

Financial Planning For Seniors

FINANCIAL PLANNING FOR RETIREMENT

- I. Advanced Planning - A MUST!
Planning Concerns - handout "Social Security will survive - System needs work"
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 - Inflation
 - Health Care

- II. Components of the Financial Plan
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PLANNING AHEAD

Most everyone looks forward to retirement. The overwhelming number of retirees and the incoming Baby Boom generation will, most certainly, change the total population makeup well into the millennium. The "graying" of America give a new urgency to the old maxim "you may live too long". As life expectancy increases retirees face the possibility of outliving their financial resources.

Retirees and future retirees must plan to make sure their financial resources will last past their 80's and beyond. Senior citizens are not only living longer; they are also having a better standard of living exemplified by their hobbies, travels and their zest for life.

The following projected demographics will give you some idea of the exploding growth of our present and future retirees. These changing demographics clearly show the pressing need of planning ahead. This ever-growing need is both a challenge and an outstanding opportunity for financial services professionals.

To provide a proper perspective, consider that in 1776, one of 50 Americans was age 65 or older. At the beginning of the 20th century, individuals over 65 represented one out of every 25 Americans. In 1994, Census Bureaus figures show that there were 33.2 million people age 65 and over, representing 12.7% of the total population. By the year 2000 it is projected there will be over one million individuals aged 85 and over.

Census projections estimate that by 2025 those 65 and older will comprise nearly 20% of the population. By the year 2040 this group will increase well over 10 million citizens. If birth rates remain low this figure will be even higher.

We will breakdown the "Senior" marketplace into four distinct segments for our study. They are as follows:

- **Pre-Retirees** - These individuals are between the ages of 55 to 65. Older baby boomers are entering this stage.
- **Early retirees** - These individuals are collecting benefits or have just retired prior to normal retirement age. These individuals are, often, in good physical health but must take steps to insure their financial well being and that of their families.
- **Young Elders** - It may include, roughly, individuals from ages 76 to 85. They climbed the corporate ladder over a long, stable career.
- **Elders** - They make up the final segment and it s composed of those individuals ages 86 and older. Many are physically frail. Social Security and corporate pension are their regular sources of income.

Addressing the Needs of the Seniors

Income Needs - Pre-retirees want to know what they can count on to meet their living expenses. Early retirees are often surprised by the results of earlier financial decision resulting in questions about methods of recasting their financial plans. Many of today's young elders have been retired for more than a decade. Elders in their late seventies and beyond are often concerned about their medical costs.

INDIVIDUAL PERSONAL SAVINGS AND INVESTMENTS

Personal savings and investments are sources of income. This area of retirement planning is the most difficult for individuals. The reasons are many; however, during the early working years most individuals are purchasing homes, cars and raising their family. Usually, there is little money left for investments and very little knowledge of what can be done.

Beginning, early in the working career, a controlled and a systematic savings plan will ensure financial security for the average worker. These individuals control both the principal and the interest derived from their personal investments based on their risk factor. The biggest advantage of individual savings and investments is that these vehicles are more likely to keep up or exceed inflation.

People tend to become more conservative as they grow older. At earlier ages, investors can take more risk with their assets. A poor or lost investment can be replaced with more earnings. Those individuals actively engaged in retirement planning need both safe growth investments to preserve the purchasing power of the retiree.

Safe investments available are savings accounts, money market accounts, bonds, Certificates of Deposit and fixed annuities. Investment instruments that may keep up with inflation are stocks and mutual funds. The investor may select from different funds or stocks, again, depending on their individual risk factor.

SOCIAL SECURITY

Our federal government is the largest insurer in the world! Most every wage earner and their covered dependents are participants in Social Security coverage. The Social Security Act, passed in August of 1935, is the largest social legislation, ever, in our country.

Employers and each of their employees, currently pay 6.20% each (12.40%), for Old Age, Survivors', Disability, and Health Insurance Program (OASDHI). This tax is applicable up to \$106,800.00 of taxable income for 2011.

Hospital Insurance (MEDICARE) taxation is 1.45%, each, with no income limit. A self-employed individual, who must pay both employee and employer parts (2.90% total), may deduct one-half of their self-employment tax for the year as a business expense in arriving at adjusted gross income.

An insurance agent, to properly address the needs of his/her clients, must be cognizant of all the benefits available under OASDHI programs.

OLD-AGE SURVIVORS', DISABILITY, AND HEALTH INSURANCE

This portion of FICA, Federal Insurance Contribution Act, insures eligible workers and provides coverage for their dependents, against the possible financial losses that may occur due to the insured worker's premature death, disability and sickness. It also provides retirement benefits for the worker and spouse.

