LIFE SECTION 4

TAXATION, RETIREMENT AND OTHER LIFE INSURANCE CONCEPTS

A. <u>Third-party ownership</u>

1. A policy owner buys a policy on someone other than themselves

2. <u>Insurable interest must be present at time of application</u>

3. The first party is the insurance company

4. The second party is the insured

   a. Must give permission and sign application (unless a child)
      1. May have to take a physical exam

   b. Insured is often a spouse, child, partner or key person

5. The third party is the owner of the policy

   a. Has all rights of ownership
      1. Pays the premium
      2. May designate the beneficiary (usually themselves)
      3. May take a loan or take cash surrender

6. Owner may assign ownership to the second party at a later date

   a. An <u>absolute assignment</u>
      1. Child turns 18, so policy is assigned to the child
      2. Key person retires, so policy is assigned to key person
         a. Key person takes cash surrender for retirement
         b. The insurance company must countersign on an assignment for it to be valid

7. In a third-party ownership situation, <u>three people must sign the application</u>

   a. <u>The owner, insured and producer (although the producer is NOT a party to the contract)</u>
      1. If the insured is a minor child, then they are not required to sign the application

   b. Beneficiaries never sign anything

B. <u>Group Life Insurance</u>

1. Usually an employer group, but could be labor union or association

2. <u>Policy owner is the employer</u>, not the employee

3. Employee receives certificate of insurance stating coverage

4. Group coverage is convertible to whole life within 31 days of job termination, without evidence of insurability

    a. Conversion is based upon current, attained age of insured
    b. Can only convert the amount of the group policy, not more
    c. Conversion always to a more expensive type of insurance
        1. Most Group life is Annual Renewable Term (ART)
        2. Conversion usually to whole life
            a. You cannot convert Term to Term

5. Group premium could be contributory or noncontributory

    a. On contributory groups, premiums are shared
        1. 75% of eligible employees must participate
            a. This prevents adverse selection for insurer
            b. Assures most of the healthy employees will enroll
    b. On noncontributory groups, the employer pays it all
        1. 100% of eligible employees must participate
    c. Group contracts are also subject to minimum enrollments
        1. The number of people required for a group varies by state

C. Retirement plans

1. Qualified plans in general

    a. Must follow federal ERISA guidelines (Employee Retirement Income Security Act of 1974)
        1. 100% vesting must occur
            a. Cliff Vesting Schedule - by the end of the third year 100% vested
            b. Graded Vesting Schedule - minimum of 20% at the end of the second year, 20% additional each following year, for 100% vesting by the end of the sixth year
            c. Vesting means ownership of employer contributions
            d. Employee contributions belong to the employee immediately
        2. No discrimination may exist in favor of higher paid workers
            a. Percentage contributions must be same for all
            b. May be set up either as a Defined Benefit - everyone gets the same benefit, or as a Defined Contribution- everyone gets the same percentage contributed; both are Qualified Plans
        3. Eligibility requirements - plan must cover all who are:
            a. Full time employees
            b. At least age 21 (not 18)
            c. Employed for at least 1 year
    b. Qualified plans are funded with before tax dollars
        1. Money contributed has never been taxed

2. Employee's cost basis is zero
   a. Employee has paid zero tax on the contributions
3. All contributions, plus tax deferred interest earned are taxable as ordinary income when withdrawn, never taxed as capital gains

c. Distribution rules
   1. Required Minimum Distributions (RMD) must begin no later than age 70 ½
      a. IRS penalty when someone does not begin RMD by no later than April 1st of the year after the client turns 70 ½ is 50% of the RMD
   2. Contributions must cease by 70 ½

d. Rollover rules
   1. Rollovers are permitted without tax or penalty
      a. From one qualified plan to another qualified plan
      b. May only be done once a year
      c. Any amount may be rolled over
      d. Must be done within 60 days of a distribution
   2. Rollovers do not avoid tax, they just defer tax

e. Premature distribution penalties
   1. 10% IRS early withdrawal penalty levied
      a. For cash surrender prior to age 59 ½
      b. No penalty for early annuitization, death or disability
   2. Penalty is added to tax due in year of distribution
   3. Deferred interest is also taxed as ordinary income

2. Specific types of qualified plans and their characteristics

   a. IRA - Individual Retirement Account
      1. