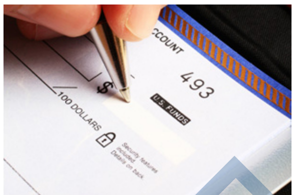
How a Roth IRA Works



Account Owner

- Contributions are not tax deductible.
- Total annual contribution is limited.[1]
- Annual contribution limits are coordinated with any traditional IRA.

ROTH IRA ACCOUNT

- May be opened anytime between January 1 of current year until due date of tax return.
- Traditional IRA can be converted to a Roth IRA.[2]
- Earnings accumulate tax deferred.
- Account is usually self-directed (owner controls investments).
- A separate spousal Roth IRA may be established for a spouse with little or no earned income.

QUALIFIED DISTRIBUTIONS

- Qualified distributions are tax-free if a five-year holding period is met and one of the following applies: the owner is over 59½, dies, becomes disabled, or the distribution is for up to $10,000 of qualified first-time homebuyer expenses.

RETIREMENT

- Assuming compensation, contributions may continue to any age.
- No mandatory age for starting withdrawals.
- No minimum distributions required while owner is alive.
- Qualified distributions are received free of federal income tax.

DEATH

- Value of Roth IRA is included in owner's federal gross estate.
- If five-year holding period is met, beneficiaries receive funds free of federal income tax.
- A surviving spouse may choose to treat an inherited Roth IRA as his or her own.

[1] The maximum annual contribution is the lesser of $6,000 ($12,000 for a married couple) or 100% of compensation. For married couples, no more than $6,000 may be contributed for either spouse. For a Roth IRA owner age 50 or older, an additional $1,000 may be contributed ($2,000 if the spouse is also age 50 or older). The maximum annual contribution to a Roth IRA is phased out for individuals with incomes in excess of certain limits.

[2] The conversion is a taxable event. Gross income is increased by previously deducted contributions, plus net earnings or minus net losses. A completed conversion may not be reversed.

Roth IRAs

The Roth IRA differs from the traditional IRA in that contributions are never deductible and, if certain requirements are met, account distributions are free of federal income tax.[1]

Funding a Roth IRA

Annual contributions: A Roth IRA may be established and funded at any time between January 1 of the current year, up to and including the date an individual's federal income tax return is due, (generally April 15 of the following year), not including extensions.

Conversion of a traditional IRA account: A traditional IRA may be converted to a Roth IRA, with the conversion being a *taxable* event. For the year of conversion, the taxpayer must include in gross income previously deducted contributions plus net earnings (or minus net losses). For individual retirement annuities, gross income is generally increased by the fair market value of the contract on the date of conversion (through a re-designation) or distribution (if held inside an IRA). If a retirement annuity is completely surrendered, the cash received is the amount includable in income. Any 10% penalty tax for early withdrawal is waived. However, if a taxpayer withdraws amounts from the Roth IRA within five years of the conversion, the 10% penalty tax will apply to those amounts deemed to be part of the conversion, unless an exception applies.

Recharacterized Contributions

In certain situations, a taxpayer who contributes to one type of IRA may "recharacterize" the contribution as if it were made to another type of IRA. For example, a taxpayer who contributes to a traditional IRA can recharacterize the contribution as if it had been made to a Roth IRA, and vice versa. Prior to 2018, a taxpayer who converted a traditional IRA to a Roth IRA could "unwind" the conversion, recharacterize the converted funds, and move them back into a traditional IRA. However, for tax years beginning in 2018, the Tax Cuts and Jobs Act of 2017 (TCJA) repealed the ability to recharacterize a Roth conversion to a traditional IRA.

[1] Income tax treatment of Roth IRAs at the state or local level may differ.

Rollovers from a qualified plan: Distributions from qualified retirement plans, IRC Sec. 457(b) governmental plans, and IRC Sec. 403(b) plans may also be rolled over to a Roth IRA.

These conversions are taxable events, with gross income for the year of conversion being increased by previously deducted contributions plus net earnings (or minus net losses).

Direct rollover from a designated Roth Account: Funds may be rolled into a regular Roth IRA from a designated Roth account that is part of a 401(k), 403(b), or 457(b) governmental plan. Such a rollover is not a taxable event and the filing status and MAGI limitations normally applicable to regular Roth contributions do not apply.

Military death payments: Under the provisions of the Heroes Earnings Assistance and Relief Tax Act of 2008, an individual who receives a military death gratuity and/or a payment under the Servicemembers' Group Life Insurance (SGLI) program may contribute to a Roth IRA an amount no greater than the sum of any military death gratuity and SGLI payment. Such a contribution is considered a qualified rollover contribution and must be made within one year of receiving the death gratuity or insurance payment. The annual dollar contribution limit and income-based phase-out of the dollar contribution limit do not apply to such contributions.

Type of Arrangements Permitted

There are currently two types of Roth IRAs.

- **Individual retirement accounts:** Trusts or custodial accounts with a corporate trustee or custodian.
- **Individual retirement annuities:** Special annuities issued by a life insurance company.

Contribution Limits

Limits: For 2022, an individual may contribute (but not deduct) the lesser of $6,000 or 100% of compensation[1] for the year. For a married couple, an additional $6,000 may be contributed on behalf of a lesser earning (or nonworking) spouse, using a spousal account.

[1] "Compensation" includes taxable wages, salaries, or commissions or the net income from self-employment.

A husband and wife may contribute up to a total of $12,000, as long as their combined compensation is at least that amount.[1] If an IRA owner is age 50 or older, he or she may contribute an additional $1,000 ($2,000 if the spouse is also age 50 or older).

Other IRAs: The contribution limits for a Roth IRA are coordinated with those of a traditional IRA; a taxpayer may not contribute more than the annual limit for that tax year into a single IRA or a combination of traditional and Roth IRAs. Excess contributions to a traditional or Roth IRA are subject to a 6% excise tax.

Contribution phase out: For 2022, the maximum contribution to a Roth IRA is phased out for single taxpayers with MAGI between $129,000 and $144,000. For married couples filing jointly, the phase-out range is a MAGI of $204,000 to $214,000. For married individuals filing separately, the phase-out range is a MAGI of $0 to $10,000.[2]

Taxation of Distributions

A distribution from a Roth IRA that is a "qualified" distribution is excluded from gross income and is not subject to federal income tax. A distribution is qualified if it is made after a five-year waiting period[3] and at least one of the following requirements is met:

- after the taxpayer reaches age 59½; or
- due to the taxpayer's death; or
- because the taxpayer becomes disabled; or
- to pay for first-time-home-buyer expenses up to $10,000.

The **earnings** portion of a "non-qualified" distribution is subject to tax. To determine any taxable distribution, the funds are considered to be withdrawn in a specified order:

- Any withdrawal is considered to come first from nondeductible **contributions**, which are not subject to tax.

[1] These amounts apply to 2022. For 2021, the maximum allowable contributions were also $6,000 for a single individual and $12,000 for a married couple.

[2] For 2021, the phase-out ranges were: (1) MFJ – MAGI of $198,000 - $208,000 and (2) Single - $125,000 - $140,000. For those using the MFS filing status, the phase-out range is $0 - $10,000, which does not change.

[3] Generally, five years after a contribution is first made, or amounts are converted to a Roth IRA.

- After all contributions have been withdrawn, any **conversion** amounts are considered next. A distribution of converted funds is not included in gross income, but may be subject to the 10% premature distribution penalty if the funds are withdrawn within five years of being converted.

- Once all contributions and conversions have been withdrawn, any remaining funds are deemed to be **earnings**, and, when distributed, are included in gross income.

