaries and the usual operating costs.

It must earn money to meet its obligations, to pay its investment advisors, and to expand and upgrade its facilities.

All funds charge these expenses against revenues; that is, they are deducted from the dividends and capital gains earned by the portfolio before any income dividends or capital gains distributions are made to the shareholders. In this way, all shareholders pay equally for the operation of the fund.

A fund's expenses will vary from year to year, but in general, they should not exceed 1.5 percent of the average NAV for a stock fund and 1 percent for an income or bond fund. There are a few exceptions, such as global funds whose costs, because of foreign operations, can climb as high as 2 percent.

Loads

Depending on how they are classified, mutual funds have different investment objectives and come with or without a sales charge. Mutual funds that have sales charges are called load funds while those without sales charges are called no-load funds.

To determine whether a fund is load or no-load, investors may find this information in the newspaper listings. All funds have an NAV, but in the column where load funds show their higher offering price, no-loads will carry the initials N.L. If a fund's NAV and its offering price are the same, the fund has other charges instead of a front-end load (discussed below), such as a deferred sales charge or a redemption fee.

Load Funds

Some mutual funds engage the services of stockbrokers, financial planners, insurance agents, or others to recommend their shares to potential clients. Individuals selling load funds are paid a fee for their services because they are there to advise and to help investors select funds that meet their investing objectives, to answer any questions that investors may have, to introduce investors to the fund's services and to troubleshoot for investors should they have any problems in understanding how the fund is or is not working for them.

The majority of a fund's sales charge gets paid to the person selling the fund shares (their commission for making the sale). The remainder goes to the company for which that salesperson is working. Usually brokers with major brokerage houses have several families of funds on which they receive commissions. The advantage of using these agents is that they can help an investor analyze their financial needs, called an objective, and can recommend an appropriate course.

A load is expressed as a percentage of the total investment. The maximum that can be charged according to the SEC is 8.5 percent, and those that charge from 6 to 8.5 percent are called "full-load funds." Those funds calling themselves "medium-load" charge about 3 to 6 percent, and those that charge 1 to 3 percent are called "low-load funds."

Usually, the load charge is made at the time of purchase and is called a front-end load. The offering price of a mutual fund represents that fund's per-share price plus its sales charge.

A back-end load is a load charged when the shares are redeemed instead of when they are bought, not to be confused with a contingent sales charge. While the contingent sales charge diminishes over time and may go away altogether, the back-end load is a commission that will always be charged when shares are redeemed. It is rare today, as most funds prefer the contingent sales charge.

Over time, a full 8.5 percent sales charge can cost quite a bit of money. If an investor places $10,000 into a fund with an 8.5 percent load and the fund gains 10 percent every year, they will wind up with $23,732.74 after ten years. If they had invested in a similar no-load fund, they would have earned $25,937.42 after ten years, which is $2,204 more. That is a difference of more than 9 percent, not 8.5 percent.

This is not to say that load funds are bad; rather, they offer several advantages. Because load funds tend to have more assets (brokers must sell them to earn their living, after all), they also tend to have lower overall expenses because the expenses are better absorbed. Plus, if an investor is lucky, the broker they just paid will give them some valuable advice, and they will more than likely achieve their investment objectives.

No-Load Funds

The reason that no-load funds exist is that some mutual funds sell their products directly to the public without the aid of field service representatives. Some no-load fund families are also referred to as direct dealers of funds.

These funds essentially wait for the public to call them. The phone staff are not brokers, although they must be registered to sell mutual fund shares. Such funds do not have a sales load charge to pass on to investors. When money is put into one of these funds, all of it is invested — none of it is deducted. The fund makes as much money as it can, pays its expenses (which usually run under 1.5 percent), and passes the rest on to its shareholders. Those costs that a no-load fund incurs — such as maintaining a telephone staff and advertising — are charged to expenses.

12b-1 Fees

Those funds that do not charge an initial sales commission, or load, may instead levy an annual fee of up to 1 1/4 percent. This fee is called a 12b-1 fee because that is the number of the SEC rule that permits this charge.

A 12b-1 fee is a fee charged by some funds to its shareholders to cover that fund's distribution costs such as advertising, sales literature, annual reports, prospectuses, and compensation for brokers selling shares.

Contingent Deferred Sales Charge

This is a charge levied if shares are sold within a specified time period following their purchase. It is stated as a percentage of the original purchase price or as a percentage of the redemption price. Usually, the amount decreases the longer the investment remains with the fund and may disappear altogether after several (usually five) years.

Reinvestment Fees

Very few funds currently make this charge. It is simply a commission, generally small, charged every time an investor's dividends are reinvested.

Categorizing Mutual Funds

Mutual funds can be organized as corporations, trusts, Unit Investment Trusts (UITs), or partnerships. After they are organized, they break down into two distinctive groups, open-end funds, and closed-end funds.

Open-End Funds

Open-end mutual funds do not rely upon matching up buyers and sellers to their fund shares before a trade can be made; hence, they are called open-end. There exists no set number of shares, which may be bought, traded or sold.

Open-end investment companies are obliged by law to issue new shares and to redeem existing shares of the fund on any business day of the year. The per-share price of an open-end fund is not controlled by supply and demand throughout the day as are stocks that trade on the stock market.

Instead, open-end mutual fund shares are fixed at one price all day, each day. This price is based on the actual value at the time of the market's closing on the previous afternoon.

The pricing of shares of an open-end mutual fund depends on two things — the market price of the securities that are in the fund's portfolio and the number of shareholders of that fund. The balance between the number of shares in the fund and the total market value of the securities in the fund, less the expenses of the fund, creates a pricing arrangement for a fund. Therefore, the value of the per-share price depends upon the securities within the fund's portfolio, how they are performing in the marketplace and the number of outstanding shares in the fund.

Closed-End Funds

While both closed-end and open-end investment companies have various investment objectives and pool the money they receive from the investors to buy a variety of securities, the primary difference between the two is that closed-end funds issue a fixed number of shares, whereas open-ended funds do not.

With closed-end funds, which comprise approximately 15 percent of the total mutual funds in the marketplace, only so many shares of that fund are issued. Those shares can be bought only through a broker (unlike some open-end funds which are not) and are traded on the major exchanges.

Since only a fixed number of shares are issued in a closed-end fund, the price of that fund is calculated differently than the price of an open-end fund. Because of the differences in calculations, the per-share price of a closed-end fund may be more (called trading at a premium) or less (called trading at a discount) than the actual value — or NAV of each share — of the total amount the securities add up to. When a closed-end fund's NAV is the same as the price at which each share is selling, the fund is said to be trading at par.

Mutual Funds as Investments

Advantages of Mutual Funds

As stated earlier, many people choose to invest in mutual funds because of the services which accompany the establishment of a mutual fund account. Another advantage is that mutual funds are a diversified investment, meaning that an investor's risk is not concentrated into one company.

Rather, the risk is spread over many different securities within a fund's portfolio. Also, these funds are managed professionally, offer a wide variety of investment objectives and provide a wide selection of funds to choose from.

Because professional advisers manage these funds, investors may discuss their investment objectives with the adviser, who will then offer professional advice and can steer the investor in the appropriate direction for achieving those objectives. Since investors have diverse needs, a mutual fund will offer many funds in order to meet the investors' objectives.

Furthermore, mutual funds allow investors to assemble a very sophisticated portfolio of investments for themselves at a very affordable cost. Because so many investors are contributing to the fund, each investor is able to purchase more for their money and are able to gain access to funds that they may not be able to afford if attempting to invest their money on their own.

Additionally, the investments are liquid, meaning that investors may purchase and redeem shares of their fund on any business day throughout the year. In fact, mutual funds are required by law to follow an investor's direction as soon as the investor issues their wishes over the telephone or in written form.

Finally, mutual funds are part of a highly regulated industry, one that must follow a strict set of SEC-mandated rules and guidelines controlling their reporting, and advertising and sales tactics. This ensures that mutual fund companies are dealing with their investors in a professional and ethical manner. While federal regulations and those set forth by the SEC are quite stringent, some states have even more strict laws, further ensuring that mutual funds conform to regulations.

Disadvantages of Mutual Funds

Mutual fund investments, other than money-market mutual funds, are, for the most part, considered long-term investments (more than one year), not short-term investments (less than one year). Unfortunately, what long-term means to one person is not what it means to another. In fact, most investors consider a long-term mutual fund to be at least a five-year (if not longer) investment.

Also, the value of the principal investment will change as the prices of the securities within the fund fluctuate because of changes in the marketplace. Furthermore, there are no performance guarantees for mutual fund investors; a fund's past performance is no guarantee of its future performance.

Choosing from the more than 3,400 available funds and finding the best performing funds in various categories can be difficult, especially as more newspapers, magazines and newsletters start reporting performance figures. Also, as investors begin redeeming shares of their funds or making changes within their accounts, the paperwork can be annoying and time-consuming. Tax time is equally exasperating when investors must deal with mutual fund investments that are not in tax-deferred accounts.

Risk

Generally, the greater the risk, the greater the potential reward. Conversely, the less risk, the smaller the reward. An investor must assess how much risk they are willing to take before they invest in any investment plan.

When creating a portfolio, risk must be considered. Because of this, if an entire family was to invest in mutual funds and establish separate portfolios, it is very possible that each portfolio would look quite different.

The composition of a portfolio, however, should not depend only on the investor's age. "Risk tolerance" must also be considered. The person who doesn't panic and sell stock holdings when the market has plunged is more risk-tolerant than one who calls their broker immediately and demands that the shares be sold.

The Time Factor

How much risk an investor should take depends on several factors. The more time an investor has to invest, the more risks they can afford to take with their money. That is because over time, the ups and downs of the financial markets smooth out. Historically, the stock market has risen steadily, no matter how often it may have experienced Fixed setbacks.

Younger investors can afford to take more risks with their investments as a result. By contrast, older investors cannot afford to put too much principal at risk because they do not have the time to make up for any losses before they need to withdraw the money.

If an investor plans to sell their shares within three years, they should stay with the lower-risk funds. But if they plan to hold the shares for ten years or more, they can take the chance on high-risk funds because, as stated before, time averages out the market's highs and lows.