RETIREMENT BENEFITS

Until the year 2000, a covered worker may retire with full benefits at age 65. The normal retirement age will begin to increase, gradually, until it reaches age 67. Early retirees, prior the year 2,002, may begin receiving benefits at age 62 and receive 80%, reduced permanently, of their retirement amount at age 65. In the year 2002, early retirement will be available at age 62 and retirees will only receive 70% of their benefit at age 67.

Under present legislation, the normal retirement age for any covered worker born between the years 1937 and 1954 will increase by two months for each year, after 1937, when that person was born. For example, those individuals born in 1940, their normal full retirement age will be age 65 and six months. Covered individuals born from 1943 to 1954 may retire, with full benefits, upon attainment of age 66. Individuals born after 1954 will receive full Social Security Retirement benefits when they reach age 67.

The spouse of a fully insured worker may collect the greater of his/her own retirement benefit or 50% of the covered worker's benefit. They may commence a permanently reduced benefit at an earlier age.

Beginning in 1985, a divorced spouse could collect on their ex-spouse benefit only if they had been married for a minimum of 10 years AND the covered worker was fully insured and receiving retirement benefits from Social Security.

As this created problems when the insured worker was not retired, since late 1985, an ex-spouse may begin receiving benefits ONLY if they were married at least 10 years, had been divorced 2 years AND both parties are age 62 or older.

A dependent child or children of a retired worker may draw benefits:

1. *If the child is unmarried and below age 18.*
2. *If an unmarried child(ren) is below age 19 and is a full-time student in an elementary or secondary school.*
3. *Any unmarried child, age 18 or over, who is disabled and can prove they were disabled prior to their attainment of age 22.*

The spouse of a fully insured retired worker, who has not attained his/her 62nd birthday, may draw a benefit if they care for a child who is receiving a benefit. It is only applicable if that spouse is taking care of a child who is below the age of 16 or if that child is disabled and receiving a benefit.

QUALIFIED INDIVIDUAL AND CORPORATE PENSION PLANS

Corporate and Individual retirement plans have certain attributes in common that will allow deductibility of the premium payments. Most of these mutual characteristics are as follows:

1. The plan must be filed and approved by the IRS.
2. Plan cannot discriminate as to whom can participate.
3. Plan must be in writing and communicated to all eligible plan participants.
4. The plan must be sponsored by the employer.
5. Employer contributions to the plan, for the benefit of the employees, is not included in the employee's income UNTIL benefits are received by the employee.

PLANNING FOR INFLATION

In planning and preparing an individual should always consider what inflation would do to their income. An income level that is more than adequate at retirement is diminished by inflation as the years pass.

In planning for seniors one should focus on preserving spending power to assure that the quality of life during retirement will not be lessened since inflation erodes the value of a fixed amount of income.

HEALTH INSURANCE CONSIDERATIONS

As we all know, aging and declination of health go hand in hand. Medicare provides health care coverage for those individuals entitled with the exception of out patient prescriptions. There are gaps in their coverage that must be paid by the retiree and/or their Medicare Supplement policy.

Timely enrollment, in order to choose the Medicare Supplement policy desired, is of the utmost importance. Even if you are not licensed to sell these products, you should know about them so you can help your client make the proper and timely decision.

Another major concern is the growing need for **Long Term Care Insurance**. Consider that in 1940 one in five retirees lived twenty years past retirement. It is projected that by 2030 three out of five will live at least another twenty years past retirement.

It is very difficult to predict who will need long-term care, but there are studies that can help on the likelihood of needing such care. For example, one study projects that 43% of those people who turned age 65 in 1990, will enter a nursing home at some time during their life.

The same study shows that among all persons who live to age 65, only 1 in 3 will spend three months or more in a nursing home; about 1 in 4 will spend one year

or more in a nursing home; and only about 1 in 11 will spend five years or more in a nursing home. In other words, 2 out of 3 people who turned 65 in 1990 will either never spend any time in a nursing home or will spend less than three months in one.

The risk of needing nursing home care is greater for women than men; 13% of the women in this study, compared to 4% of the men, are projected to spend five or more years in a nursing home. Of course, the risk of needing nursing home care also increases with age. The chances of needing home health care are substantially greater than needing nursing home care.

CORPORATE PENSION PLANS

Corporate sponsored pension plans are installed by corporations for the benefit of their employees. Some of these plans may utilize annuities, whether group or individual, to fund their contributions on behalf of their employees.

These corporate sponsored plans can be classified either in terms of their contributions or the form in which benefits are to be received from the plan by participants. Below is a brief description of the plans.