Premature Distributions

If a **taxable** distribution is received prior to age 59½, a 10% penalty tax is added to the regular income tax due, unless one or more of the following exceptions apply:

- A distribution is made because of the death or disability of the account owner.
- A withdrawal is part of a scheduled series of substantially equal periodic payments.
- A distribution is rolled-over into another Roth IRA.
- A withdrawal is used to pay for deductible medical expenses.
- The distribution is used to pay for certain qualified higher-education expenses.
- Amounts are withdrawn to pay for first-time homebuyer expenses of up to $10,000.
- In certain situations, to pay health insurance premiums for unemployed individuals.
- Distributions by certain military reservists called to active duty after 09/11/2001.
- A distribution is transferred to a Health Savings Account (HSA).
- In case of an IRS levy on the account.
- To pay expenses (up to $5,000 per parent) related to the birth or adoption of a child.
- A distribution was a Coronavirus-related distribution.
- Certain disaster related distributions.

Coronavirus-related distribution (CRD)

One section of the Coronavirus Aid, Relief, and Economic Security (CARES) Act provided for a "Coronavirus-related distribution," or CRD. A CRD – optional (not mandatory) for a qualified retirement plan sponsor – was a distribution made from January 1, 2020, through December 30, 2020, from an IRA or qualified retirement plan. A CRD could not exceed $100,000 in aggregate per individual, was exempt from the usual 20% mandatory federal income tax withholding, and must have been made to an individual (or spouse or dependent) who was diagnosed with SARS-CoV-2 or COVID-19, or who experienced an adverse financial consequence as a result of the COVID-19 pandemic. A CRD was exempt from any 10% early withdrawal penalty that may have applied and, unless the individual chose otherwise, the CRD could be included in taxable income ratably over a three-year period. A CRD may be re-paid, without regard to the normal contribution limits, over a three-year period.

Distribution Requirements

Roth IRAs are not subject to the mandatory required minimum distribution (RMD) rules during the life of the owner (triggered at age 72), applicable to traditional IRAs.[1] However, there are mandatory distribution requirements applicable to non-spouse beneficiaries who *inherit* a Roth account.

Qualified Charitable Distributions (QCD)

Federal income tax law provides for an exclusion from gross income of up to $100,000 for distributions made from a Roth or traditional IRA *directly* to a qualified charitable organization. Such a distribution is known as a Qualified Charitable Distribution, or QCD. The amount excluded from gross income may be reduced if an individual continues to make deductible IRA contributions after reaching age 70½. If applicable, a QCD counts towards the taxpayer's RMD requirements. The IRA owner (or beneficiary of an inherited IRA) must be at least age 70½ when the distribution is made. No charitable deduction is allowed for a QCD.

[1] The age 72 "trigger" date applies to distributions required to be made after December 31, 2019, to individuals who reach age 70½ after that date. Under prior law, age 70½ was the mandated age for beginning RMDs.

Transfers to Health Savings Accounts (HSAs)

Federal law allows for a limited, one-time, direct transfer of funds from an IRA to an HSA. If certain requirements are met, any otherwise taxable portion of the distribution is excluded from income and the 10% early distribution penalty will not apply.

Investment Alternatives

- **Banks, savings and loans, credit unions:** Certificates of deposit in Roth IRAs are generally insured by either the FDIC or the NCUA for amounts up to $250,000. Fixed and variable rates are available. There may be stiff penalties for early withdrawal.
- **Annuities:** Traditional, fixed individual retirement annuities issued by life insurance companies can guarantee fixed monthly income at retirement and may include a disability-waiver-of-premium provision. Variable annuities do not guarantee a fixed monthly income at retirement.
- **Money market:** Yield fluctuates with the economy. Investor cannot lock in higher interest rates. It is easy to switch to other investments.
- **Mutual funds:** A wide variety of mutual funds with many investment objectives are available.
- **Zero coupon bonds:** Bonds are issued at a deep discount from face value. There are no worries about reinvesting interest payments. Zero coupon bonds are subject to inflation risk and interest rate risk.
- **Stocks:** A wide variety of investments (and risk) is possible. Losses are generally not deductible.
- **Limited partnerships:** Some limited partnerships are especially designed for qualified plans, specifically in the areas of real estate and mortgage pools.

Prohibited Investments or Transactions

- **Life insurance:** Roth IRAs cannot include life insurance contracts.
- **Loans to IRA taxpayer:** Self-borrowing triggers a constructive distribution of the entire amount in an IRA.

- **Collectibles:** Purchase of art works, antiques, metals, gems, stamps, etc., will be treated as a taxable distribution. Coins issued under state law and certain U.S. gold, silver and platinum coins are exceptions. Certain kinds of bullion may be purchased.

Other Factors to Consider

- What is the yield? More frequent compounding will produce a higher return. Is the interest rate fixed or variable? If interest rates drop, a fixed rate may be better, especially if you can make future contributions at the same fixed rate. If interest rates go up, you may be able to roll the account to another Roth IRA.
- How often can you change investments? Is there a charge?
- Refunds of federal income taxes may be directly deposited into an IRA.
- Federal bankruptcy law protects assets in Roth IRA accounts, up to $1,362,800.[1] Funds rolled over from qualified plans are protected without limit.

[1] Effective April 1, 2019. The limit is indexed for inflation every three years.

Do You Desire "Retirement Peace of Mind?"

In December, 2012, a landmark study was launched to determine a national retirement peace of mind.[1] It included more than 6,000 respondents age 45 and older. It found that average Americans have a lot of challenges and a lot of expectations for their retirement years.

Retirement Expectations

Traditionally, many Americans have viewed retirement as a time of leisure. Today, more and more of us expect to work during our retirement years. Seven out of ten of those surveyed in the study said that their ideal plan for balancing work and leisure in retirement would be to include some work.

The reasons are not purely economic. Many Americans see retirement as a time for renewal and accomplishment. When asked if they would seek the same kind of work in retirement or pursue a different career, half of those surveyed said they would seek a different line of work.

A desire for more money and economic security was the most important reason for working in retirement according to a majority of the survey participants, but 48 percent said a desire for stimulation and satisfaction was their top reason for continuing to work during retirement.

When asked about their most important financial goal, 88 percent said they would like to save enough money to have financial peace of mind, versus 12% who said they would like to accumulate as much wealth as possible.

Retirement Challenges

The study also sought information on the greatest concerns facing those nearing retirement. Not surprisingly, in today's complex economic and social climate, they found many complications that could make the task of retirement planning even more challenging.

- **Health problems:** Americans are expected to live longer than ever before. When asked what concerned them about living a long life, 72% of those surveyed said they feared

[1] "Americans' Perspectives on New Retirement Realities and the Longevity Bonus, a 2013 Merrill Lynch Retirement Study, conducted in partnership with Age Wave." © 2013 Bank of America; All rights reserved

serious health problems, making it the top retirement worry. This compares with 47% who said they worried they would run out of the money they need to live a comfortable retirement.

There is good reason for concern. The study found that the top reason for early retirement given by those already retired was due to personal health problems. Fully 57% of study participants who had already retired reported they retired earlier than they had planned.

- **Caring for family members:** More and more Americans today are left caring for others in their families: adult children, grandchildren, parents or in-laws, siblings. These Americans are often referred to as the “Sandwich Generation”, finding their own needs for saving and retirement security squeezed by the needs of others they love.

Among study participants aged 45 or older with children, over half said they expected to have to continue to provide support to adult children. More than a third expected to have to support grandchildren. Fewer said they expected to have to support parents (16%) or their siblings (10%).

The types of support they expected to provide included financial support (cash or loans), housing (sharing a home or helping pay for housing), education and healthcare. The study also found a relationship between income and expectations for providing support: participants with higher incomes were two times more likely to say they expected to provide support to their adult children, grandchildren and parents than those with lower incomes.

Do You Have “Retirement Peace of Mind?”