The Income Factor

Another consideration is how much income the investor will require from their investments. If they need investment income to cover living expenses, they will need to stay with lower-risk, lower-yielding investments, which typically produce more income than their riskier counterparts. For example, they might avoid most types of stock funds, which usually aim to increase the value of shares and do not pay much attention to dividends. Bond funds, which are usually much less risky, would be a better choice because they concentrate mostly on producing dividend income for their shareholders.

The Rate of Inflation Factor

Protecting the investment against inflation is also critical. The longer the amount of time that an investor invests, the greater the chances that inflation will diminish the value of the investment. Thus, inflation risk is a particular worry for younger investors. To evaluate inflation risk, an investor must understand the concept of "real return," the annual return on an investment less the rate of inflation for that year.

For example, if an investor puts $10,000 into a certificate of deposit (CD) that yields 5 percent and the rate of inflation is 3 percent, the real return is 2 percent — the difference between the 5 percent yield and the 3 percent inflation rate.

However, if the inflation jumps up to 7 percent — an investor would lose money by investing in a CD. Their yield of 5 percent less the 7 percent of the inflation rate would yield a real return of minus 2 percent, meaning that the money would buy less at the end of the year than it would have at the beginning of the year.

Returns on Mutual Fund Investments Yield

Yield is the fund's dividend payout as a percentage of its assets. It does not include capital gains distribution. This figure will be high in bond funds and relatively low for equity, or stock, funds. Growth funds and the like often have no yield at all since the funds invest in corporations that reinvest their profits for expansion rather than pay them out as dividends.

Total Return

Total return is the fund's appreciation, including reinvestment of dividends and capital gains. Figuring out the total return is not difficult. Suppose that a fund's NAV at the beginning of the share was $7 per share and that on the last day of the year it was $8.53; also, during the year the fund paid dividends and capital gains distributions amounting to $1.14 per share.

Here's how to figure the fund's return. Start with the final NAV, $8.53. Add in the distributions of $1.14. That brings the total to $9.67. Next, subtract the initial NAV, $7 per share. That amounts to $2.67, which is the fund's "profit" for the year. Next, divide the $2.67 profit by the starting NAV ($7), which comes to 0.381. To turn that into a percentage, just multiply by 100. The total return is 38.1 percent.

What we have just figured is how well the portfolio manager performed by excluding any load or sales charge as part of the formula. Here is how to calculate an investor's return:

Suppose an investor invested $2,000 in a mutual fund and reinvested the dividends and capital gains distributions of $325. At the end of the year, consider that their account is worth $2,415. To figure their return, take the value of their shares at the end of the period — $2,415. If the fund has a back-end load or redemption fee that applies to them and they are considering selling the account, subtract that from the current value.

Next, subtract their initial investment. If they paid a load, that is already figured into the initial investment. If they reinvest dividends and capital gains, there is no need to add them back because they are counted in the current value of their shares.

However, if they do not reinvest them and take distributions in cash, they must add them back to the current value. Then, they take the difference, $415, and divide that by the initial investment, $2,000. That yields approximately .208, so they would multiply that by 100 to come up with approximately 20.8 percent.

Sometimes, the total return will be less than the payout. That means that the NAV declined during the prior year. A few years ago, this phenomenon was most evident with junk bond funds; in 1992, total returns for many international bond funds were less than the yield. If a bond fund is paying out a yield higher than its total return, the fund's income distributions may be a return of the investor's principal. Such payouts, also known as return of the capital, are tax-free. In effect, the investor is getting their own money back because the fund could not earn a real return on it.

Tax Considerations

There is a special set of rules that governs how the mutual fund must be run in order to keep its special tax status. Most mutual funds are also corporations, and shareholders of corporations, in effect, pay tax twice.

The corporation pays taxes on its earnings, and if any of the earnings are paid to shareholders as dividends, the earnings are taxed again as part of shareholders' income. Mutual funds, however, escape this double taxation. The fund is treated as a conduit, meaning that all the income and responsibility for paying the tax on the income passes through the fund to its shareholders.

Therefore, the IRS views mutual funds as an intermediary between investors and the corporations whose securities the fund holds. The fund itself incurs no taxes because it makes no profit. All its cash revenues are distributed to its shareholders after the deductions of expenses (management and brokerage fees, marketing costs and overhead).

Also, in the eyes of the IRS, mutual funds do not pay dividends because they only pass along cash revenues earned from their portfolios.

Mutual Funds and Their Tax Status

To keep their special tax status, mutual funds have to live within vigorous rules. For example, there are rules about diversification. A fund cannot hold more than 10 percent of the outstanding voting stock in a particular company. Mutual funds must also distribute at least 90 percent of their taxable income — dividends and short-term net gains. Even tax-exempt funds must distribute 90 percent of their tax-exempt income.

There is also what is known as the "short-short" rule, which states that no more than 30 percent of the funds' gross income can come from securities held for less than 90 days.

Taxes and Distributions

Although fund directors can vote to make the distributions at any time, tax considerations can result in distributions piling up at the end of the year. Some funds have a policy of making quarterly income distributions, and some may make capital gains distributions at least once during the year. But if a fund has any income or gains to distribute, investors can count on most funds making payouts in December.

Sometimes the distribution may even be declared on December 31 and not paid until January. However, that does not relieve shareholders from paying taxes on it for the year that ended in December.

Mutual funds have been living under yet another set of requirements since the 1986 tax act. Prior to that, funds could take profits in December and make distributions in January. That way, the tax on the distribution would not be due for another 15 months (April 15 of the following year).

To stop this tax deferral, funds must distribute 98 percent of their income and dividends and do it in the calendar year in which they are earned. In addition, the funds must distribute 98 percent of their net realized capital gains, both long- and short-term capital gains. If the funds fail to meet those distribution tests, they can be hit with a 4 percent excise tax on the distributed income.

How much a fund distributes in income and capital gains has direct bearing on its after-tax return (the total return less federal income taxes). Suppose two mutual funds have the same pretax total return. One made no income or capital gains distributions because it did not buy dividend-bearing stocks and tended to hold rather than trade the stocks in the portfolio.

The second fund had the same total return, but about half of it came in the form of distributions. The one that made no distribution would have a higher after-tax return. Of course, if the fund is held in an IRA or other tax-deferred plan, the distributions do not matter. But if the account is taxable, a fund's history and policy of making distributions is a real concern in deciding whether to invest in a particular fund.

When looking at the distributions, investors must remember that not all funds are taxed equally. Distributions of dividends, interest income and short-term capital gains are taxed at the same rate at which the shareholder's earned income is taxed, which can be as high as 39.6 percent. Long-term capital gains - - they are long-term if they were generated by investments held for more than a year — get more favorable tax treatment; the maximum rate is 28 percent no matter how high the shareholder's regular tax rate is.

Redeeming or Exchanging Shares and the IRS

When investors redeem or exchange mutual fund shares, they incur tax liabilities. Even when investors switch funds within the same family of funds, the IRS classifies that as the sale of one fund and the purchase of another. The amount of gain or loss is the difference between the amount realized from the sale, redemption, or exchange and what the investor claims as the cost of the shares.

If an investor sells any shares in a fund, the fund company also has to report the proceeds of the sale to the IRS, which means that the investor will have to account for the transaction as well. Investors, though, usually do not forget since the fund will remind them by sending a 1099-B. Like the 1099-DIV, which summarizes an investor's mutual fund activities for tax purposes, the investor gets one copy, and the IRS gets the other.

There may be taxes due, or the investor may actually have a loss that can be applied as a deduction against them. Without good records, the investor could end up paying too little in taxes and get caught or paying more tax than necessary.

It was stated earlier that share purchases before or after dividend distributions have no consequences as far as total return, but they can have tax consequences. Investors should plan any major share purchases after an ex-dividend date. Otherwise, investors could be taxed on the return of their money. Even if the money is immediately reinvested, for IRS purposes, that money is a dividend or capital gain, as the 1099-DIV will designate.

Types of Mutual Funds

Stock Mutual Funds

There are two types of stock — common and preferred – to which investors may contribute. Common stock entitles investors to a vote on a variety of corporate decisions by exercising proxies sent to investors by the company.

Preferred stock, by contrast, is generally not voting stock. However, the preferred shareholders get priority when dividends are distributed. When the board of directors decides to issue dividends, payments are made first to bondholders, then to preferred stock owners and finally to common stock shareholders.

Common Stocks

Common stocks are units of ownership in a corporation. Because they constitute ownership, stocks are referred to as equity instruments. Stockholders share in the fortune of their corporations in two ways: capital gains and dividends.

Shareholders of a mutual fund are not considered equity owners of the corporations in which the fund holds stock. The fund is considered the owner, and the fund may vote its shares as it chooses. While individuals seldom hold enough shares in a corporation to make a real difference in corporate votes, mutual funds may own thousands of shares, thereby having a substantial voice on shareholder issues.

Aggressive Growth Stock Funds

The goal of aggressive growth stock funds is capital appreciation, not income. The share prices can fluctuate wildly, and periods of superior returns can be followed by serious slumps. These funds are best suited to investors who have the time and patience to wait for the big payoff.

Most of the aggressive growth funds try to create big returns by investing mainly in stocks of smaller, lesser-known companies and often buy shares in initial public offerings. Such companies are usually growing quickly and trade at high price-to-earnings ratios — prices that are high relative to their earnings. Some have no earnings at all because they spend heavily on research and development costs.

Also, the current income of the company is not a significant factor. Some may invest in stocks of businesses that are somewhat out of the mainstream, such as fledgling companies, new industries, companies fallen on challenging times or industries temporarily out of favor. The risk inherent is obviously much higher than for growth funds.

The companies these funds own shares in do not usually pay dividends, so shareholders of these funds should not expect regular income. However, if the fund manager is successful, there will be a capital gains distribution, usually once a year.

In recent years, the scope of maximum growth funds has widened. Aggressive investing no longer means just buying stocks in fast-growing companies, but also making big bets in concentrating the portfolio in a few industries or by using various forms of investing such as leverage, short selling, and buying warrants and options to increase profit.

Equity Income Stock Funds

This combination of stock and bond funds has a primary goal of income and a secondary goal of growth. These may be a desirable choice for those who need some investment income, but investors should be reminded that with a high payout comes higher taxes.

These perform well when the prime rate is dropping because both stocks and bonds are appreciating plus earning interest and dividends. They are poor performers when the prime rate is going up because any stock gains are automatically wiped out by bond losses.