A defined benefit plan has a formula, which is utilized to calculate the income to which the employee will be entitled at retirement. This type of plan is paid completely by the employer. The employer's contributions, along with the investment earnings are used to provide the benefit specified in the plan.

The plan will determine the employee's retirement benefit. Some of the most common formulas used are:

1. A Percentage of the annual earnings. This formula could pay a percentage, anywhere between 25 to 50 percent of the average annual compensation in the last 5 years of employment.
2. Flat amount for all employees. The provisions of the plan may say that each retiring employee will receive the same amount of retirement compensation, say \$400.00 or \$500.00 a month.
3. Percentage of the annual earning per each year of service. For example, a plan could provide that a retiring employee would receive 2% of his/her average annual earnings for each year of service, subject to a maximum. The maximum is usually 60 to 70 percent.
4. Flat amount based on the number of years employed. Such a plan may provide that a retiring employee would receive \$10.00, monthly, for each year of service to the company. If the employee had been employed at retirement for 25 years, then his/her monthly retirement benefit would be \$250.00.

As in all pension plans there are limits to the contributions that can be made on behalf of the employee. For example, the maximum benefit that the contribution may provide is 100% of average compensation of the individual's three highest years and subject to a maximum dollar amount. In 1988 the maximum dollar amount was \$90,000.00. (**\$185,000.00 in 2008!**)

INDIVIDUAL RETIREMENT ACCOUNTS (IRAS)

The new rules for tax deductible IRAs, as of January 1, 2011, are as follows:

An individual, not covered under an employer sponsored qualified retirement plan, can make a tax deductible contribution to an IRA. The maximum tax deductible contribution is defined as "the lesser of \$5,000.00 or 100% of compensation."

In 2011 even if an individual is covered under an employer's qualified plan, married and their adjusted gross income (AGI) is \$90,000.00 or less, each can make a full tax deductible contribution to an IRA. The deductibility phases out when their AGI exceeds \$90,001.00. and completely phases out when their income exceeds \$110,000.00

If both spouses work and NEITHER is covered under an employer sponsored retirement plan, each may make a contribution up to the maximum of the lesser of \$5,000.00 or 100% of compensation. If both are covered under a qualified plan and their adjusted gross income is \$53,000.00 or less, they can STILL make a tax-deductible contribution of \$5,000.00 each.

Any individual who is age 50 and above, may a \$1,000.00 "catch up" contribution.

If an individual makes contributions in excess of the maximum limit, the IRS will impose a 6% penalty on the excess contribution. The 6% penalty is imposed each year until the excess contribution is withdrawn or the taxpayer reduces the contribution to equal the amount of excess contribution made.

PROFIT SHARING PLANS

A corporation may decide to start a qualified profit sharing plan whereby contributions to the plan are made only if there are profits. In most cases, the amount of the contribution to be made on behalf of the participants is a share of the company's profits for that year and up to a certain percentage of each employee's compensation.

In the years where there is no profit made by the corporation a contribution may not be made by the employer. In these types of plans there no are guarantees in the benefit that will be paid upon retirement of the employees. There will be a lump sum of money at retirement to purchase a single premium immediate annuity.

In a profit sharing plan, the plan document will dictate what is to be done in the event of any forfeiture. Forfeitures are amounts that are not vested whenever an employee ends employment. The plan document may indicate that forfeitures are to be used to reduce the employer's contribution for that year or distributed among remaining employees. The limits on tax-deductible contribution by the employer are 15 percent of the total compensation of participating employees.

Along the same lines, the employer may decide to install a defined contribution plan. In this type of qualified plan the employer agrees to make a specific contribution on behalf of all eligible employees. The contribution is customarily expressed as a percentage of compensation. Most plans utilize a 5 to 10 percent contribution.

401(k) PLANS

The fastest growing Profit Sharing Plan for the past few years has been the Cash or Deferred Profit-Sharing Plan, known as 401(k) plans.

The employee elects to have a portion of his/her salary to be invested, in one or more tax-deferred vehicles, to provide funds for the retirement of the employee. The employer, to encourage participation, will usually match a certain percentage of the employee's contributions. For example, the plan document may read "we will match the employee contributions up to 6 percent of total compensation."

In this type of plan the employee is always fully vested in his/her contributions to the plan. The employer may have a 5-year vesting schedule for their matching contributions.

The maximum contribution, in 2011, that an individual may make to a 401(k) plan is \$16,500.00. "Catch up" contributions, limited to individuals aged 50 and above is \$5,500.00.

SIMPLE Retirement Plans

This legislation creates a new type of simplified pension plan for small employers that can be used with an IRA or as part of a 401(k) plan. The goal of the new Savings Incentive Match Plan for Employees (SIMPLE) is to encourage small employers to provide retirement coverage and to encourage employees to save for retirement. The SIMPLE plan allows employees to defer part of their salaries AND requires employer-matching contributions but does not require nondiscrimination testing.