The study tried to determine how close participants were to achieving retirement peace of mind by asking them to respond to these survey questions:

Question
• I feel content and comfortable about how I will spend my retirement years.
• I have many worries about what might happen during my retirement.
• Thinking about my retirement gives me feelings of security and stability.
• I feel anxious and uneasy about how I will support myself and my family during retirement.
• I feel well prepared for whatever may happen during my retirement.

Do You Desire "Retirement Peace of Mind?"

The study found that participants had an average score of 5.3, based on a scale of 1 to 10, or slightly above average. Scores varied, though, by gender, the amount of savings, and if the participant worked with a financial professional.

- Men were more likely than women to have retirement peace of mind. The average score for male participants was 5.6 while female participants averaged 5.0.
- Participants with $500,000 or more in investable savings averaged a score of 7.5 while those with under $250,000 in investable savings averaged 4.8.
- Participants who worked with a financial professional at the time of the study had an average score of 6.3, while those who did not work with a financial professional had a score of 4.7.

How Can You Improve Your Retirement Peace of Mind?

The results of the national study suggest several steps you can take today to improve your peace of mind during retirement:

- **What is your most important financial goal?** Are you like the 88 percent who said they would like to save enough money to have financial peace of mind? Or, are you more like the 12% who said they would like to accumulate as much wealth as possible? The answer may help determine your retirement savings and investment strategy.
- **Do you intend to work during retirement?** Will you stay in the same line of work, or start a new career… maybe even a business of your own? If you do intend to work, it could affect the Social Security benefits for which you qualify. You will want to research the impact carefully.
- **What will you do for personal satisfaction?** While a desire for more income and security was the top reason for working in retirement, almost half of the study participants said they intended to do so for personal stimulation and satisfaction. What will you do for stimulation and satisfaction? Do you wish to travel? Start a new career? Volunteer in your community? Whatever your choices, look carefully to see how they may affect your retirement savings goals. Do you need to save money to start a business? To complete a college education? To travel?
- **Are you prepared for any personal healthcare issues that could arise?** Problems with personal health lead more people to retire earlier than planned more than any other

cause. Do you understand your medical care and long-term care options? Does your employer offer extended healthcare benefits to retirees or will you be required to provide your own? Is disability insurance appropriate for your situation?

- **Do you have any other family obligations to consider?** More and more retirees today find they must continue to provide financial support for their adult children, grandchildren, parents or siblings. Are you supporting family members today? Do you intend to support family members during retirement? How is supporting family today affecting your ability to save for retirement? Are there other strategies you should consider? Is life insurance something you should consider to help care for survivors or heirs?
- **Would you benefit from professional financial advice?** Participants in the nation-wide study reported overall higher levels of retirement peace of mind when they worked with a financial professional. Would discussing your retirement goals and challenges with a professional help you?

Whatever your expectations for retirement, like all important things in life, it pays to have a plan to achieve them and to regularly measure your progress towards your goals.

An Overview of Social Security Benefits

What Is Social Security?

Social Security is a system of social insurance benefits available to all covered workers in the United States. Begun in 1937, the Social Security system covers a wide range of social programs. The term "Social Security," as it is commonly used, refers to the benefits provided under one part of the system, known by its acronym, OASDI, or Old-Age, Survivors, and Disability Insurance.

OASDI benefits are funded primarily by payroll taxes paid by covered employees, employers, and self-employed individuals. Both the OASDI portion of the payroll tax, as well as that part of the tax that goes to finance hospital insurance, HI (Medicare), are provided for under the Federal Insurance Contributions Act, FICA.

Insured Status

To qualify for benefits, a worker must be either "fully" insured or "currently" insured. An insured status is acquired by earning "credits", based on the wages or self-employment income earned during a year. In 2022, an individual must earn $1,510 in covered earnings to receive one credit and $6,040 to earn the maximum of four credits for the year.

A worker generally becomes fully insured by earning 40 credits, typically by working 10 years in covered employment.[1] To be considered currently insured, a worker must have at least six credits in the last 13 calendar quarters, ending with the quarter in which he or she became entitled to benefits.

All benefits are available if a worker is fully insured. Some benefits are not available if the worker is only currently insured. Special requirements apply to disability benefits.

What Benefits Are Available?

- **Worker's benefit:** This is a monthly income for a retired or disabled worker.
- **Spouse's benefit:** Refers to monthly income for the spouse or former spouse of a retired or disabled worker.

[1] For those working less than 10 years, an alternative test to determine fully-insured status may apply.

- **Widow(er)'s benefit:** Refers to monthly retirement income for the surviving spouse or former spouse of a deceased worker.
- **Child's benefit:** A monthly income for the dependent child of a deceased, disabled, or retired worker. To qualify, a child must be under age 18, or 18 or 19 and a full-time elementary or high school student, or 18 or over and disabled before 22.
- **Mother's or father's benefit:** Monthly income paid to a surviving spouse who is caring for a worker's dependent child who is under age 16 or disabled before age 22. If under age 62, the spouse of a retired worker receives the same benefit.
- **Parent's benefit:** Monthly income paid to the surviving dependent parent or dependent parents of a deceased worker.

On What Is the Amount of a Social Security Benefit Based?

In general, a covered worker's benefits, and those of his or her family members, are based on the worker's earnings record. The earnings taken into account are only those reported to the Social Security Administration (SSA), up to a certain annual maximum known as the "wage base." The wage base is indexed for inflation each year and effectively places a cap on the amount of Social Security benefits a worker can receive, regardless of earnings. The wage base for 2022 is $147,000.[1]

Using a worker's earnings record, the SSA calculates a number known as the Primary Insurance Amount, or PIA. The PIA is the basic value used to determine the dollar amount of benefits available to a worker and his or her family.

What Is the Benefit Amount?

The table below summarizes the benefit amounts generally payable under OASDI in the event of a worker's death, disability, or retirement. All monthly benefit amounts are subject to reduction to meet a "family maximum" limit. Individual benefits may also be reduced if the recipient has earned income in excess of specified limits.

[1] The wage base for 2021 was $142,800.

An Overview of Social Security Benefits

	Death[1]	Disability[2]	Retirement[3]
Worker's benefit		100% of PIA	100% of PIA
Spouse's benefit	N/A	50% of PIA	50% of PIA
Widow(er)'s benefit	100% of PIA	N/A	N/A
Child's benefit	75% of PIA	50% of PIA	50% of PIA
Mother's or father's benefit	75% of PIA	50% of PIA	50% of PIA
Parent's benefit	82.5% of PIA[4]	N/A	N/A

Workers age 60 or older and who are not receiving Social Security benefits automatically receive a paper Social Security Statement each year, listing the worker's earnings as well as providing estimated retirement, disability, and survivors benefits.

Earnings information may also be verified by calling the SSA directly at (800) 772-1213; TTY (800) 325-0778, Monday through Friday, 7:00AM to 7:00PM. On the internet, the SSA can be found at https://www.ssa.gov/.

[1] Reduced widow(er)'s benefits are available at age 60.
[2] Disability benefits are subject to a very strict definition of disability. At full retirement age (FRA), disability benefits cease and retirement benefits begin.
[3] Unreduced benefits are available at FRA. For those born before 1938, FRA is age 65. For individuals born after 1937, FRA gradually increases from age 65 to age 67. For example, for baby boomers born between 1943 -1954, FRA is age 66. A larger retirement benefit is available to those who continue to work past FRA.
[4] If one parent qualifies, the benefit is 82.5% of the PIA. If both parents qualify, the benefit is 75% of the PIA to each.

Early or Delayed Retirement's Effect on Social Security Benefits

Full retirement age (FRA) is the age at which "full" Social Security retirement benefits – 100% of an individual's Primary Insurance Amount (PIA)[1] – are available. For many years, FRA was set at age 65. Beginning with individuals born in 1938, FRA gradually increases until it reaches age 67 for those born in 1960 or later.