Growth Funds

Growth mutual funds, an avenue for long-term investors, invest primarily in the common stocks of well-established companies whose earnings are expected to outpace the average. The theory behind growth stock investing is that, over time, the earnings that a company generates will raise its stock price because investors are willing to pay more for a stock that creates consistently good earnings.

Since growth funds aim for capital appreciation, they generally pay small, if any, dividends because investors who buy a growth fund are more interested in seeing the fund's share price rise than in receiving income from dividends.

Growth and Income Stock Funds

A stock fund that attempts to give the investors capital growth and income at the same time is called a growth and income stock fund. These portfolios often emphasize blue chips, companies that consistently maintain good earnings. These funds invest in stocks when they are lower in price, making the yield higher. Dividend yield is the amount of dividends paid per share divided by the price of one share. The lower the price, the higher the yield.

Because of the income component, the growth and income funds are far less risky than growth or aggressive growth funds. They are normally a desirable choice for people who want to take less risk with their investment principal and for those who want to participate in the stock market but who need a certain amount of investment income.

Preferred Stock Mutual Funds

Specialty stock mutual funds buy stocks using a special selection process, leverage or other type of investment formula not used by the regular stock funds and are generally only for more knowledgeable and speculative investors.

Balanced Funds

These mutual funds invest in a combination of common stocks, bonds, and preferred stocks, usually (but not always) in a fixed ratio of 60 percent stocks and 40 percent bonds. These generally have a three-part investment objective: to conserve the investors' initial principal, to pay current income (dividends) and to promote long-term growth of both the principal and income. With these funds, investors get stocks for growth and bonds for income.

Balanced funds are based on the principle that stock prices and bond prices go in opposite directions. In a booming economy, for example, stock prices go up because of increasing corporate profitability. The boom creates increasing demand for credit, so interest rates rise and bond value drops. Then, in a recession, the opposite happens — stock prices fall and bonds rise.

Index Funds

A mutual fund that theoretically owns shares from all of the companies in an index such as the Standard and Poor's 500 is called an index fund. The growth, therefore, is the same as that of the index.

Index funds are mutual funds that are designed to replicate, rather than to beat, the performance of a market index. That's why they are low-cost; computers can manage them. Although some investors worry that accepting an index's return is the same as settling for an average, others argue that it is better than not beating the index.

Industry Funds

Funds that purchase stocks related to only one industry are called industry funds. Industry funds are for aggressive investors and should be used only during periods when the prime rate is dropping. Industries represented by industry funds include, but are not limited to: computer software, leisure, defense, restaurants, air transport, drugs, computers, and high tech. The narrower a sector fund's mission, the riskier it is, because when all of one industry goes sour, the entire fund will respond in kind.

Option Funds

This mutual fund buys stock options instead of stocks. An option is the right to buy or sell a specific number of shares of a stock at a fixed price by a specific date. Some option funds buy stocks and then attempt to hedge against a price drop by purchasing options to sell on the same stock. Current return generally consists of dividend premiums from writing options, net short-term gains from sales of portfolio securities on exercises of options or otherwise and any profits from closing purchase transactions.

Precious Metals Funds

Precious metals maintain two-thirds of their portfolios invested in securities associated with gold, silver, platinum, and other precious metals. Some investors see an investment in gold as a hedge against inflation, a safe haven in times of international upheaval or economic strife. Regardless of this, most diversified equity funds do not own any gold shares at all, so a precious metals fund helps an investor's portfolio offer additional diversification.

Bonds and Stocks

Unlike a share of common stock, which represents ownership of a corporation, a bond, sometimes called a fixed-income security, is a written promise by a company or a government (federal, state or local) to repay borrowed money by a specified time and at a specified interest, or "coupon" rate. Buying bonds makes investors the lenders and gives investors access to capital and diversity.

Bonds are a loan to the company for a set period of time. The interest is paid to the owner annually, and at the end of this period of time or when the bond matures, the principle is paid back.

The mechanism for pricing bonds is complex and completely different from stocks. It depends to a great extent on the bond's rating, the current interest rate (in conjunction with the coupon rate) and the security date. For this reason, as a debt instrument, bonds may be safer than stocks because interest payments take precedence over the payment of dividends. In case of dissolution, the bondholders have prior claims to the assets of the company.

Investor Objectives

There are so many diverse types of bond funds that there is bound to be something for everyone. Almost every type of bond has been packaged into mutual funds. Investors who are looking for safe, steady income can buy shares in U.S. government bond funds or high-grade corporate bond funds.

Investors in the top tax bracket who want tax-free income can buy municipal bond funds. Investors who are willing to take some risks with their money in exchange for potentially higher returns can buy "junk" bond funds. Investors may even find potential opportunities for investing in foreign bonds.

Rating Bonds

Rating companies rate bond issues according to the financial shape of the issuing company and its ability to make interest payments and return the interest at maturity. Bonds with a low rating must pay high rates of interest to attract buyers and are considered riskier investments. High-rated bonds pay less interest but are considered far more reliable investments.

AAA- to A-rated bonds are the highest quality bonds, indicating a strong to extremely strong capacity on the part of the issuer to pay interest and principal. BBB bonds are considered medium quality, with the issuer having adequate capacity to pay obligations on the bonds. Institutional investors generally will not invest for their own portfolio in anything of a lesser grade. The remainder of the ratings is as follows:

- BB - speculative.
- B - low grade.

- CCC - poor, risky.
- CC - highly speculative.
- C - lowest grade. Usually there is no interest being paid.
- D - issuer in default.

Mutual funds, which invest in bonds, state in their prospectuses the investment grade bonds in which they invest. Those funds, which buy bonds with higher yields, assume a much higher risk. In general, bond funds that are the safest pay the lowest interest rates.

Bonds and Risk

When investors choose a bond fund, their first task is to evaluate how much risk they are willing to take. Bond risk comes in two forms: credit risk and market risk.

Credit risk is the risk that the issuer of the bond will not make regular interest payments or be able to repay principal when the bond matures (the date the borrower agrees to repay the loan). Market risk is the risk that rising interest rates will push down the price of a bond. The shorter the term of the bond, the smaller the market risk, because the chances that interest rates will rise while investors hold the bond are limited.

Types of Bonds

As with stocks, investors should carefully analyze their investment objectives; the wide variety of bonds available will fit the needs of virtually any investor.

Corporate Bond Funds

As the name implies, corporate bonds are an investor's loan of money to a corporation. Bonds do not represent ownership in the company although bondholders normally have priority over stockholders in dividend distribution.

The goal of high-quality corporate bond funds is to provide investors with regular dividend income without unduly risking the principal value of their shares. Compared to stock funds, corporate bond funds offer more income and less volatility in share price. However, bonds are not as good a hedge against inflation as stocks are.

That means that while investors receive a steady income from the fund, the dividends they receive will buy less if prices for goods and services rise. This is why it is important for investors to keep at least a small part of their portfolio in stock funds.

Convertible Securities Bond Funds

For investors who waffle between purchasing bonds and stock, one solution may be convertible securities funds. Convertibles are hybrids that pay a certain amount of income each year but can be converted into shares of stock up to a specified date at a fixed rate.

Traditionally, convertibles have been within the domain of smaller companies because the value built into the conversion feature lets the issuers, who are usually less financially stable than more established companies, pay less interest on the debt than they would have to otherwise. In other words, investors are getting more than they would have if they purchased a regular bond — that is, a chance to participate in company profits because of their stock ownership. So they are willing to accept a smaller yield.

For investors, convertibles offer a big plus over stocks. Because of their high yields, convertibles offer some protection on the down side; at worst, they trade like bonds of comparable quality, maturity, and coupon rate. This means that prices of these hybrid securities can drop only so far while stock prices drop to zero.

Treasury Bills, Bonds and Notes Funds

Treasury bills, treasury bonds, and treasury notes, collectively known as the "treasuries," constitute a loan of money to the government. As a result, treasuries are virtually risk-free because the federal government is considered to be a solid risk.

Treasury bills (T-bills), which mature in three, six or twelve months, are sold in lots of $10,000. They are sold for less than face value. Instead of paying interest, the government buys them back at full value when they mature. The profit equals the difference between what the investor paid and the face value of the bill at maturity.

Treasury bonds and notes are sold for as little as $1,000, but investors tie up the money for longer periods of time than with T-bills.

Notes mature in one to ten years; bonds run longer, usually 30 years. Notes and bonds are not sold at discount, as are T-bills. Instead, investors receive semi-annual interest payments. The interest rates paid on treasuries are set by supply and demand. As you would expect with treasuries, what investor's gain in safety, they give up in income. Yields of government bonds are lower than the yields of comparable corporation securities.

While the credit risk is virtually nonexistent, government bond funds are subject to market risk. When interest rates rise, the value of the government bond will fall, taking the price of the fund shares with it. When sponsors of government funds tell investors that their investment is guaranteed by the U.S. government, they mean that the government guarantees payment of interest and principal when the bond matures. What they don't tell investors sometimes is that they do not guarantee that the share price will not drop during times of rising interest rates.

Mortgage-Backed Bond Funds

A second type of government bond fund is the mortgage-backed fund. The chief appeal of mortgage-backed funds is high credit safety and high yields. To encourage investment in the housing market, three federal agencies buy mortgages from lenders, pool them and then resell shares in the pool to investors.

These three agencies are: the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Association (the "Freddie Mac"), and the Government National Mortgage Association (Ginnie Mae). The Fannie Mae and the Freddie Mac invest mainly in conventional mortgages while the Ginnie Mae buys Federal Housing Administration and Veterans Administration mortgages.

Federal agency debt is slightly riskier than regular government bonds because Congress must approve payments of principal in the event of default. While default is highly unlikely, government agency debt yields more — usually .5 to 1.5 percent more — than treasuries.

Because of the government guarantees, mortgage-backed funds are virtually as safe as regular U.S. government bond funds, although their share prices can slip because of "prepayment risk." When interest rates drop, many homeowners refinance their mortgages to get lower monthly payments. When this happens, some of the higher-rate mortgages in the funds are replaced with lower-rate ones, which reduces the funds' yields.