A SIMPLE plan may be established by employers who do not maintain another qualified plan and who have 100 or fewer employees who received at least \$5,000.00 in compensation for the preceding year.

Employees may make elective salary deferral contributions of up to \$11,500.00 per year and employers are required to make matching contributions. Employees are 100% percent vested for all contributions - theirs and their employer's. "Catch up" contributions are limited to \$2,500.00

An employer may choose between two different contribution formulas when making the required matching contribution. The employer must match up to 3% of pay that employees set aside or contribute 2% of pay for all employees.

SIMPLE plans may be established as a SIMPLE IRA plan or as a SIMPLE 401(k) plan. SIMPLE plans are not subject to the nondiscrimination rules and top-heavy rules applicable to other qualified plans.

Distributions from SIMPLE plans are generally taxed just like IRA distributions, and are includible in an individual's income when withdrawn. Distributions from a SIMPLE plan may be rolled over to another SIMPLE plan or to an IRA.

Withdrawals made prior to age 59 1/2 are generally subject to the 10% premature distribution penalty. However, withdrawals made during the two-year period beginning on the date that the individual first began participating in the SIMPLE plan are subject to a 25% premature distribution Penalty.

EMPLOYEES OF NONPROFIT ORGANIZATIONS

The employees of certain nonprofit organizations that fall under the Internal Revenue Code as a Section 501(c) (3) organization may establish individual retirement programs called 403(b) plans.

This type of retirement vehicle was, and continues to be, geared primarily for employees of school systems, churches and not for profit hospitals.

Quite simply, the employee and employer enter into a salary reduction program. The amount of the reduction is equal to the contribution that is to be made to the retirement program where the contributions, as well as the interest earned, are deferred until distribution at retirement. The employee is then taxed at a lower marginal rate and his contributions are made by the employer to the retirement program.

In the majority of the cases all contributions to this type of retirement plan are made by the employee. The maximum allowable deductible contribution is 20 percent a year.

An annuity may be funded by the purchaser utilizing a single premium, also known as a single payment, or by making periodic payments. The payment may be derived from funds the annuitant inherited, received as a lump sum settlement or by utilizing the cash surrender value of his/her policy.

The purchaser may purchase and make "level premium payments" over a stated period of time. Some of the older annuity contracts required a set amount of money to be paid each year into the policy, similar to a whole life insurance policy. These contracts had a guaranteed value and received dividends.

With the advent of computerized annuity records, companies began marketing Flexible premium annuities. What characterized these types of policies is the flexibility in the amount and frequency of payments by the annuitant.

There is no guarantee of a stated amount at a certain age; instead, these policies have a "floor" (will earn a minimum amount of interest) and the company may credit any excess interest, usually on the anniversary date of the contract. The insurance company will accumulate the amounts paid in plus the accumulated interest that the annuitant may utilize to begin annuity payments.

Annuities may also be classified as deferred or as immediate. That is, the benefit (annuity payment to annuitant) is to begin immediately or deferred to some future date and/or event.

NON-QUALIFIED

A non-qualified annuity is a plan whereby the annuitant is paying premiums with "after tax dollars:" therefore, there is no tax deduction for the payment of premium for him/her.

An individual may purchase a non-qualified annuity for the primary purpose of supplementing their retirement and/or to allow the funds to grow tax deferred until annuitization.

A Corporation may utilize a non-qualified annuity as the funding vehicle for a Deferred Compensation benefit for corporate executives and/or key employees. Since the corporation can discriminate, choose a "select few" to participate, the plan is nonqualified. These plans should ALWAYS be reduced to writing between the employer and the employee(s).

The written document agrees to delay receipt of current compensation until disability, death or retirement of that employee. Quite simply, the employer "funds" the deferred compensation by purchasing and owning the annuity on the life of the key employee or executive.

As the plan discriminates in favor of the highly compensated individuals, the premium payments are not tax deductible to the corporation. However, the corporation may carry the cash value of the annuity as an asset.

The growth of the values, under present tax law, is tax deferred. The corporation receives a tax deduction whenever they transfer ownership to the individual and annuity payments begin. Upon receipt of the deferred compensation, later, the employee will be taxed on the amounts received as current income and the employer is allowed to deduct the amounts as present compensation that is being paid to the employee by the corporation.