If an individual chooses to receive retirement benefits before his or her FRA, the benefit paid is reduced to reflect the fact that income will be paid over a longer period of time. Similarly, if an individual chooses to delay retirement benefits, the benefit is increased for each year of delay (up to age 70) beyond FRA. The table below shows the effect of early or delayed retirement on an individual's retirement benefit, depending on the year of birth.

Retirement Benefit as a Percentage of the Primary Insurance Amount at Various Ages[2]									
Year of Birth	Full Retirement Age (FRA)	Credit for each year of delayed retirement after FRA (Percent)	Benefit as a % of PIA at Age						
			62	63	64	65	66	67	70
1924	65	3	80	$86\frac{2}{3}$	$93\frac{1}{3}$	100	103	106	115
1925-1926	65	3½	80	$86\frac{2}{3}$	$93\frac{1}{3}$	100	103½	107	117½
1927-1928	65	4	80	$86\frac{2}{3}$	$93\frac{1}{3}$	100	104	108	120
1929-1930	65	4½	80	$86\frac{2}{3}$	$93\frac{1}{3}$	100	104½	109	122½
1931-1932	65	5	80	$86\frac{2}{3}$	$93\frac{1}{3}$	100	105	110	125
1933-1934	65	5½	80	$86\frac{2}{3}$	$93\frac{1}{3}$	100	105½	111	127½

[1] The PIA is calculated by the Social Security Administration based on a person's lifetime earnings record.

[2] Source: Social Security Administration.

Early or Delayed Retirement's Effect on Social Security Benefits

Retirement Benefit as a Percentage of the Primary Insurance Amount at Various Ages[1]									
Year of Birth	Full Retirement Age (FRA)	Credit for each year of delayed retirement after FRA (Percent)	Benefit as a % of PIA at Age						
			62	63	64	65	66	67	70
1935-1936	65	6	80	$86^{2}/_{3}$	$93^{1}/_{3}$	100	106	112	130
1937	65	6½	80	$86^{2}/_{3}$	$93^{1}/_{3}$	100	106½	113	132½
1938	65, 2 mos	6½	$79^{1}/_{6}$	$85^{5}/_{9}$	$92^{2}/_{9}$	$98^{8}/_{9}$	$105^{5}/_{12}$	$111^{11}/_{12}$	$131^{5}/_{12}$
1939	65, 4 mos	7	$78^{1}/_{3}$	$84^{4}/_{9}$	$91^{1}/_{9}$	$97^{7}/_{9}$	$104^{2}/_{3}$	$111^{2}/_{3}$	$132^{2}/_{3}$
1940	65, 6 mos	7	77½	$83^{1}/_{3}$	90	$96^{2}/_{3}$	103½	110½	131½
1941	65, 8 mos	7½	$76^{2}/_{3}$	$82^{2}/_{9}$	$88^{8}/_{9}$	$95^{5}/_{9}$	102½	110	132½
1942	65, 10 mos	7½	$75^{5}/_{6}$	$81^{1}/_{9}$	$87^{7}/_{9}$	$94^{4}/_{9}$	101¼	108¾	131¼
1943-1954	66	8	75	80	$86^{2}/_{3}$	$93^{1}/_{3}$	100	108	132
1955	66, 2 mos	8	$74^{1}/_{6}$	$79^{1}/_{6}$	$85^{5}/_{9}$	$92^{2}/_{9}$	$98^{8}/_{9}$	$106^{2}/_{3}$	$130^{2}/_{3}$
1956	66, 4 mos	8	$73^{1}/_{3}$	$78^{1}/_{3}$	$84^{4}/_{9}$	$91^{1}/_{9}$	$97^{7}/_{9}$	$105^{1}/_{3}$	$129^{1}/_{3}$
1957	66, 6 mos	8	72½	77½	$83^{1}/_{3}$	90	$96^{2}/_{3}$	104	128
1958	66, 8 mos	8	$71^{2}/_{3}$	$76^{2}/_{3}$	$82^{2}/_{9}$	$88^{8}/_{9}$	$95^{5}/_{9}$	$102^{2}/_{3}$	$126^{2}/_{3}$
1959	66, 10 mos	8	$70^{5}/_{6}$	$75^{5}/_{6}$	$81^{1}/_{9}$	$87^{7}/_{9}$	$94^{4}/_{9}$	$101^{1}/_{3}$	$125^{1}/_{3}$
1960 and later	67	8	70	75	80	$86^{2}/_{3}$	$93^{1}/_{3}$	100	124

[1] Source: Social Security Administration.

Sources of Retirement Income

Most retirees derive their retirement income from three primary sources: Social Security retirement benefits, qualified retirement plans, and individual savings and investments.

Social Security Retirement Benefits

Social Security retirement benefits are intended to provide only a portion of an individual's retirement income. Traditionally, retirement benefits began at age 65. For those born after 1937, however, the age at which full benefits begin will increase gradually, until it reaches age 67 for those born in 1960 and later. A reduced benefit is available, beginning at age 62. The monthly benefit amount is based on an individual's past earnings record. A worker can earn a larger retirement benefit by continuing to work past full retirement age, up to age 70. Up to 85 percent of a retiree's Social Security retirement benefits may be subject to federal income tax (state law may vary) as ordinary income. Social Security retirement benefits are subject to adjustment for inflation on an annual basis.

Qualified Retirement Plans

A retirement plan is considered to be "qualified" if it meets certain requirements set by federal income tax law. In general, employer or employee contributions to a qualified plan are currently deductible and the earnings are tax deferred until paid out of the plan. Mandatory distribution rules typically apply and taxable withdrawals before age 59½ may be subject to an additional 10% penalty tax.[1]

- **Employer-sponsored qualified plans:** Employer-sponsored plans can generally be classified as either defined benefit or defined contribution. Defined benefit plans specify the benefit amount a participant will receive at retirement; an actuary estimates how much must be contributed each year to fund the anticipated benefit. The investment risk rests on the employer. Benefits are generally taxable.
  In contrast defined contribution plans, such as 401(k), 403(b) or SEP plans, typically put a percentage of current salaries into the plan each year. The retirement benefit will

[1] The rules and regulations surrounding qualified plans are complex. This discussion is intended to be only a brief, general description. State or local law may vary.

depend on the amount contributed, the investment return, and the number of years until a participant retires. The investment risk rests on the individual participant. Benefits are generally taxable.

- **Individual qualified plans:** Include the traditional Individual Retirement Account (IRA) and the Roth IRA. Contributions to a traditional IRA may be deductible and earnings grow tax deferred. Distributions from a traditional IRA are taxable to the extent of deductible contributions and growth. Contributions to a Roth IRA are never deductible and earnings grow tax deferred. If certain requirements are met, retirement distributions from a Roth IRA are tax free.[1]
- **Nonqualified retirement plans:** An employer may set up a plan, often in the form of a deferred compensation plan, which does not meet federal requirements to be considered "qualified." Benefits are generally taxable when received. Such plans are often used as a supplement to qualified retirement plans.

Individual Savings

Individual savings and investments are the third primary source of retirement income. An individual can choose to accumulate funds using a wide range of investment vehicles. The appropriate type of investment will depend on a number of factors such as an individual's investment skill and experience, risk tolerance, tax bracket, and the number of years until retirement. Below are listed some of the more commonly used choices.

- **Savings accounts:** Including regular savings accounts, money market funds, and certificates of deposit (CDs) at banks, savings and loans and credit unions.
- **Common stock:** May also include other forms of equity ownership such as preferred stock or convertible bonds. Stock can be owned directly, in a personal portfolio, or indirectly through a mutual fund or an exchange-traded fund (ETF).
- **Bonds:** Includes corporate, government or municipal bonds. Bonds can be directly owned in a personal portfolio or indirectly held in either a mutual fund, unit investment trust, or an exchange-traded fund.