The prepayment risk also makes mortgage-backed funds tricky investments to analyze. Regular bond funds respond to changes in interest rates in predictable ways — in general, rising rates depress bond prices while falling rates push bond prices up. With mortgage-backed funds, the line is less clear. Because of their yield advantage, the funds usually do best during periods when interest rates are flat or rising gradually because their higher yield cushions some of the lost principal value.

Adjustable Rate Mortgage Bond Funds

The adjustable rate mortgage funds were developed as a lower-risk alternative to the Ginnie Mae funds. They offer higher yields than money-market funds, less volatility than long-term bond funds and the credit safety of securities backed by U.S. government agencies.

The adjustable rate mortgage funds invest in offerings from the same agencies as the Ginnie Mae funds but with a twist — the mortgages they buy are adjustable-rate, not fixed-rate. The advantage is this: Because the rates on adjustable-rate mortgages move up and down when market interest rates shift, the homeowners holding the mortgages have less incentive to refinance them.

That reduces the prepayment risk although it does not entirely eliminate it, and it acts as a cushion against sharp rate declines. Adjustable-rate mortgage funds also offer competitive yields as rates rise.

What is the trade-off for lowering some of the interest rate risk?

For one thing, monthly dividends fluctuate more than they would with a standard Ginnie Mae fund, potentially every month. They could pose problems for people who rely on regular checks to cover their living expenses. Another problem is that the fund yields will drop when interest rates fall. That is because the underlying mortgages will pay less over time as the borrowers' rates are adjusted downward.

Even when interest rates rise, the funds will lag because the rates on the underlying mortgages are adjusted periodically, not immediately. And when mortgages are prepaid, the money is often reinvested at a lower rate.

On the other hand, share prices of these funds are relatively stable, usually more so than the Ginnie Mae funds. Add that to the government guarantees built into these funds and they become a viable choice for investors who need some investment income but want to take insignificant risk with their principal value.

Municipal (Tax-Exempt) Bond Funds

Municipal bond funds, which are also known as tax-exempt bond funds, invest in the bond and note issues of states and municipalities. These bond issues are used to finance public projects and services and are backed by the taxing power of the issuer as well as by revenues from specific projects like toll roads.

Municipal bonds, usually sold in $100,000 lots, generally mature in 20 or 30 years. They are backed by the taxing power of the municipality that issued them.

There are also municipal notes, used for short-term borrowing to bridge shortfalls in revenue. They mature in six months to one year and are backed by the municipality's expectations of income from taxes or state or federal aid. Notes are generally sold in blocks of $5,000, although some issues sell for as little as $1,000.

When the municipal bond issuer is relatively weak and poses a credit risk, the yield it offers on its bonds is higher to compensate the buyer. The yield of the bond is also higher the longer the time before the issue matures.

The main reason municipal bonds are attractive, other than their appeal to civic pride, is that the income they generate is free of federal income taxes and may also be free of local taxes in the state or municipality where they are issued. That is to say, dividends paid by the funds are tax-free though the investor will owe taxes on any capital gains. As a result, although the yields offered by municipal bond funds are lower than for comparable taxable funds, the investor's return on them may actually be higher, depending on the investor's tax status.

Zero-Coupon Bond Funds

Zero-coupon bonds are unlike regular bonds in that they make no interest payments, so they are sold at a steep discount to their face value. When an investor holds them to maturity, the return equals the difference between the price the investor paid and the amount investors receive when the bonds mature.

As a result, their return is completely predictable. The downside, of course, in addition to inflation risk, is that if the market rises sharply, the investors don't benefit from potential gains.

Zeros are created when investment bankers separate the interest payments from the principal on Treasury, municipal or corporate bonds and sell each component separately; zeros are the principal portion. They are packaged in zero-coupon bond funds, which are also called "target maturity" funds because the bonds mature (and the funds liquidate) at a specified date. Zero yields are usually comparable to those of Treasury funds.

Zero-coupon bonds are good choices for investors who want to know exactly what they will have in hand several years down the road and who are comfortable locking in their yields for prolonged periods of time, from five to as long as 30 years. Because they own zeros, the funds pay no dividends, unlike regular bond funds.

But the amount by which the zeros increase in value each year (called "phantom income") is taxed until the bonds mature. Like regular bonds, zero-coupon bond funds respond to changes in interest rates; however, the zeros respond much more sharply because they pay no interest.

International Bond Funds

Investing internationally is another way to diversify because securities markets in various countries tend to move independently of one another. By investing abroad, investors can also take advantage of interest rates that may be higher than U.S. rates, thus boosting the return on their portfolio.

International bonds are selected the same way as domestic bonds, with an eye on expense and risk. The lower the expenses, the better. Because bond returns move in much narrower ranges than stock returns, expenses make a bigger dent in the return.

Similarly, the risk is based mainly on two factors: the shorter the term of the bond, the less risk, and the credit-worthier the issuer, the less risk. However, international bonds offer a third risk: changes in the relative values of U.S. and foreign currencies. To buy foreign bonds, managers must convert their U.S. dollars into whatever local currency applies. When they sell the bonds, they have to convert the money they receive back into U.S. dollars.

Currency translation is a plus when the U.S. dollar is strong because fewer dollars buy more French francs or British pounds. Obviously, the opposite is true when the dollar is weak.

Short-Term Global Income Bond Funds

One popular type of international bond fund is the short-term global income funds, which invest in high quality U.S., and foreign bonds. These funds promise higher yields than money market funds or CDs and less fluctuation in value than long-term bond funds. However, these funds are not without risk. They carry a three-year term, which increases the interest rate risk, as well as the currency risk. Furthermore, their share value can fluctuate.

Money-Market Mutual Funds

By 1982, money-market funds had commandeered about $200 billion in assets. In fact, in the whole scheme of things, they are the safest investments around, some of which even rival the security of a bank account. They even resemble a bank account; interest earned each day is credited daily, and while the payments are technically dividends; they are the functional equivalent of interest.

Every fund has to keep some cash in the short term, so money-market instruments are used to keep the cash producing while waiting to be paid out or reinvested. Money-market instruments have maturities of from one day to less than one year.

The interest rate credited daily to money-market fund investors is a composite of interest rates on all the investments held by the fund. Money-market mutual funds are not the same as money-market bank accounts — another term for bank savings plans that pay variable instead of fixed interest.

Unlike stocks and bonds, money-market investments are so short-term in nature that the funds are able to maintain their NAV at $1 per share. The small profits and losses in the portfolio can be accounted for by varying the payout. If there is a small capital gain, the fund can just pass it along as a little extra yield.

Similarly, the income stream, resulting in a slightly lower payout, can absorb small losses in principal. Many funds use an accounting method that allows them to carry the securities on their books at cost. Under those rules, assets do not fluctuate at all.

Most money-market funds offer checking privileges. However, since they usually require a check amount of several hundred dollars, they cannot realistically replace a bank checking account. One should always read the prospectus; some funds set limits not only on the minimum amount of a check but on the number of checks that may be written as well.

Risk

The shorter the maturity, the faster the yield will respond to changes in interest rates. If one fund has an average maturity of 30 days and another has 15 days and the interest rate rises in the next two weeks, the yield on the 15-day fund is going to rise more quickly. That is because the fund has more investments maturing sooner and will be able to roll them over at higher interest rates.

However, if interest rates fall during that period, the longer fund fares better because it will hold onto its higher-yielding investments much longer.

As a result of the fluctuations in rates and portfolio maturities from week to week, the differentials look big. But over a year's time, those differences smooth out. *Income & Safety*, a newsletter that tracks money-market funds, says that the difference between the highest- and lowest-yielding funds in any year is about 0.9 percentage points.

That means that if an investor has an average balance of $10,000 in the lowest-yielding fund, they would receive only $90 less income than from the highest-yielding fund. Of course, as the principal investment amount increases, that 0.9 percentage point results in a more significant monetary difference between the highest- and lowest-yielding funds.

The SEC and Money-Market Funds

To circumvent problems, the SEC lowered the ceiling on the maximum average maturity of a money- market fund to 90 days from 120 days. In general, the shorter the maturity of a security, the lower the risk of owning it.

Then the SEC came down hard on credit quality. Funds can no longer invest in below-investment-grade commercial paper. Also, no more than 5 percent of the fund can be invested in the lower tier of investment-grade paper, that which do Standard & Poor's and P-2 by Moody's rate A-2.

That rule followed two defaults by issuers of junk commercial paper held in part by two money-market funds. In both cases, fund shareholders were spared losses because the two funds' managers made up for the losses, although they were under no legal obligation to do so.

Finally, the SEC made exotic fixed-income investments such as inverse floaters off-limits to money-market funds. Such instruments gained a following among a handful of money fund managers in the early 1990s.

As interest rates fell, the interest payments paid by these vehicles actually went up. But that also meant that if interest rates went up, the interest payments, along with the principal value, would go down. That threatened to undermine money funds' abilities to maintain a NAV of $1, so regulators outlawed it.

Regular Money-Market Funds

These are short-term debt instruments issued by the U.S. Treasury and other government agencies that are guaranteed by the U.S. government. Securities held in these funds are free of credit risk but have lower yields than the general-purpose funds. Still, in times of economic uncertainty, many fund analysts say going to the government is advisable even if investors must settle for lower returns.

However, it is not necessarily a given that investors must give up a better yield if they invest in the government. By careful fund shopping, it is possible to find some funds with better yields than those, which also include bank CDs, and commercial paper. Moreover, even if an investor switches from a general-purpose fund to a government money-market fund in the same family, the difference in yields may not be more than 0.20 or 0.30 percentage points, a small price to pay to overcome credit risk.

U.S. Government bonds also have another advantage. Just as the federal government does not tax interest earned by investing in state and local government debt, most state and local governments do not tax interest earned on federal debt. Regular money-market funds, or taxable funds, of which there are dozens, invest in the following:

U.S. Treasury Bills

These are short-term obligations of the U.S. government, which can come in three-month, six-month, or one-year maturities. Individual investors can buy these on their own, but there is a $10,000 minimum.

Other U.S. government agencies also raise short-term funds in the money markets from time to time. Their securities are also permissible in many funds.

Bank Certificates of Deposits (CDs)

Many people are familiar with Certificates of Deposits (CDs), but these funds invest in "jumbo" CDs over $100,000, which are not insured by the FDIC. The creditworthiness of the bank is the only thing that backs them up.

Sometimes money-market funds invest in Eurodollar CDs, which are dollar-based CDs issued by European (usually London) branches of U.S. banks. Those interest rates are usually a little higher than those of domestic CDs.

Banker's Acceptances

These instruments are irrevocable obligations of banks that issue them, so their quality is similar to that of a bank's CD. Acceptances are created as a financial tool for international trade, but holders of the acceptances can raise cash immediately by selling them into the money market, where money-market funds often buy them.

Sometimes these are short-term bank guarantees that finance imports and exports. The importer does not want to pay a foreign company until goods are received.

An exporter does not want to ship the goods until they are guaranteed they will receive their money when the goods are delivered. Bankers' acceptances are the guarantees and are virtually risk-free investments.

Commercial Paper

As a less costly alternative to bank borrowings, many large corporations raise funds through commercial paper, or short-term IOUs. There is no collateral behind commercial paper. The only backing is the creditworthiness of the issuer. Maturity dates are typically up to nine months.

Repurchase Agreements

"Repos" as they are commonly called, are short-term borrowings using U.S. government securities as collateral. The following discusses how these work. A bank or securities dealer has an inventory of Treasury bonds it needs to finance for, say, 20 days. Sometimes the term of the loan is merely overnight.

The dealer borrows from a money-market fund and gives the fund securities as collateral for the loan. The arrangement is called a repurchase agreement because the borrower agrees to "repurchase" the collateral by paying back the loan. The credit on the line is the bank's or dealer's, but as long as the fund can claim the securities in case of default, the credit quality is considered high.

Tax-Exempt Money-Market Funds

Tax-exempt money-market funds share many characteristics with taxable funds: short-maturity securities, liquidity, and check writing privileges. Despite the similarities, the average maturity of these tax-exempt securities is 75 days compared to 45 days for a regular money-market fund. Of course, the main difference is that the income from these funds is beyond the reach of the IRS.

These funds escape taxes by investing in a variety of short-term instruments that are issued by state, county, and municipal governments and public authorities. For instance, most communities collect taxes several times a year, but their need for cash does not conform to that tax collection schedule. Therefore, they may issue tax anticipation notes, which are short-term borrowings meant to carry the municipality or agency over until the tax receipts are collected.

The tax-free money funds rely heavily on "put" funds and variable-interest demand notes. In either security, the interest rate is reset frequently, sometimes in as short a period as seven days. If the fund manager does not like the new interest rate, they can always give them back or "put" the bonds back to the issuer for redemption.

Such bonds are rarely put back. The rates are set so that they are competitive with the current rates in the tax-exempt market.

Such bonds, which are often backed with a bank letter of credit to assure investors the money will be there to redeem them, almost always trade at par. That makes them especially good investments for money-market type funds that strive to hold their NAV at $1. In fact, investment bankers devised these floating-rate securities largely to meet the needs of tax-exempt money-market funds.

When looking at tax-free funds, investors must remember that the income is not necessarily out of the reach of state and local taxes. States usually exempt income from municipal securities issued in their state, but do not care about those issued by others. So a general tax-exempt money-market fund may not be totally tax-free. The only part of the income that the investor's state income tax authorities will waive is that which is from the investor's own state.

The most important consideration when looking at tax-free money funds is the investor's overall tax bracket. The bigger the bite from the federal, state, and local taxing authorities, the better a tax-free fund is going to feel.

Single-state tax-free funds have some disadvantages. For starters, the portfolios lack geographical diversification. If the state an investor lives in is undergoing fiscal difficulties that will reflect in the marketplace for all municipal securities issued in that state. As long as the state can handle its problems, such troubles should be Fixed, and the worst that can happen is that the yield may go up a bit. The issuers will have to compensate investors for taking on a little higher risk.

Mutual Funds and Retirement

Investors, whether the objective is to achieve immediate or long- term income, may want to consider mutual funds for the specific purpose of establishing retirement income. For example, employees could do this on their own, or they may opt to establish such plans through their employer.

Personal Life Insurance

No matter how much money a person has managed to save, it is seldom enough to meet either routine or extraordinary expenses of survivors immediately after the death of a provider. Some of the major financial requirements that can be satisfied by the proceeds from an adequate life insurance policy after the death of an insured include:

- Funeral expenses or other costs of disposing of the body.
- Payment of death or estate, federal and state gift, income, and property taxes. Payment of short-term obligations or debts, such as promissory notes, charge cards, and installment loans.
- Mortgage payments.
- Health, vehicle, and home insurance.
- Fixed source of income until a will is probated.
- Expenses of education.
- Utility bills.
- Hospital expenses not covered by insurance, Medicare or Medicaid.

There are other advantages to life insurance in addition to providing survivors with income and a source of funds to meet ongoing debts and liabilities. The proceeds of a life insurance policy are payable to the beneficiaries immediately after the death of the insured, free from the burden of federal income tax, and are not subject to probate proceedings.

Basically, there are two types of life insurance — cash value and term. In term life insurance, a policy is written for a period of one to five years and can be renewed with an increase in the premium until the insured reaches old age. If an insured dies within that term, the beneficiaries are paid a cash settlement. A term policy has no cash value. Term insurance can be purchased with an option to convert to a cash-value policy.

A cash-value life insurance policy is commonly referred to as "whole life" insurance. When an insured dies, beneficiaries are paid the face value of the policy. The cash value (the amount which will be paid to the insured if the policy is surrendered to the insurance company) increases over years of coverage. Insurance agents usually try to push whole-life insurance on a consumer because the premiums are higher.

Thus, the amount of commission is increased. There are certain advantages and disadvantages of a whole-life policy.

- Advantages include:
- Accrual of cash value over time.
- Payment of interest.
- The ability to collect a portion of the face value during the lifetime of an insured.
- Use as collateral for a loan.
- Renewal is virtually automatic.
- No change in premiums.
- Premiums are deductible for federal income tax purposes when the cash value is withdrawn.

Following are some disadvantages:

- For a fee, an insurer will invest the premiums.
- A policyholder has no control over how funds are invested.
- Premiums are higher.
- Variable whole life insurance allows the policyholder to select the kinds of investments in which they would like their premiums placed.
- The premiums for variable whole life are fixed, and the insurance company guarantees face value.
- The insurer offers the policyholder an opportunity to invest in money market funds, bond funds, common stock funds, and income-oriented funds.

Mortality tables, which reveal the rate of death of various segments of society, constitute the basis for calculating the costs of premiums. Such statistics may be kept by an insurance company or may be obtained from the National Association of Insurance Commissioners.

There are several steps a consumer can take to help contain the costs of a life insurance policy, including:

Buying a policy from a company that is financially sound, with at least an "A" rating.

Obtaining a policy through a group program, such as one sponsored by an employer or a trade or professional association.

Using veteran's insurance.

Buying insurance from mutual companies that pay dividends.

Acquiring no more insurance than is necessary.

There are two main factors which determine whether a physical examination as a condition of coverage will be required:

- One's age; and
- The amount of insurance the individual seeks to purchase.

Most life insurance contracts contain a clause providing for a grace period of 31 days, during which the policy remains in effect after the time for payment of a premium has passed.

If payment has not been made within the grace period, a policyholder will receive notification from an insurer that the policy has lapsed. Frequently, the notification will advise the insured of their rights of reinstatement, if any.

One of the conditions of reinstatement may be renewed proof of insurability.

Other conditions include repayment of any indebtedness incurred against the policy and payment of delinquent premiums.

Many policyholders borrow frequently against their single-premium whole life policy until the account is depleted. The amount of the loan can usually be repaid at a low interest rate, and if not repaid will reduce the amount of the death benefits by the amount of the loan. The amounts borrowed are taxed as ordinary income.

Social Security

The Social Security system is more than just a retirement program. In addition to making retirement benefits available to eligible persons over the age of 67, Social Security also provides benefits for dependent family members of a worker who becomes disabled or retires, family members who survive a worker who dies, workers under 67 years of age who become completely disabled, health insurance for retired persons over 67 years of age and their dependents and certain disabled people through Medicaid.

More than 43 million Americans receive Social Security checks monthly. The average retired worker recovers the entire amount they paid into the Social Security system while they were employed in two to three years after retirement.

Participation in Social Security provides some retirees more protection than a private pension plan since monthly payments are tied to the Consumer Price Index (CPI). Social Security should not be thought of as a welfare system since payments are not based on need but on age and the amount of contributions.

There are two basic requirements which must be met before one can qualify for Social Security payments — age and the number of years worked. The minimum age for which one can begin to receive monthly payments is 62 years. Payments begin at the end of the first full month after attaining the minimum age.

Additionally, one must have had 10 years' worth of work or 40 credits to qualify. The amount of time one must work to earn a credit is nominal.

However, there are some jobs where an employee is not required to pay Social Security taxes, such as schoolteachers in states where their retirement system did not merge into the Social Security system. Such persons are not eligible for Social Security payments. Military service pay is credited toward Social Security eligibility.

The amount of monthly Social Security checks which a retiree will receive, is based on the age when checks will begin to be received and average earnings over a lifetime. Just as there is a cap on the amount of Social Security taxes, which must be paid, there is a limit on the amount of monthly payments a retiree can receive. Full retirement benefits are payable at age 65.

If one begins to receive payments at age 62 the monthly amounts will be reduced. Early retirement results in payments being about 80 percent of what one might have received had they waited until age 67.

There is no adjustment to full payment when one reaches full retirement age. The break-even point is reached when a retiree reaches age 70. Those who wait until after 67 years of age receive a higher monthly payment. Presently, a higher normal retirement age is being phased in. For example, persons born after 1959 will have to wait until the age of 67 until they can qualify for full retirement benefits.

Spouses are eligible for benefits. Applicable state laws determine the relationship of the spouse. A spouse may be a current or a former one. One who is 65 years old is eligible for 50 percent of a spouse's full retirement benefits. At early retirement, benefits drop to 37.5 percent of a spouse's full retirement benefit.

A former spouse who was married to an eligible participant for more than 10 years and is at least 62 years old can receive the same percentage of a participant's benefits. An eligible participant need not be retired in order for a former spouse to qualify.

If one is eligible to receive payments based upon either a former spouse's eligibility or upon their own merit, the amounts will not be combined, but rather such person will receive only the highest of either amount. If a person were married to more than one spouse and each marriage exceeded 10 years, the amount of monthly payment such person will receive is the highest they would be eligible to receive when each possibility is viewed separately.

The widow or widower of a deceased worker is entitled to receive 100 percent of the deceased person's benefits if that person is age 65 or older, unmarried, or remarried after the age of 60. If a survivor is 60 years old, they can receive 71.5 percent of a deceased worker's benefits. In addition to monthly benefits, a surviving spouse may receive a one-time lump sum death payment in the amount of several hundred dollars.

One who is receiving Social Security payments can earn a certain amount of wages from a part-time job before monthly Social Security payments will be reduced. Once a participant has reached the age of 70, there is no ceiling on the amount of wages that can be earned from employment. Higher earnings reduce the amount of Social Security payments.

The only type of wages that count toward determining if a reduction in Social Security payments is warranted are those from employment or net earnings from self-employment. Investment income does not count. The amount of wages, which can be earned before payments are reduced, is determined yearly.

Social Security benefits may be subject to federal income tax. To compute the amount subject to income tax, a taxpayer's adjusted gross income is added to nontaxable interest income and one-half of Social Security benefits. From that amount, an individual may subtract $25,000, and a couple $32,000. The remainder, or excess amount, is taxable.

Supplemental Security Income

Retirees who have so little income that they cannot survive may qualify for Supplemental Security Income (SSI). The goal of SSI is to provide a subsistence level of income for disabled and aged persons. Those who participate in SSI are also eligible for Medicaid. SSI, which is funded from general revenues, is not part of the Social Security system. To be eligible to participate, one must have reached the age of 65 or be blind or disabled and have low income and low resources.

The Deferred Annuity Mortgage

For a retiree who owns their house free from any lien or mortgage, the deferred annuity mortgage, sometimes called a "reverse mortgage," may be another way of providing additional monthly income.

A reverse mortgage is based upon the equity in one's residence. A lending institution lends money to a retiree based upon the amount of such equity, sends payments monthly to the retiree and credits the amount of such payments toward the loan, which increases, as the retiree grows older. Upon the sale of the residence, a move or the death of the owner, the loan will become due.

Although reverse mortgages are not universal, there is an FHA program that permits deferred annuity mortgages to homeowners who are at least 62 years of age. The older a retiree is when applying for a reverse mortgage, the higher the monthly payment. One of the disadvantages of a reverse mortgage is that accompanying interest rates are high.

Individual Retirement Accounts

An individual retirement account (IRA) is a savings account that allows the holder to set aside a certain amount of money every year for retirement without paying tax on any earnings and to take a deduction for tax purposes if certain IRS rules are followed.

There are two significant requirements that must be satisfied to qualify for preferred tax treatments. A person under 70 1\2 years old and who receives payment for personal services that must be reported as income is eligible to open an IRA. Income can be earned by working for an employer or from self-employment. Alimony and court-ordered spousal maintenance payments qualify as earned income.

There is a common misconception that an IRA can only be opened at a bank or a savings and loan, and that the money must remain in a savings account. However, there are a number of other financial institutions that offer IRAs, including brokerage firms, insurance companies, mutual fund sponsors, and credit unions.

Funds can be placed in a wide range of investment options, such as certificates of deposit, treasury paper, mutual funds, stocks, annuities, real estate investment trusts, bonds, and diverse types of savings accounts. A number of factors must be considered when determining how to invest funds held in an IRA. These include risk, age, fees, and flexibility.

Risk

The primary factor in determining how funds should be invested is the degree of risk one is willing to assume. Since money held in an IRA is intended for retirement, a fair degree of caution is warranted.

Age

Age is an integral element of risk. A higher degree of risk may be more appropriate for a younger person, since there would be more time to recoup losses arising from speculative investments. If one intends to invest in the stock market, they should anticipate holding such investments for a period of years in order to achieve a solid return.

Fees

A holder of an IRA may end up paying double fees.

- By way of illustration, Charlie went to his local bank and opened an IRA.
- Being somewhat conservative in financial matters, he chose to invest his IRA in a mutual fund. When he received the first account statement from the bank, Charlie was surprised to find that the bank charged an annual administration fee and the company which managed the mutual fund assessed another fee based upon the assets underlying his interest in the mutual fund.

If one selects a "self-directed" IRA, which is opened with a brokerage house that allows the holder to buy and sell stocks at will, a broker's fee will be imposed every time there is a trade.

Flexibility.

If a holder of an IRA wants flexibility to move their money around, they should place their funds in a more liquid investment, such as a money market or a certificate of deposit, rather than in stocks, bonds, or mutual funds.

Even if a taxpayer participates in another retirement account, such as a Keogh or a 401(k) plan, they can still maintain an IRA.

An IRA does not have to be funded all at once. A taxpayer can contribute the full amount on an installment basis throughout the year. If the full amount is not deposited in one year, the deficit cannot be carried over to a subsequent year. IRA accounts for any given year must be opened no later than April 15 of the following year.

No federal income tax is paid on money placed into an IRA or on any income earned on the account if funds are not withdrawn until the account holder reaches the age of 59½. If the holder of an IRA is in a lower tax bracket at the time of withdrawal, substantial tax savings can be realized, especially if IRAs are opened when an account holder is younger.

The amount of a deduction, which can be taken under federal income tax laws for funds placed into an IRA, depends on the amount of income earned by an account holder and whether the person participates in other retirement plans.

If an individual deposits more than the maximum permissible amount in an IRA, they may be subject to penalties imposed by the Internal Revenue Code. The excess amount cannot be taken as a deduction against gross income, and an excise tax is levied on the unauthorized amount for the full time that such funds remain in an IRA.

When an account holder reaches 59½ years of age, they can withdraw funds from an IRA without penalty. Premature withdrawals are subject to a penalty of 10 percent of the amount taken out of an IRA.

By the time an account holder is 70½ years of age, they must withdraw IRA funds. Failure to do so will result in the imposition of a tax equal to 50 percent of the amount that would have been paid if the funds had been withdrawn in a timely manner. Contributions to an IRA can continue until a taxpayer has reached the maximum age for withdrawal.

Other Investments or Sources of Income

The Commodities Market

There are a number of other investments which can provide a source of income during retirement. However, a few are extremely speculative, and if one were to plot the risks and rewards on a graph, the curves would resemble the path of a roller coaster.

Among the more speculative are commodities futures and precious metals. The commodities futures market deals in raw materials, such as corn, soybeans, or precious metals, and in intangible items such as currencies and interest rates. In the case of crops, the underlying commodity is subject to certain vagaries, such as the weather.

Those who provide raw materials grow the commodity and those who use them are able to hedge against wild price swings by entering into contracts for future delivery at a specified price. Speculators then take such contracts and trade them in a fashion similar to trading securities in the stock market. The commodities market can be seductive to an ordinary investor because of the low down payment required to purchase a contract — sometimes as little as 5 to 10 percent. However, if the value of the underlying commodity decreases, so does the value of the contract, thus the potential for enormous losses is significant. Rarely does an investor take delivery of the underlying commodity.

Contracts are bought and sold in a brief period of time, and if sold at a loss, an investor must produce sufficient funds to cover the loss. To spread the risk, some commodities traders deal in commodities pools, the equivalent of a commodities mutual fund.

Precious Metals

Investing in gold is one of the more effective ways of hedging against inflation. Gold can be purchased in its purest form by buying wafers or gold bars. Some investors choose to acquire precious metal by acquiring gold coins. The measure of the value of a gold coin is sometimes determined by more than just the amount of gold it contains if historical value is attached.

When gold is a hot commodity, some investors may choose to buy stock in mining companies. Care must be taken to avoid a company with limited earnings history that issues cheap or penny stocks.

Silver is used both as a precious metal and in industry. Like gold, silver can be purchased in the form of wafers or bars from brokers, banks, and coin dealers. For the more conservative investor, stock can be acquired and sold in companies, which mine silver. Because silver has industrial applications, its price tends to become depressed in times of recession.

Other precious metals, such as uranium, titanium, chromium, rhodium, and vanadium are rarely available to an individual. Should one encounter any attempts by another to sell such metals, one can probably conclude that the proposed transaction is a sham.

Real Estate

Tax benefits attendant to investing in real estate have diminished considerably over the past 10 years. Ownership of rental property at one time provided many a retiree a steady source of income and generous tax deductions.

But with the erosion of the capital gains tax, the extension of time in which property can be depreciated, the limitation on tax losses and deductions, which could be taken, and the slowing of the rise in the value of residential real estate, the accumulation of rental property can now be more of a burden than a benefit.

A person approaching retirement who has assembled a portfolio of rental houses over their working years may consider selling several and carrying the financing to provide an additional source of monthly income.

FOCUS POINTS

- Variable annuities are sold mostly by life insurance companies and combine the features of a mutual fund with life insurance and tax-sheltered retirement funds.
- Annuities carry no limitation as to the amount of money that can be invested in them.
- Funds in a variable annuity are taxed only upon withdrawal.
- Funds placed in a variable annuity must be kept in the annuity until the investor reaches age 59½ to avoid early withdrawal penalties.
- If funds from an annuity are withdrawn early all regular income taxes must be paid in addition to a ten percent penalty.
- A mutual fund is a corporation, trust or partnership that makes investments on behalf of other individuals and institutions.
- Mutual fund companies hire portfolio managers to manage, buy, sell, and assess all the securities within the fund's portfolio.
- The SEC requires that all investors be given a prospectus prior to the purchase of fund shares.
- The NAV is the fund's total assets minus its liabilities and divided by the total number of outstanding shares in the fund.
- The NAV fluctuates from day to day depending on how the securities the fund owns performed on the previous day.
- An investor will earn capital gains when they sell shares in the fund for more than they paid for them originally.
- Net realized capital gains are the profits from assets that grew in value before being sold, minus losses from assets that declined in value before being sold.
- Dividends distribution is the distribution of dividends and interest from investments to the mutual fund shareholders.
- The ex-dividend date is the date on which declared distributions are deducted from the fund's assets.
- The price at which a mutual fund's shares can be purchased is known as the "ask price."
- A fund's "cash position" refers to its present cash assets.
- 80% of all mutual fund investors elect to have their dividends and capital gains distributions automatically reinvested.
- Mutual funds that have sales charges are called load funds.
- Mutual funds without sales charges are called no-load funds.
- A load is expressed as a percentage of the total investment.
- The maximum load that can be charged to an investor according to the SEC is 8.5 percent.
- Load charges made at the time of purchase are called a front-end load.
- A back-end load is a load charged when the shares are redeemed.
- A 12b-1 fee is a fee charged to cover a fund's distribution costs such as advertising, sales literature, annual reports, prospectuses, and compensation for brokers.
- 12b-1 fees are limited to a maximum of 1 $^{1}/_{4}$ percent per year.
- A reinvestment fee is a fee charged to an investor each time that investor's dividends are reinvested.
- Mutual funds can be organized as corporations, trusts, Unit Investment Trusts (UITs) or partnerships.
- Open-end mutual funds have no set number of shares to be bought, traded, or sold.
- The share price of an open-ended fund is based on the actual value at the time of the market's closing on the previous afternoon.
- 15% of all mutual funds in the marketplace are closed-end funds.
- Shares in close-ended funds must be traded through a broker and are traded on the major exchanges.
- The major advantage in investing in a mutual fund is diversity.
- Investments in mutual funds are considered to be "liquid" because shares may be purchased or redeemed on any business day throughout the year.
- The SEC mandates rules and guidelines controlling the reporting, advertising and sales tactics of mutual funds and mutual fund companies.
- In addition to the federal laws set forth by the SEC, some states enact even stricter laws regulating mutual funds and mutual fund companies.
- Mutual funds are considered to be long-term investments.
- The more time an investor has to invest, the more risks they can afford to take with their money.
- The longer an investor invests, the greater the chances that inflation will diminish the value of the investment.