Roth IRAS - Pros and Cons

The Roth IRA, which became effective January 1, 1998, can be a very attractive savings vehicle because income accumulates tax-free and qualifying withdrawals from a Roth IRA are not taxable. **Besides, Roth IRAs are not subject to the minimum distribution rules that apply to tax-deductible IRAs.**

The Roth IRA is only available to those taxpayers whose income does not exceed certain limits. Therefore, Roth IRAs will be of limited benefit for many high-income taxpayers.

Who can contribute to a Roth IRA?

Joint taxpayers whose adjusted gross income (AGI) is below \$169,000.00 and single taxpayers whose income is below \$107,000.00. However, the maximum amount that may be contributed to the Roth IRA is prorated based on their AGI.

Individuals may make, in 2008, non-deductible contributions up to \$5,000.00 per year to a Roth IRA. A taxpayer's ability to make contributions is phased out for adjusted gross income levels between \$107,000.00 and \$122,000.00 for single taxpayers and between \$169,000.00 and \$179,000.00 for married taxpayers filing a joint return. The maximum amount is reduced by the amount of contributions to a non-Roth IRA.

How much can be contributed to a Roth IRA?

Individuals may contribute up to the lesser of \$5,000.00 or 100% of earned income. A married couple with joint earnings of at least \$10,000.00 in a tax year can contribute as much as \$5,000.00 to each of their Roth IRAs for that year, EVEN IF one of them does not earn income. An individual may contribute to a Roth IRA even if you are an active participant in an employer's pension plan provided that your AGI is below the limits shown in the next question.

A great advantage to the Roth IRA is there is no age limits for contributing to a Roth IRA. Unlike the traditional IRAs, you may continue contributions even after age 70 1/2!

May I contribute to both a Roth and a traditional IRA?

Yes you may contribute to both types of IRAs as long as you meet the income eligibility and the total of your contributions to both types of IRAs do not exceed \$5,000.00 per individual. (**\$6,000.00 if over the age of 50**)

How Can I determine which IRA to make my contributions?

If you are eligible to make contributions to a tax deductible IRA and you expect to be in a lower income-tax bracket whenever you retire, then the traditional IRA may result in a greater after-tax accumulation of money at retirement.

If, on the other hand, at retirement you expect your tax bracket to be the same or perhaps higher, then a Roth IRA may be a better choice. If you are not eligible for a deductible contribution to a traditional IRA, contributions to a Roth IRA will be better than the non-deductible contributions to a traditional IRA.

The non-deductible IRA is the least attractive alternative of the three choices; yet, it offers tax-deferred accumulations. If you do not qualify for a Roth or a deductible traditional IRA, you should always consider making contributions to a non-deductible IRA.

Can I convert my traditional IRA into a Roth IRA?

Yes you can convert it in 2011 regardless of income. Whenever you convert (roll over) your traditional IRA into a Roth IRA you will have to pay taxes on the amount converted.

A special tax rule was applied to IRAs that were converted into a Roth IRA by December 31, 1998. This special rule allowed you to take the taxable income from the conversion of your traditional IRA into income prorated over the next four years. Therefore, it allows you to pay the income tax due over the next four years! The 10% early withdrawal penalty will not apply to any amount converted to a Roth IRA.

What is the tax treatment of Roth IRA distributions?

Qualified distributions from a Roth IRA are not included in the taxpayer's income and are not subject to the 10% premature distribution tax. To be considered a qualified distribution, the distribution must satisfy a five-year holding period and MUST meet one of the four requirements.

To fulfill the five-year holding period, the Roth IRA distribution may not be made before the end of the five-tax year period beginning with the first tax year for which the contribution was made to the Roth IRA. For example, if a contribution is made on April 15, 1999 for the 1998 tax year, the five-year holding period begins to run starting in 1998.

In addition to the five-year holding period, a qualified distribution must be:

- (1) made on or after the date on which an individual attains age 59 1/2.
- (2) made to a beneficiary (or to the individual's estate) on or after the individual's death.
- (3) attributable to the individual being disabled; or

- (4) a distribution to pay for "qualified first time homebuyer expenses". This last requirement also applies to Traditional IRA's in avoiding the 10% tax penalty on premature distributions.

Any other Roth IRA distribution is considered a non-qualified distribution. All distributions are treated as coming from your contributions first. Therefore, no portion of a distribution is treated as taxable income until all distributions have exceeded the total amount of contributions. Non-qualified distributions are treated as ordinary income and are also subject to the 10% tax penalty on premature (prior to age 59 1/2) distributions.

May I withdraw from a Roth IRA for education expenses?

Educational expenses that are categorized as "qualified higher education expenses" of the taxpayer, his/her spouse, or any child or grandchild of the taxpayer (or spouse) avoids the 10% penalty on premature distributions whether it is made from a Roth or a tax deductible IRA.