[1] The discussion here concerns federal income tax law; state or local tax law may vary.

- **Real estate:** Individually owned investment real estate or indirect investment through a real estate investment trust or limited partnership.

- **Precious metals:** Such as gold or silver, in the form of coins, bullion, or in the common stock of mining companies.

- **Commercial deferred annuities:** Commercial, deferred annuities are purchased from a life insurance company and can provide tax-deferred growth through a variety of investment choices.

Other Income Sources

- **Immediate annuity:** An "immediate" annuity is purchased from a life insurance company, typically with a single, lump-sum payment. Within one year after purchase, the annuity begins to make regular, periodic payments to the annuity owner.

- **Qualified longevity annuity contract (QLAC):** A QLAC is a type of annuity contract paid for with funds from IRAs or other qualified retirement plans, designed to provide a steady income stream in the *later years* of retirement.

- **Continued employment:** On either a full or part-time basis. Earned income is usually taxable and before-full-retirement-age[1] earnings above a certain level may affect the amount of Social Security retirement benefits received.

- **Home equity:** A reverse mortgage may provide additional income, without giving up home ownership. Another way a reverse mortgage can improve cash flow is by replacing a traditional mortgage with a reverse mortgage so that there are no monthly principal and interest payments.

- **Life insurance:** A permanent life insurance policy may have cash value that can be withdrawn or borrowed against to supplement other sources of income during retirement. If certain tax rules are followed, the income will generally be received income-tax free.

[1] "Full retirement age" is the age at which an individual is entitled to "full" Social Security retirement benefits – 100% of an individual's Primary Insurance Amount. Under current law, this age will vary from 65 to 67, depending on an individual's year of birth.

Seek Professional Guidance

Providing an adequate stream of income during retirement can often involve dealing with complex tax, investment, and insurance questions. The advice and guidance of trained, experienced professionals is strongly recommended.

IRA Rollover as a Qualified Plan Conduit

When an employee leaves a job or a qualified plan is terminated, a special IRA – called a rollover or conduit IRA - can be used to hold a qualified plan distribution until it is either transferred into a new qualified retirement plan or is later distributed to the employee.[1] Tax-sheltered annuity and IRC Sec. 457 governmental plan distributions may also be transferred to an IRA rollover.

If the distribution is transferred to an IRA rollover[2] (or another qualified plan) in a direct rollover, no income tax is withheld and the employee avoids current income tax on the distribution.

If the distribution is first paid to the employee before being rolled over (it must be rolled over within 60 days) the plan administrator will withhold 20% of the distribution. In order to roll over the entire distribution and avoid current taxation (and a possible 10% penalty tax on the 20% of the distribution that was withheld), the employee will have to make up the 20% withholding from his or her separate funds.

Distributions from a traditional IRA, Roth IRA, or SIMPLE IRA are not subject to the mandatory 20% tax withholding. However, if the distribution is not rolled to a plan of the same kind within 60 days, the entire distribution is generally taxable.[3]

Three Options

A qualified plan participant has three possible options when leaving a job:

- In some situations, a participant may be able to leave his or her funds in the previous employer's plan.
- A participant may choose to roll the funds into a conduit IRA and leave them there until age 72, when distributions from the IRA must begin.[4].

[1] Based on federal law. State or local law may differ.
[2] The IRA referred to here is a traditional IRA, not a Roth IRA.
[3] If a SIMPLE IRA is rolled to any other type of IRA within two years of the SIMPLE IRA being established, a 25% penalty tax is assessed.
[4] Applies to required distributions after December 31, 2019, to those who reach age 70½ after that date.

- A participant may roll the funds into a conduit IRA and then later roll them into another qualified plan (if permitted). This will requalify the funds for 10-year[1] income averaging, if no regular IRA contributions have been made to the conduit IRA.
- A participant may choose to take all or part of a qualified retirement plan distribution outright; amounts received but not rolled over are generally included in gross income in the year received. If the participant is under age 59 ½ at the time of the distribution, a 10% income tax penalty for early withdrawal will apply, unless an exception applies. There will also be a mandatory 20% federal income tax withholding. A state may also require income tax withholding on the distribution. Amounts withheld and remitted as tax are considered to be amounts received.

Other Considerations

- Partial distributions can also qualify as eligible rollover distributions and can be tax deferred.
- Both deductible and nondeductible employee contributions may be rolled to the IRA.
- Noncash assets which are distributed can be sold and the cash proceeds transferred to the rollover IRA without realizing a current tax on any gain.
- Following the decision of the U.S. Tax Court in Bobrow v. Commissioner, T.C. Memo. 2014-21, beginning January 1, 2015, the IRS intends to apply the IRC Sec. 408(d)(3)(B) one-rollover-per year limitation for IRAs on an aggregate basis, regardless of the number of separate IRA accounts that an individual may hold. Under prior IRS guidance, the one-rollover-per-year limitation applied on a per-account basis.
- The IRA conduit rollover should be distinguished from a direct trustee to trustee transfer. In a direct transfer, the funds are transferred directly from one plan to another without going through a conduit rollover or being distributed to the participant.
- Federal bankruptcy law provides significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans. Generally, assets in IRA accounts are protected for amounts up to $1,362,800.[2] However, funds rolled over from qualified plans are protected without limit.

[1] Those born before 1936 may be able to elect 10-year income averaging or capital gain treatment; these strategies are not available to those born after 1935.

[2] Effective April 1, 2019. The limit is indexed for inflation every three years.

IRAs Compared

There are substantial differences between a traditional (nondeductible) IRA, a traditional (deductible) IRA, and a Roth IRA.

Item	Traditional IRA (Nondeductible)	Traditional IRA (Deductible)	Roth IRA
Basic eligibility requirements	Any person of any age who has compensation.	Any person of any age who has compensation.	Any person of any age who has compensation.[1]
Maximum contribution	Generally, the lesser of $6,000[2] ($12,000[3] for a married couple) or 100% of compensation.[4]		
Is the contribution deductible?	No	Yes, if neither spouse is covered by a qualified plan (QP). If single and covered by a QP, contribution is deductible if modified adjusted gross income (MAGI) is less than $68,000. Deduction phased out for MAGI between $68,000 and $78,000. If MFJ and one spouse is covered by a QP, the nonparticipant spouse may make a deductible contribution if MAGI is $204,000 or less. This deduction is phased out for MAGI between $204,000 and $214,000. The participant spouse may make a deductible contribution if MAGI is $109,000 or less. This deduction is phased out for MAGI between $109,000 and $129,000.[5]	No

[1] For 2022, the maximum contribution to a Roth IRA is phased out for single taxpayers with modified adjusted gross income (MAGI) between $129,000 and $144,000. For married couples filing jointly, the phase-out range is a MAGI of $204,000 to $214,000. For married individuals filing separately, the phase-out range is a MAGI of $0 to $10,000.

[2] This amount applies to 2022. For 2021, the maximum allowable contribution was also $6,000.

[3] This amount applies to 2022. For 2021, the maximum allowable contribution was also $12,000.

[4] If an IRA owner is age 50 or older, he or she may contribute an additional $1,000 ($2,000 if the spouse is also over 50).

[5] These are 2022 limits. For 2021 the phase-out ranges were (1) MFJ - MAGI of $105,000 - $125,000; (2) Single - $66,000 - $76,000. For taxpayers using the MFS filing status, the phase-out range is $0 - $10,000, which does not change.