- A fund's yield is its dividend payout as a percentage of its assets.
- A fund's yield does not include capital gains distribution.
- Growth funds have no yield because the funds invest in corporations that reinvest their profits for expansion rather than pay them out as dividends.
- A funds total return is the fund's appreciation, including reinvestment of dividends and capital gains.
- Since all cash revenues derived from a fund are distributed to its shareholder, funds are seen to make no profit, thus they incur no taxes.
- In order for a fund to keep its special tax status it cannot hold more than 10 percent of the outstanding voting stock in a particular company and must distribute at least 90 percent of their taxable income.
- The "short-short" rule states that no more than 30 percent of the funds' gross income can come from securities held for less than 90 days.
- Prior to the tax act of 1986, funds could take profits in December and make distributions in January. This would put off paying the tax on the distribution for another 15 months (April 15 of the following year).
- Funds must now distribute 98 percent of their income and dividends in the calendar year in which they are earned.
- When shares are redeemed, exchanged, or switched within the same family they incur tax liabilities.
- When an investor sells any shares in a fund, the fund company must report the proceeds of the sale to the IRS.
- The 1099-DIV summarizes an investor's mutual fund activities for tax purposes. One copy is given to the investor, and another copy is given to the IRS.
- The two classifications of stock are common stock and preferred stock.
- Common stocks are units of ownership in a corporation and are referred to as equity instruments.
- The goal of aggressive growth stock funds is capital appreciation, not income.
- Growth mutual funds are considered long-term investors and invest primarily in the common stocks of well-established companies whose earnings are expected to outpace the average.
- Growth and income funds attempt to provide investors with both capital growth and to pay the investor income.
- Growth and income stock funds mostly invest in blue chips, companies that consistently maintain good earnings.
- Balanced funds invest in a combination of common stocks, bonds, and preferred stocks, usually in a fixed ratio of 60 percent stocks and 40 percent bonds.
- Mutual funds that own shares in all of the companies in a particular index are called index funds.
- Index funds are mutual funds that are designed to replicate, rather than to beat, the performance of a market index.
- Industry funds purchase stocks related to one specific industry.
- Mutual funds that invest in options rather than stocks are called option funds.
- Precious metals funds maintain two-thirds of their portfolios invested in securities associated with gold, silver, platinum, and other precious metals.
- A bond is considered a fixed-income security.
- Bonds are written promises made by a company or a government to repay borrowed money by a specified time and at a specified interest or "coupon" rate.
- Rating companies rate bond issues according to the financial shape of the issuing company or and its ability to make interest payments and return the interest at maturity.
- Bonds with a low rating must pay high rates of interest to attract buyers and are considered riskier investments.
- High-rated bonds pay less interest but are considered far more reliable investments.
- Treasury bills, treasury bonds, and treasury notes are a loan of money to the government.
- Treasury bills mature in three, six or twelve months and are sold in lots of $10,000.
- Treasury notes mature in one to ten years.
- Municipal bond funds invest in the bond and note issues of states and municipalities.
- In general, the shorter the maturity of a security, the lower the risk of owning it.
- Money Market funds are short-term debt instruments issued by the U.S. Treasury and other government agencies that are guaranteed by the U.S. government.
- Securities held in money market funds carry no credit risk but have lower yields than the general-purpose funds.
- Jumbo CDs are CDs over $100,000.
- Repurchase Agreements are short-term borrowings that use U.S. government securities as collateral.

- Tax-exempt money-market funds pay no taxes because they invest in a variety of short-term instruments that are issued by state, county, and municipal governments.
- Term life insurance policies are written for a period of one to five years and can be renewed with an increase in the premium until the insured reaches old age. If the insured dies within that term, the beneficiaries are paid a cash settlement.
- A term life insurance policy has no cash value.
- When an insured dies with a cash-value policy beneficiaries are paid the face value of the policy.
- The cash value is the amount which will be paid to the insured if the policy is surrendered to the insurance company. The cash value increases over years of coverage.
- Variable whole life insurance policies allow the policyholder to select the kinds of investments in which they would like their premiums placed.
- FHA permits deferred annuity mortgages to homeowners who are at least 62 years of age.
- With a deferred annuity mortgage, lending institutions send monthly payments to retirees based on the equity of the retiree's home.
- An individual retirement account allows the holder to set aside money every year for retirement without paying tax on any earnings and to take a deduction for tax purposes.
- If an investor participates in another retirement account, such as a Keogh or a 401(k) that investor may still participate in an IRA.
- No federal income tax is paid on money placed into an IRA or on any income earned on the account if funds are not withdrawn until the account holder reaches the age of 59½.

CHAPTER 5: PLANNING FOR LTC

Long-Term Care Insurance

Catastrophic illness and long-term health care can virtually eliminate a lifetime accumulation of retirement funds if one is not adequately insured. The annual costs of residing in a nursing home range presently from $50,000 to $120,000 a year or more. It has been estimated that every American over the age of 65 has at least a 20 percent chance of spending at least a year in a nursing home. Long-term care (LTC) coverage is one effective way of preventing an erosion of retirement funds.

LTC insurance covers services necessary to support a person who is chronically ill or handicapped. It provides a variety of services, including medical, convalescent, and custodial care provided by physicians and nursing personnel.

LTC insurance covers extensive stays in nursing homes, residential facilities, and health-related facilities.

Home care may be covered. Long-term care insurance should be acquired as many years before retirement as possible since the premium can become quite prohibitive if one waits until just before retirement.

For example, one who is 55 years old pays almost 60 percent less in premiums than one who is 64 years of age.

There are a number of factors to consider in deciding whether to acquire LTC. One needs to look at the longevity of immediate family members, whether there are other assets that could be used to pay for extended nursing home care, life expectancy, net worth, whether there are others who are financially dependent on such person and if extended care could be provided at home or by another family member.

Before acquiring LTC coverage, the proposed policy should be reviewed carefully to make certain that at least the following features are included:

- The policy should have a provision that allows for waiver of premiums after an insured has been receiving payments for a specified period of time.
- Prior hospitalization should not be required before coverage begins.
- Coverage should be available for Alzheimer's and related diseases.

- An insured should be able to cancel the policy before the end of the first 30 days with no penalty or further obligation.
- The policy should allow the insured to alternate between home health care and a nursing home.
- The policy should be renewable for life.
- There should be a provision allowing for adjustment of benefits in the event of inflation.
- The premium should be fixed.
- Coverage should start the day the insured enters a nursing home.

Medicare

The Medicare program, adopted in 1965, provides basic health insurance protection. In order to qualify for Medicare, a person must be 65 years of age and eligible for Social Security retirement benefits, or at least 65 years of age, ineligible for Social Security retirement benefits and pay a fee for Medicare benefits, or have kidney failure, or have been receiving Social Security disability income benefits for the previous two years.

Medicare coverage is divided into four parts. "Part A" covers hospitalization expenses and "Part B" extends to medical costs. No premium is required for Part A, but there is a deductible as well as copays. Reasonable and necessary expenses of hospitalization for a specific period are covered, including the costs of a semi-private room, nursing services, the intensive-care unit, X-rays, anesthesia, drugs, meals, laboratory work and operating and recovery room expenses.

Part A offers partial coverage for nursing home expenses, including physicians' visits, after a specified number of days have been spent in a hospital. Under Part B, there is a monthly premium and a deductible and coinsurance of 20%.

Part B extends to expenses for inpatient and outpatient medical treatment, doctors' services, medical supplies, ambulance charges, and blood. Items like eyeglasses, hearing aids, long term nursing care and dental care are not covered. If medical care is covered by both an employer-sponsored health care plan and a retiree, Medicare becomes a secondary payor.

Part C advantage plans allows contracts between the Health Care Financing Administration and various managed care and fee-for-service organizations. It is the HMO/PPO/POS of the Medicare world.

Part D is for prescription medication. Anyone who is on Medicare is eligible for Part D.

Medigap

Although Medicare is an inestimable source of health care coverage, it has always been intended as basic coverage and therefore does not extend to every medical expense. Some of the more common gaps in Medicare coverage are the deductible in Part A hospital coverage, the expenses for extended hospital care after 60 days, health care costs incurred while in a foreign country, the expenses of nursing-home care, the deductible for medical bills under Part B and the charges in excess of allowable fees, prescription costs, dental expenses, vision costs and expenses attendant to preventive care.

Medigap is a private supplemental insurance program designed to fill in the gaps in Medicare coverage. The premium varies with the amount of holes which the insured elects to close.

A typical Medigap policy will cover the 20 percent share of Part B charges, full coverage for hospital stays in excess of 60 days, the first three pints of blood not covered by Medicare, the insured's share of skilled nursing care facility expenses, the Part A deductible for hospital stays, the Part B deductible for doctor bills and excess physician charges, medically-necessary emergencies while traveling abroad, short-term assistance for at-home recovery and certain costs of prescriptions after a deductible has been met.