When must I begin distributions from a Roth IRA?

The minimum distributions that is required from a tax deductible IRA at age 70 1/2 **does NOT** apply to the Roth IRA. You may keep your money in the Roth IRA until you die. If your spouse is the designated beneficiary, the spouse also does not have to take a minimum distribution.

Upon the second spouse's death, the value in your Roth IRA must be distributed at least over the beneficiary(ies) lifetime. However, as with traditional IRAs, beneficiaries can always take more than the minimum distribution.

IF an individual makes a withdrawal from either a qualified or non qualified IRA prior to age 59 1/2 the amount of the "premature distribution" is subject to a 10% penalty in addition to the tax due on the amount received.

If an individual makes contributions in excess of the maximum limit, the IRS will impose a 6% penalty on the excess contributions. The 6% penalty is imposed each year until the excess contribution is withdrawn or the taxpayer reduces the contribution to equal the amount of excess contributions made.

If an individual makes a withdrawal from either the qualified or non qualified IRA prior to the attainment of age 59 1/2 the amount is subject to a 10% penalty AND the tax due on the amount received.

ANNUITY SETTLEMENT OPTIONS

Settlement options may be used by the policyowner, beneficiary or annuitant to pay out the proceeds from a policy contract. The amount of the proceeds that are to be paid out in installments is determined by the settlement option selected.

Whenever the proceeds are derived from death benefits, usually, the policyowner (in most cases he/she is also the insured) will select the settlement option to be utilized for the benefit of the beneficiary. In the event of a lump sum settlement, the beneficiary may elect one or more of the settlement options available and supported by an insurance company.

By utilizing an annuity payout by the insurance company, the policyowner can prevent the beneficiary from foolishly spending all the money. He can provide for monthly payments and not give the right to commute the balance until a later date, usually upon reaching the age of majority.

A great advantage of utilizing a settlement option is the Spendthrift Clause. Just as the insured's creditors cannot get to the death proceeds, unless the beneficiary is the insured's estate; the beneficiary's creditors cannot get to the principal, nor to the monthly benefit, if annuity payments are being made by the company on a regular basis.

Annuity payouts (settlement options) can be classified into those who involve a life(s) contingency and those that do not. Below is an explanation of the most widely utilized and those that are seldom used.

Interest only settlement option is selected by those individuals who do not want to touch the principal and just receive interest payments. Usually these payments are made on the monthly basis. By using this option, the annuity will pay a guaranteed minimum amount of interest, such as 3 to 4 percent. The company may declare excess interest that could be utilized to increase the amount of payment or increase the principal.

Whenever an Annuity Certain is chosen, the annuitant is guaranteed income for a certain period or amount. This guaranteed period or amount can range anywhere from 5 to 30 years. Of course, the longer the guaranteed period is, the lower the payment that will be received. Conversely, the larger the amount the shorter the period.

The payments will continue even if the annuitant dies prematurely. The annuitant designates a beneficiary who will receive the balance of the proceeds for the remaining guaranteed period. The annuitant can live longer than the guaranteed period outliving his/her retirement benefit.

LIFE CONTINGENCY PAYOUTS

Although rarely used, an individual may select to receive his annuity as a Temporary Annuity. This type of annuity provides for a specified period of time (such as 10 or 15 years), or until annuitant dies... whichever of these two possibilities occurs first!

This type of annuity does not guarantee a period nor does it guarantee payments for the lifetime of the annuitant. This type of annuity usually provides for a higher monthly payout since the annuitant is taking a greater risk.

LIFE ONLY ANNUITY

Commonly referred to as a straight life annuity, this type of payout provides for an annuity benefit that will be paid for the lifetime of the annuitant.

The annuitant is taking all the risks. He/she must live long enough to collect, at least, an amount equal to the amount invested in the annuity. In the event of his/her premature death, payments cease altogether; therefore, the payout amount will be the highest.

REFUND ANNUITY

The refund annuity option provides for the annuitant to receive annuity payments for the rest of his/her life if he/she lives longer than the guaranteed amount.

By selecting this option the annuitant will be, at least, assured that his/her total investment (amount utilized to provide the annuity) in the contract will be paid out.

In the event of premature death, the annuitant will elect a beneficiary to receive the balance of the proceeds until the total amount paid out to the original annuitant and his/her beneficiary will receive an amount equal to what used by the insurance company to provide the annuity payments.

The annuitant may provide, if allowed by the insurance company, the beneficiary with the right to commute the value of his annuity. In other words, the beneficiary could elect to receive a lump sum settlement of the present value of future payments.