Item	Traditional IRA (Nondeductible)	Traditional IRA (Deductible)	Roth IRA
Are earnings currently taxed?	No	No	No
Taxation of withdrawals at death or disability[1]	Contributions are received tax-free and earnings are taxable.	All distributions are taxable.	No taxation of qualified distributions.
Taxation of $10,000 withdrawn for first-time home purchase[1]	Proportionate part attributable to earnings is taxable.	All $10,000 subject to income tax.	"Qualified" distributions are not subject to tax. The earnings portion of a "non-qualified" distribution is taxable at ordinary rates.[2]
Taxation of withdrawals to pay for deductible medical expenses, e.g., expenses in excess of 7.5% of adjusted gross income (AGI)	Proportionate part attributable to earnings taxed as ordinary income. For those under age 59½, 10% penalty does not apply to amounts that qualify as deductible medical expenses, e.g., amounts in excess of 7.5% of AGI.	Entire withdrawal taxable as ordinary income. For those under age 59½, 10% penalty does not apply to amounts that qualify as deductible medical expenses, e.g., amounts in excess of 7.5% of AGI.	"Qualified" distributions are not subject to tax. The earnings portion of a "non-qualified" distribution is taxable at ordinary rates.[2]
Taxation of withdrawals to pay for qualified higher education expenses[1]	Proportionate part attributable to earnings is taxable.	Entire withdrawal is subject to income tax.	"Qualified" distributions are not subject to tax. The earnings portion of a "non-qualified" distribution is taxable at ordinary rates.[2]

[1] For individuals under age 59½, the 10% penalty tax does not apply in these situations.

[2] Generally, a "qualified" distribution is one made at least five years after a contribution is first made to a Roth IRA and because the owner reaches age 59½, dies, becomes disabled, or uses the funds to pay for first-time homebuyer expenses.

Item	Traditional IRA (Nondeductible)	Traditional IRA (Deductible)	Roth IRA
Taxation of distributions not covered above[1]	Nondeductible contributions received tax-free. Earnings are taxed at ordinary rate.	All distributions are taxable at ordinary rates.	"Qualified" distributions are not subject to tax. The earnings portion of a "non-qualified" distribution is taxable at ordinary rates.[2]
Are there required minimum distributions (RMDs)?	Distributions must start by April 1 of the year following the year the account owner reaches age 72[3].	Distributions must start by April 1 of the year following the year the account owner reaches age 72[3].	No minimum distribution is required during the life of owner.
Are direct transfers of funds in an IRA to a Health Savings Account allowed?	Yes	Yes	Yes
By when must an IRA be set up and funded?	By the due date for filing the IRA owner's federal income tax return for the year of the contribution, generally April 15 of the following year.		
Federal bankruptcy protection	Federal bankruptcy law protects assets in all IRAs, up to $1,362,800. Funds rolled over from qualified plans are protected without limit. State law may vary.		
May federal income tax refunds be directly deposited into the IRA?	Yes	Yes	Yes
Are tax-free direct transfers of up to $100,000 to a qualified charity by an owner at least age 70½ allowed?	Yes	Yes	Yes
Was a "Coronavirus Related Distribution[1] (CRD) permitted?	Yes	Yes	Yes

[1] All taxable amounts are subject to penalty tax of 10% if received prior to age 59½, unless an exception applies.

[2] Generally, a "qualified" distribution is one made at least five years after a contribution is first made to a Roth IRA and because the owner reaches age 59½, dies, becomes disabled, or uses the funds to pay for first-time homebuyer expenses.

[3] Applies to distributions required to be made after December 31, 2019, to individuals who reach age 70½ after that date. Under prior law, age 70½ was the mandated age for beginning RMDs.

Comparison of Returns from Various Types of IRAs

The table below is a hypothetical illustration of the impact of time and income taxes on the various types of IRAs.[1] The calculations assume that any tax savings from deductible contributions are invested in a separate, annually-taxable fund and that all funds are withdrawn in a lump sum at retirement.

Assumptions:

Desired net annual contribution: $6,000
Marginal income tax bracket – pre-retirement: 28.00%
Marginal income tax bracket – post-retirement: 25.00%
Tax-deferred growth rate: 7.00%
After-tax growth rate: 5.04%
Number of years until retirement: 20

Item	Traditional IRA (Nondeductible)	Traditional IRA (Deductible)	Roth IRA
A. Pre-Retirement			
1. Contributions are made	After-tax	Before-tax	After-tax
2. Gross amount	$8,333	$6,000	$8,333
3. Income taxes payable	2,333	0	2,333
4. Net annual contribution to IRA	6,000	6,000	6,000
5. Annual tax savings to taxable account	0	1,680	0
Total net annual savings	**$6,000**	**$7,680**	**$6,000**
B. At Retirement			
1. Net accumulation in the IRA[2]	$263,191	$263,191	$263,191
2. Future value of tax savings	0	58,598	0
3. Total available before taxes	263,191	321,789	263,191
4. Income taxes payable	-35,798	-65,798	0
Net after income taxes	**$227,393**	**$255,991**	**$263,191**

[1] Based on federal law. State or local law may differ.
[2] Assumes annual contributions are made at the beginning of each year.

Supplementing Retirement Income with a CRUT

Another Way to Fund Retirement

In many instances, a charitable remainder trust is set up to provide cash flow during retirement, with the donor making a single, large gift to the trust. Such a trust allows an individual to combine charitable goals with retirement income planning.

A Charitable Remainder Unitrust (CRUT) can be established some years before retirement. Beyond the initial contribution, the CRUT allows additional, annual gifts to the trust. For individuals planning for retirement, this type of trust can combine charitable objectives with asset accumulation goals.

Who Should Consider a CRUT to Accumulate Retirement Assets?

A person who:

- Desires to support one or more public charities.
- Has a high level of current income;
- Has at least five to ten years before retirement and desires to put away more for the retirement years;
- Has reached the maximum level of contributions to his or her qualified retirement plan; and/or
- Needs to shelter retirement funds from current income taxation.

The “Flip” CRUT – A Typical Example

- The donor establishes a CRUT with income for life or for the lives of the donor and/or spouse. Payouts are set at the annual minimum 5.0% of the net fair market value of assets or the income generated by the trust, whichever is less. The trust document specifies that the trust will convert (“flip”) from its net income format to a standard form of unitrust at some pre-determined date or other triggering event. At that point, the trustee will distribute a full 5% of the trust’s then value using both income and corpus if required. Prior to the “flip,” the trust payout is limited to actual net income earned, up to the 5.0% payout limit.

Supplementing Retirement Income with a CRUT

- The donor makes annual gifts to the trust.
- In the early years, the trustee invests the annual gifts in capital gain assets which generate little or no current income.
- At the death of the last income beneficiary, the trust assets pass directly to the charity.

The result: Due to very small (perhaps zero) payouts in the pre-retirement years, the assets in the trust can grow much larger. When the 5.0% payments begin, the annual income can be substantially higher.

How It Works – A Hypothetical Example

Assumptions:

Married couple ages 45 and 43. First spouse dies at age 83, second spouse also dies at age 83.
Gifts of $25,000 per year (may be cash or appreciated property) are made each year for 20 years.
Net income CRUT for 20 years paying out the actual net income realized or 5.0%, whichever is less.
Trust "flips" at the end of the 20th year to a standard trust which must pay 5.0% of the trust value.
In years 1 through 20, trust assets are invested for total return; the analysis assumes 1% net income realized and paid as income with 6.0% as growth.
In years 21 through 41, trust assets are invested for total return; the analysis assumes 1.0% net income and 6.0% growth.