Coverage similar to Medigap can be obtained by membership in a prepaid health care organization, such as an HMO or a competitive medical plan.

Medicaid

Medicaid is a joint program between the states and the federal government, which is designed to provide health care to persons who cannot afford private coverage. The programs vary from state to state. A physically- or mentally-disabled person is eligible for Medicaid, provided such person satisfies the requirements of three tests, which include:

Age or disability. A person must require institutionalization or nursing home care, and must be either 65 years old, blind, or physically or mentally disabled. Thus, one who is 70 years old would be eligible for Medicaid if in need of institutionalized care, without regard to whether they are disabled, if they satisfy the assets and income criteria, which follow.

Assets. The total amount of assets that one can retain and still be eligible for Medicaid is limited. There are two basic types of assets which are considered.

"Non-countable assets" are those, which do not figure into the limitation, and "countable assets" are used to determine eligibility for Medicaid.

There is another category, sometimes referred to as "inaccessible assets," which include, for example, property which has been placed into an irrevocable trust. Except for assets that are exempt or are inaccessible, all assets owned by a person are countable. An individual may not have in excess of a nominal amount of countable assets, as prescribed by state law, to qualify for Medicaid.

Income. Individual income cannot exceed the amount which is allowed by state law. Income of any kind in excess of the permissible amount will disqualify a person from Medicaid coverage. Some states may allow a person to qualify if excess income is spent on long-term care.

The following assets are excluded from an eligibility determination:

- Trust funds. Primarily irrevocable trusts.
- Family vehicles. The entire value of a vehicle can be excluded.
- Burial plots. Only those owned by people with disabilities or members of their immediate family.
- Principal residence. In the case of a multiple dwelling, the exemption applies only to that portion which is the principal residence of a disabled person.
- Keogh, IRA, and pension funds. Such funds are not counted until they become accessible to a disabled individual.
- Income-producing property. Includes assets that are fairly non-liquid, and the income attributable to such property if it is vital to self-support.
- Non-cancelable, prepaid burial contracts. These should be in the form of an irrevocable burial trust with a funeral home appointed to serve as trustee.
- Personal belongings, furnishings, and jewelry. The amount may be limited under the laws of some states.
- Burial account. A nominal amount, which must be segregated in a bank account and used only to defray burial expenses.
- The cash value of life insurance if the face value is minimal.
- If there are multiple insurance policies, the face values are aggregated for purposes of determining the amount to be excluded.
- Term life insurance policies in any amount of face value.

If the estate of an insured is the beneficiary, a Medicaid lien will be imposed on the proceeds of the policy.

Under Medicaid regulations, joint bank accounts are presumed to be held entirely by a person seeking eligibility.

However, if another account holder is not a spouse, the presumption can be refuted if such other person presents adequate evidence that they contributed funds to the joint account.

Other assets, which are held jointly, such as real estate or stocks, are treated as if owned equally by both owners, again subject to proof of disproportionate ownership.

Although it is not a foolproof method, owners of jointly held property can partition such assets and transfer their respective interests to individual owners.

Any gift of an ownership in assets held jointly within 30 months of making application for Medicaid is disregarded.

A sale of an interest of the joint owners would have a better chance of resisting such a challenge, especially if the money received from the sale is placed into an irrevocable trust or is converted into a non-countable asset.

Upon application for Medicaid, a person's bank statements and financial records for the prior 30 months are subject to examination.

Any qualifying assets that were transferred within such period of time are customarily treated as though still owned by an applicant.

Even though an applicant no longer holds title to assets that were transferred, regulations require that such applicant will not be eligible for Medicaid until they spend an amount equal to that which they gave away down to a nominal amount.

Transfers or sales of an applicant's primary residence for less than fair market value will disqualify such person for Medicaid, unless the sale was affected under one of the following circumstances:

To a child who has made provisions for the applicant, making it possible for a disabled person to avoid institutionalization during that time, provided the child has lived in the home for two years.

To a child not yet 21 years old who is either permanently and totally disabled or blind.

To the applicant's spouse.

To an applicant's sibling who is a joint owner and who resided there for at least a year before the applicant was institutionalized.

Other exempt assets can be transferred for any consideration at any time without affecting eligibility for Medicaid.

A lien can be placed on a primary residence for Medicaid reimbursement by a state under limited circumstances.

The right of the government to recoup Medicaid expenditures extends only to costs paid for the benefit of a person over the age of 65, and can be recovered from that person's estate, provided the spouse has died and there are no children under 21 years of age or who are blind or disabled continuing to live in the house.

However, if the primary residence is sold while a disabled person in an institution is still alive, the state may be able to enforce such lien. Since it is the intention of Congress to limit the lien to property in a decedent's estate, a house can be protected from a Medicaid lien by keeping it out of probate. Placing it into a living trust is usually the best device for such protection.

The regulations, which prohibit transfers of assets within 30 months, govern assignments or transfers made without adequate consideration. Various experts, including taking cash to pay off a mortgage or other loan on a non-countable asset, purchasing a car, or acquiring an annuity, so that in each instance cash would no longer be a countable asset, have suggested several methods of converting countable assets into exempt property.

At the time of institutionalization, all countable assets of both spouses are pooled so that a spousal resource allowance can be established for the non-disabled spouse. Anything in excess of such allowance is included for determining if a disabled spouse is eligible for Medicaid.

The spousal resource allowance is equal to one-half of such pooled assets, subject to a minimum and maximum which are adjusted for inflation. The amount of such spousal resource allowance must be transferred to a healthy spouse within 90 days after a disabled spouse qualifies for Medicaid, otherwise the allowance will be lost. The assets should be transferred to a revocable trust in favor of the healthy spouse.

Since a spousal resource allowance is only calculated once while a person is institutionalized on a continual basis for more than 30 days, a healthy spouse can receive any property after such time without any effect on such allowance. Thus, the full amount of any inheritance would not be counted toward the spousal resource allowance if eligibility for Medicaid has already been determined.

A healthy spouse is entitled to a spousal income allowance in addition to a spousal resource allowance based on poverty guidelines set by the federal government, subject to annual adjustment for inflation.

In some cases, a healthy spouse can petition a state administration agency to increase both the maximum amounts of the spousal income and resource allowances if it can be demonstrated that the maximum allowable amounts are not sufficient to meet basic living conditions. A court-ordered support or alimony agreement takes precedence over a spousal resource or income allowance.

Thus, if a disabled spouse has assets and income which allow for a court-ordered settlement or alimony payments greater than what the healthy spouse would receive from either a spousal resource or income allowance, a separation or divorce would provide greater financial security and would make it easier for a disabled spouse to qualify for Medicaid.

However, it must be remembered that the costs of obtaining a legal separation or divorce from a disabled spouse are quite expensive, since the appointment of a guardian to protect the rights of the disabled spouse may very well be involved. It is necessary to weigh the costs of obtaining a divorce against any probable savings that may be realized by the healthy spouse over the long term.

If the assets of a healthy spouse are not protected, a problem can arise if such spouse predeceases the disabled spouse. If their assets pass to their disabled spouse, they may no longer be eligible for Medicaid. Following are some methods, which can be used to protect a healthy spouse's assets:

- A durable power-of-attorney. Offers protection in the event a healthy spouse becomes disabled or incapacitated, and can no longer manage or protect their own assets and affairs.
- Non-disposition of assets. The property of a healthy spouse should not be distributed to a disabled spouse either by will or under state laws, which affect distribution of the property of one dying without a will.
- Irrevocable trust. The assets of a healthy spouse should be assigned irrevocably in trust so that, in the event they become disabled, it will be easier to establish eligibility for Medicaid.

If an applicant is denied Medicaid benefits, they will receive a Notice of Denial from the applicable state agency that administers the program. Depending on the state in which a disabled person resides, an applicant has from 60 to 90 days to request a fair hearing in writing. Within two to four weeks after the request, the state agency will notify an applicant of the date on which the appeal will be heard. If the disability prevents an applicant from attending the hearing, it can be held in the applicant's home.

The hearing is a rather informal procedure, and if witnesses are reluctant to appear, they can be subpoenaed. An applicant has a right to view their file before the appeals hearing. If an applicant loses an appeal, a rehearing can be requested. An adverse decision from a rehearing is appealed directly to a state court.

An applicant has an extremely limited period of time in which to take the matter to court after a rehearing has concluded.

FOCUS POINTS

- LTC insurance covers services necessary to support a person who is chronically ill or handicapped.
- LTC insurance covers extensive stays in nursing homes, residential facilities, and health-related facilities.
- In order to qualify for Medicare, a person must be 65 years of age and either have kidney failure or have been eligible for Social Security disability benefits for the previous two years, or be at least 65 and eligible for Social Security retirement benefits, or at least 65 years of age, ineligible for Social Security retirement benefits and pay a fee for Medicare benefits.
- Medicare Part A covers hospitalization expenses.
- Medicare Part B covers to medical costs.
- Medicare Part C allows contracts between the Health Care Financing Administration and various managed care and fee-for-service organizations. Medigap is a private supplemental insurance program designed to fill in the gaps in Medicare coverage.

- Medicaid is a joint program between the states and the federal government, which is designed to provide health care to persons who cannot afford private coverage.
- Under Medicaid regulations, joint bank accounts are thought to be held entirely by a person seeking eligibility.
- When applying for Medicaid, a person's financial records for the prior 30 months are subject to examination.
- Under limited circumstances, a state may place a lien on a primary residence for Medicaid reimbursement.
- A spousal resource allowance is only calculated once while a person is institutionalized on a continual basis for more than 30 days.
- A healthy spouse is entitled to a spousal income allowance in addition to a spousal resource allowance based on poverty guidelines set by the federal government.
- A court-ordered support or alimony agreement takes precedence over a spousal resource or income allowance.
- Durable power-of-attorney offers protection in the event a healthy spouse becomes disabled or incapacitated and can no longer manage or protect their own assets and affairs.
- With non-disposition of assets, the property of a healthy spouse should not be distributed to a disabled spouse either by will or under state laws, which affect distribution of the property of one dying without a will.
- With an irrevocable trust, the assets of a healthy spouse should be assigned irrevocably in trust, so that in the event they become disabled, it will be easier to establish eligibility for Medicaid.