PERIOD CERTAIN AND LIFE THEREAFTER

When an annuitant chooses the life with period certain annuity, he/she is guaranteed an annuity for the rest of his/her natural life; however, to safeguard against premature death the annuitant can elect a period of years where the insurance company will continue payments to a named beneficiary until payments have been made to the annuitant and the beneficiary for the guaranteed number of years.

The longer the guaranteed period is, of course, the lower the payment that is going to be made to the annuitant. You can choose from 5, 10, 15, 20 or more years for the guaranteed period. In actuality, most individuals choose the 10-year certain period. Most likely, it is because the average life expectancy for a male age 65 is a little over 10 years; therefore, you have a guaranteed period equal to the average life expectancy and the assurance that payments will continue for as long as you are alive.

JOINT AND SURVIVOR ANNUITY

This form of annuity payout was designed and calculated based on the life expectancy of two individuals, usually husband and wife, with the annuity payments being continued until both annuitants have died.

The annuitant can choose from many different payout options. For example, if they choose the "survivor 100%", payments will continue to the survivor for the same amount. However, if they choose the survivor and 2/3, then the survivor will only receive 2/3 of the annuity amount upon the death of the death of the first annuitant.

Joint and Survivor Annuity should not be confused with a Joint Life Annuity. The latter only provides payments to be continued while both annuitants are alive. Upon the death of one annuitant payments cease for the survivor.

Since the mid 1980s any annuity payout from a qualified pension plan must include this valuable settlement option. If the spouse is to be excluded from receiving any benefits from the retirement plan, such as provided under the joint and survivor annuity option, then he/she must give the "spousal consent" in writing to the Trustee.

It is strongly suggested to any trustee when the spouse is to be left out from receiving any survivor benefits, that their signature in the document, where he/she gives the consent, must be notarized.

GENERAL RULES ABOUT TAXATION OF ANNUITIES

Before proceeding, let's make clear that the ensuing items are our understanding of taxation of distributions based on our understanding and readings. IT IS NOT TO BE INTERPRETED AS PROVIDING YOU WITH TAX OR LEGAL ADVICE. We strongly suggest that in each individual situation that you or your client should consult your individual tax advisor or legal counsel.

The statutes in Section 72 of the Internal Revenue Code dictates the income taxation of all and any amounts received under an annuity contract by the annuitant is dictated by the laws found in Section 72 of the Internal Revenue Code under the heading of Annuity Rules.

From the beginning let us understand that any interest payment only, and not a part of a systematic liquidation of the principal, are not, under Section 72, considered annuity payments. Any payment of interest alone is fully taxable to the payee.

PREMATURE DISTRIBUTIONS

To prevent the use and abuse of annuities, as a short-term tax deferred investment vehicle, legislation was enacted to impose a 10% tax penalty on many "premature distributions." This penalty applies to both qualified and non-qualified annuities as well as some life insurance contracts deemed to be Modified Endowment Contracts.

When an annuity contract is fully surrendered during the accumulation phase, the owner must pay income tax on the earnings in the contract. The owner is not taxed on amounts that represent a return of contributions (such as investment or premiums in the contract).

Partial withdrawals, including policy loans, from an annuity in the accumulation phase are taxed on a last in, first out (LIFO) basis. Simply stated, withdrawals from the annuity are made earnings first and the owner is taxed on the payments until all of the earnings have been distributed.

There is one exception to the earnings first rule for contribution made to annuity contracts prior to August 14, 1982. These contributions are distributed as first in, first out (FIFO) basis and the owner is not taxed on the earnings until the contributions made are paid out.

The penalty does not apply if the annuitant is 59 1/2 or older on the date the distribution is made, nor does it apply if any payment is attributable to the death or the annuitant becoming disabled, or if the payments (distributions) are made in a series of equal payments over the life expectancy of the annuitant, or joint lives or joint life expectancy of the annuitant and beneficiary .

The penalty, also, does not apply if the distribution arises from the purchase and the annuitization of an immediate annuity or if the distribution is attributable to investment(s) in the annuity made prior to August 14, 1982.

While there are few other exceptions, these will be the one that you will encounter most often.

QUALIFIED VERSUS NON QUALIFIED ANNUITIES

As a general rule, the annuitant will not have a "cost basis" in a qualified plan. As you will remember, "cost basis" is that amount of money that exceeds the investment (premiums) in the contract. This rule applies, whether the annuitant is a regular employee of the corporation or whether he is self-employed.

Remember, if you are self-employed and make contributions to an IRA or a Keogh plan, most likely, you have deducted these contributions from your taxes in the year they were made. Hence, all contributions to these retirement plans have been made with "pre-tax" dollars.