Pre-Retirement Period – Maximize Capital Accumulation, Minimized Income and Taxes

Year	Total Contributions to CRUT at $25,000/Year	Cumulative Deduction Allowed	Cumulative Pre-Retirement Income	CRUT Year-End Value
1	$25,000	$3,232	$20	$25,119
5	125,000	17,819	3,773	147,640
10	250,000	40,368	16,159	346,958
15	375,000	68,720	39,782	613,691
20	500,000	104,019	78,440	970,640

Supplementing Retirement Income with a CRUT

Post-Retirement ("flip") Period – Maximize Income, Charitable Legacy

Year	Total Contributions to CRUT	Current-Year Income	Cumulative Post-Retirement Income	CRUT Year-End Value
21	$500,000	$48,532	$48,532	$990,053
23	500,000	50,493	148,528	1,030,051
25	500,000	52,533	252,564	1,071,665
27	500,000	54,655	360,802	114,961
29	500,000	56,863	473,413	1,160,005
31	500,000	59,160	590,573	1,206,869
33	500,000	61,550	712,466	1,255,627
35	500,000	64,037	839,284	1,306,354
37	500,000	66,624	971,226	1,359,131
39	500,000	69,316	1,108,499	1,414,040
41	500,000	72,116	1,251,317	1,471,167

Total post-retirement income.......................................$1,251,317

Charitable legacy (remainder)...................................... $1,471,167

Seek Professional Guidance

Because of the complexities involved, the advice and guidance of trained, experienced tax, legal, and other financial professionals is strongly recommended.

Considerations in the Purchase of Life Insurance

Who Will Be the Owner of the Policy?

Life insurance proceeds are included in the estate of a deceased if he or she has any incidents of ownership in the policy. Ownership by adult children or an irrevocable life insurance trust should be considered if there is an estate tax problem.

How Much Life Insurance?

This will depend on the need it is fulfilling. Amounts needed to fund a business transfer or to pay death taxes may be readily determined.

Calculating the value of a human life to a family is more difficult. Consider these projected total earnings up to age 65 assuming a 5% annual increase including inflation.

Projected Total Earnings to Age 65

Current Age	Current Monthly Income		
	$2,000	$4,000	$8,000
25	$3,044,154	$6,088,309	$12,176,618
35	1,674,259	3,348,518	6,697,036
45	833,262	1,666,524	3,333,048
55	316,963	633,926	1,267,852

What Type of Policy Should Be Purchased?

A person trained in life insurance can explain the many different policies available and assist in selecting the one which best fits your needs.

How Should the Premium Be Paid?

Sometimes the amount of the premium can be paid from current income, while other times it may be prudent to reposition other assets so as to be able to acquire sufficient insurance protection.

Considerations in the Purchase of Life Insurance

If the insured is a business owner or executive, a corporation may assist in paying premiums. Other times it may be better to have the corporation own the policy and use the proceeds to purchase part or all of the owner's interest at death.

Insurance can also be purchased in certain qualified retirement plans.

Using Cash Value Life Insurance

Accumulating Funds to Meet Savings Goals

Saving money to reach an accumulation goal is a problem many of us face. Some goals, such as retirement or a college fund for a child, are long-term savings goals. Many of us also have shorter-term savings goals such as a vacation or a Christmas or holiday fund.

Whatever the objective, the basic problem is the same, i.e. where to put money aside to reach a particular savings goal. For many short-term goals, a savings account at a local bank or credit union is a popular choice. For college funding, Coverdell IRAs or IRC Sec. 529 plans are often used. For retirement savings, many individuals depend on Individual Retirement Accounts (IRAs) or employer-sponsored retirement plans such as an IRC Sec. 401(k) plan.

An additional option for long-term savings, one that is sometimes overlooked, is using a cash value life insurance policy.

What is Cash Value Life Insurance?

Life insurance comes in two basic variations, "term" insurance and "cash value" life insurance. Term life insurance can be compared to auto insurance. Protection is provided for a specified period of time or "term." No death benefits are paid unless the insured dies during the term the policy is in force. If the insured lives beyond the term period, the policy generally expires with nothing returned to the policy owner.

In addition to providing a death benefit, "cash value" life insurance also provides for the tax-deferred accumulation of money inside the policy. These funds can be used by the policy owner while the insured is alive to provide the resources for needs such as funding a college education, making improvements to the home, or starting a business. When the policy owner uses the cash values to meet such needs, he or she is said to have used the "living benefits" of a cash value life insurance policy.

When to Consider Cash Value Life Insurance

Using a cash value life insurance policy to reach a saving goal works best in certain situations:

- **A need for life insurance death benefit:** Apart from the need for additional savings, an individual should have a need for the death benefit that life insurance provides. For example, such a need exists when an individual has a dependent spouse or children who would suffer economically if the individual died. Someone with a large estate might need additional cash at death to pay estate and other taxes as well as final expenses.

- **Other savings aren't enough:** Because of limitations in federal tax law,[1] other accumulation vehicles might not allow enough money to be put aside to meet a particular savings goal.

- **Time frame:** Ideally, there should be at least 10 to 15 years between today and the time the money will be needed. Because of mortality expenses and other policy charges, significant cash value accumulations are generally deferred until a policy has been in force for a number of years. Additionally, federal income tax law affects the design of cash value life insurance policies as well as the taxation of cash value withdrawals in the early years a policy is in force.

- **Insurable:** The insured needs to be healthy enough to have a policy issued on his or her life.

- **An ongoing obligation:** Cash value life insurance policies tend to have a higher premium cost than comparable term life policies. Paying the premiums over a number of years represents an ongoing financial obligation, to both keep the policy in force and achieve the savings goal.

Income Tax Considerations

There are a number of income tax issues to keep in mind when considering any life insurance policy. The death benefit payable under a life insurance contract because of the death of the insured is generally received income-tax free. Federal income taxation of life insurance "living benefits" is more complicated:

- **Tax-deferred growth:** The growth of cash value inside a life insurance policy is tax-deferred.

[1] The discussion here concerns federal income tax law. State or local tax law may vary widely.

- **Cost recovery rule:** Amounts withdrawn from a cash-value life insurance contract are included in gross income (and become subject to tax) only when they exceed the policy owner's basis in the policy. This basis is also known as the "investment in the contract." This effectively treats withdrawals from the policy first as a non-taxable return of premium and secondly as taxable income.
- **Investment in the contract:** The total of all premiums paid less any policy dividends and any other prior tax-free distributions received.
- **Policy dividends:** Some "participating" life policies pay what are termed "dividends." Such dividends are a return of a portion of the policy owner's previously paid premiums. Policy dividends are not taxable until they exceed the owner's basis in the life insurance contract.
- **Policy loans:** Some cash value life insurance policies allow the policy owner to borrow at interest a portion of the accumulated cash value. While a policy is in force, policy loans are generally not taxable. However, if a policy is surrendered with a loan outstanding, taxable income will result to the extent that the unpaid loan amount exceeds the owner's basis in the contract.
- **Modified Endowment Contracts (MECs):** Some life insurance policies – primarily because there are large premium payments in the early years of the contract – are termed "Modified Endowment Contracts," or MECs. Under federal income tax law, distributions from a policy considered to be a MEC are treated differently than distributions from non-MEC policies. Withdrawals from a MEC (including a policy loan) will first be taxed as current income until all of the policy earnings have been taxed. If the owner is under age 59½, a 10% penalty also applies, unless the payments are due to disability or are annuity type payments. Once all policy earnings have been distributed (and taxed), any further withdrawals are treated as a non-taxable return of premium.

Accessing the Contract's Cash Values

When the time comes to use the accumulated cash values, withdrawals from the policy should be done in such a way as to avoid current income taxation (to the extent possible) <u>and</u> keep the policy in force.

- **Withdrawal to basis:** Initially a policy owner can take withdrawals (partial policy surrenders) until he or she has withdrawn an amount equal to the basis in the policy.