The actual taxation of distributions made under a non-qualified annuity necessitates the separation as to what is "investment" (amount paid into the annuity) and interest the money earns on the tax deferral basis. This is accomplished by calculating the exclusion ratio". Quite simply, this formula separates the taxable and non-taxable amount of each payment.

The exclusion ration for a fixed annuity is the ratio the investment in the contract bears to the expected return under the contract. The expected return is the annual amount to be paid to the annuitant multiplied by the number of years of life expectancy using annuity tables defined by the Internal Revenue Service.

The following illustration will help you understand the exclusion ratio. Assume John Smith, now age 70, has invested \$100,000.00 into his contract. The current value in the contract is \$150,000.00. The annuity table indicates his life expectancy is 16 years. The monthly payment, based on the age and annuity table, is \$1225.17:

$$\text{Exclusion Ratio} = \frac{100,000}{1,225.17 \times 12 \times 16} = 42.5\%$$

Monthly payment	Non-taxable	\$520.70	=(42.5% X 1,225.17)
	Taxable	\$704.47	=(57.5% X 1,225.17)
	total	\$1,225.17	

The exclusion ratio for an annuitant whose annuity payments started after December 31, 1986 applies to all payments received until the payment in which the investment in the contract is fully received. In that payment the only amount that is not included in his/her taxes is restricted to the balance of the unrecovered investment. All future payments received are fully taxable to the annuitant.

Different tax consequences apply depending on the date the annuity was started. If the annuity starting date was before January 1, 1987, the exclusion ratio will apply to all payments received throughout the entire payment period even though the annuitant may have recovered his/her investment.

Consequently, it is quite possible, for a long-lived annuitant, to receive tax-free amounts, which, in totality, will be more than his/her investment in the annuity contract.

The exclusion ratio for a **variable annuity** is determined by dividing the investment in the contract by the total number of expected payments. The same as you would do for a fixed annuity.

If, however, losses in the portfolio result in monthly payments that are less than the excludable amount, then the investment in the contract for future payments is recalculated by deducting the amount by which the nontaxable portion is greater than the payment received. Simply stated, any loss incurred on the separate accounts is taken into consideration in the computation of the taxable gain.

Once the total amount of the investment in the contract is recovered using the exclusion ratio, the annuity payments are fully taxable.

COLLATERAL ASSIGNMENTS

Those policyowners who assign their annuity contracts as collateral for loans may be surprised by the treatment of assignments. Generally, any amount collaterally assigned, pledged or received as a loan under an annuity issued after August 13, 1982 is treated as if it was distributed from the annuity.

The amount collaterally assigned is taxed according to the rules applicable to partial withdrawals and full surrenders. The amount may also be subject to the 10% penalty tax. If the entire contract is assigned or pledged, then earnings subsequently credited to the contract are automatically deemed subject to the assignment or pledge and are treated as additional partial withdrawals.

UPON THE OWNER'S DEATH

If the policyowner dies after the annuitization (payouts) has begun, the remaining payments, if any, must be paid out at least as rapidly as under the annuity payout option that was in effect at the time of the owner's death.

If a beneficiary receives the remaining payments under the annuity payout option in effect at the owner's death, the taxable and nontaxable portions of such payments will continue to be determined by the original exclusion ratio.

If the policyowner dies during the accumulation phase, the entire death benefit must be distributed within five years of the date of death of the owner. There is, however, an exception to the five-year rule if the death benefit is paid as an annuity over the life, or a period not longer than the life expectancy, of the beneficiary and the payments start within one year of the owner's date of death. If the annuity contract has joint owners, (such as husband and wife) the distribution at death rules applied upon the first death.

There is a special exception to the distribution at death rules, if the beneficiary is the surviving spouse of the owner. The annuity may be continued with the surviving spouse as the new owner of the annuity.

If the owner of the annuity is a non-natural owner, such as a corporation, upon the annuitant's death the distribution at death rules, as discussed above, are applicable. Further, the distribution at death rules are also triggered by a changed in the annuitant on an annuity contract owned by a non-natural person.

Unlike death proceeds paid from life insurance policies, which are received tax free, the beneficiary may be taxed on distributions made from an annuity after the owner's death. Amounts paid under the five-year rule are taxed in the same manner as partial withdrawals or full surrenders, and amounts paid under an annuity option are taxed in the same manner as annuity payments.

As you can see, working in retirement planning demands a wide range of product, taxes, and tax qualified plans and governmental benefits. Keep in mind that retirees do not have the time to "make up" financial losses incurred due to improper advise or products.

You may work closely with your clients' attorney and/or financial advisors to maximize the income and tax breaks available to your clients. You should be knowledgeable about taxes, trusts and wills; however, you should leave legal and tax questions to the experts.