- **Switching to policy loans:** Once the basis has been withdrawn, the policy owner then begins using non-taxable policy loans. The interest payable on these policy loans is typically much less than a loan from a commercial bank or credit union.
- **A combination:** A policy owner can also use a combination of withdrawals and policy loans.
- **Caveats:** There are a number of issues that a policy owner needs to keep in mind:
  - Withdrawals reduce the death benefit available under the policy.
  - If an insured dies with a policy loan outstanding, the policy's death benefit is reduced by the amount of the loan balance.
  - Excessive use of withdrawals and policy loans can result in the policy lapsing. Such a lapse can result in unexpected, negative tax results as well as the loss of a valuable financial asset.

A Multi-function Tool

Used appropriately, cash value life insurance can serve as financial tool with multiple uses. It can be used, in conjunction with more traditional savings vehicles, as a way to accumulate funds for long-term savings goals. At the same time the policy can, if the insured dies, provide a death benefit when the funds are most needed.

Seek Professional Guidance

Determining the appropriate amount of life insurance, the best type of policy to meet the needs of an individual's specific situation, and planning when and how to access a policy's cash values can be complex and confusing. The advice and guidance of trained insurance, tax, and other financial professionals is strongly recommended.

Education Savings Plans Compared

Benefit or Feature	"529" Prepaid Tuition Plan[1]	"529" Education Savings Plan[1]	Coverdell Education Savings Account
Basic concept	Buy tomorrow's tuition at today's prices.	Tax-advantaged savings account to accumulate funds for education.	Tax-advantaged savings account to accumulate funds for education.
Federal income tax treatment	Contributions are not deductible; growth is tax-deferred; withdrawals for qualified education expenses are exempt from tax.	Contributions are not deductible; growth is tax-deferred; withdrawals for qualified education expenses are exempt from tax.	Contributions are not deductible; growth is tax-deferred; withdrawals for qualified education expenses are exempt from tax.
State or local income tax treatment	Varies. Some states follow federal income tax law, while others do not.	Varies. Some states follow federal income tax law, while others do not.	Varies. Some states follow federal income tax law, while others do not.
Level of investment risk	Generally a low level of risk. Sponsoring state or organization typically promises to invest funds to match tuition increases. Later contributions may be required.	Varies, depending on the underlying investments. An investment manager typically manages the funds. Both gains and losses are possible.	Varies, depending on the underlying investment. A wide range of self-directed investments is available. Both gains and losses are possible.
Where to purchase	Directly from the state or private institution involved.	Investment brokers, banks, credit unions, insurance companies, or directly from the state involved.	Investment brokers, banks, credit unions, and insurance companies.
Who can contribute?	Generally, anyone. Residency restrictions may apply.	Generally, anyone. Residents in one state can often invest in another state's plan.	Generally, anyone.

[1] "529" refers to Section 529 of the Internal Revenue Code, the section of federal law which authorizes these plans.

Education Savings Plans Compared

Benefit or Feature	"529" Prepaid Tuition Plan	"529" Education Savings Plan	Coverdell Education Savings Account
How much can be contributed?	Contributions must be in cash and may not exceed what is needed to fund the beneficiary's education expenses. The program sponsor will specify the maximum amount.	Contributions must be in cash and may not exceed what is needed to fund the beneficiary's education expenses. The program sponsor will specify the maximum amount.[1]	Contributions must be in cash and may not exceed $2,000 per beneficiary per year.
Beneficiary age limits for contributions?	None	None	Before age 18 unless a special needs student.
How are payments made?	In a lump-sum or periodic payments.	In a lump-sum or periodic payments.	Typically, in periodic payments.
Do income limitations apply to the donor?	No	No	Yes. Contribution is phased out for donors whose AGI exceeds certain limits.[2]
Who controls the funds?	Generally, the donor.[3] If the account is a custodial account, the beneficiary becomes the owner when he or she reaches age 21 (18 in some states).	Generally, the donor.[3] If the account is a custodial account, the beneficiary becomes the owner when he or she reaches age 21 (18 in some states).	Generally, the donor.[2] If the account is a custodial account, the beneficiary becomes the owner when he or she reaches age 21 (18 in some states).

[1] In some education savings programs, more than $250,000 may be contributed for a single beneficiary.

[2] For unmarried individuals, the contribution is phased out when adjusted gross income (AGI) is between $95,000 - $110,000. For married couples filing jointly, the phase-out range is an AGI of $190,000 - $220,000.

[3] With a "529" prepaid tuition plan or a "529" savings plan, if the assets are not used for education they may be returned to the donor. In a Coverdell Education Savings Account, if the assets are not used for education, they will ultimately become the property of the beneficiary.

Education Savings Plans Compared

Benefit or Feature	"529" Prepaid Tuition Plan	"529" Education Savings Plan	Coverdell Education Savings Account
What expenses are covered?[1]	Tuition and fees for primary, secondary, and post-secondary education are covered. Some plans include a room and board option or allow excess tuition credits to be used for other qualified expenses.	For primary and secondary schools, tuition and fees are covered. For post-secondary education, costs such as tuition, fees, books, supplies, computers, software, and internet access are covered. Reasonable costs for room and board qualify if the student is attending school at least half time. Expenses related to participation in a registered apprenticeship program, as well as repayment of interest or principal on a qualified education loan for the designated beneficiary or a sibling, also qualify.	A wide range of expenses is allowed, to attend Kindergarten thru 12th grade, as well as post-high school educational institutions. May include tuition, fees, books, supplies, and equipment, as well as reasonable costs for room and board.
What schools may the beneficiary attend?	Prepaid tuition plans typically limit attendance to same-state schools or colleges.	Funds accumulated in the savings plan of one state may usually be used at institutions of higher education throughout the U.S. Elementary or secondary public, private, or religious schools, apprenticeship programs registered with the Secretary of Labor, and some foreign schools also qualify.	For K-12, any school that qualifies under state law, including public, private, or religious schools. For post-high school, most institutions in the U.S. qualify.

[1] Technically, under IRC Sec. 529, the same definition of "qualified higher education expenses" applies to both prepaid tuition plans and education savings plans. In practice, however, for prepaid tuition plans, the sponsoring entity will limit the use of the funds to the types of expenses shown above.

Education Savings Plans Compared

Benefit or Feature	"529" Prepaid Tuition Plan	"529" Education Savings Plan	Coverdell Education Savings Account
Effect on financial aid?	Generally reduces financial aid. Account owned by student penalized more than parent-owned account.	Generally reduces financial aid. Account owned by student penalized more than parent-owned account.	Generally reduces financial aid. Account owned by student penalized more than parent-owned account.
May account be rolled-over to other family members?	Yes	Yes	Yes

How a 529 Education Savings Plan Works

A “529” education savings plan is a tax-favored program operated by a state designed to help families save for future education costs. While the fees, expenses, and features of these plans will vary from state to state, as long as a plan satisfies the requirements of Section 529 of the Internal Revenue Code,[1] federal tax law provides tax benefits for both the contributor and the beneficiary.

How Does It Work?

EDUCATION SAVINGS PLAN

- A tax-advantaged account to save for education.
- Earnings accumulate tax deferred.
- Does not guarantee admission.
- If a beneficiary does not use funds, a new beneficiary can be designated.

Tax-Free Withdrawals

Taxable Withdrawals

WITHDRAWALS FOR EDUCATION

- Withdrawals for qualified expenses are generally tax-free.
- Qualified expenses generally include tuition, books, fees, supplies, equipment, and room and board.

NON-QUALIFIED

- Any part of a withdrawal that is not applied to a qualified expense is considered non-qualified.
- The earnings portion of non-qualified amounts is taxable and a 10% penalty is generally applied.

[1] Federal law does not allow income tax deductions for contributions to 529 plans, although growth inside a plan is tax-deferred and qualified distributions are tax-exempt. State or local tax law can vary widely. 529 plans involve investment risk, including possible loss of funds, and there is no guarantee an education – savings goal will be met.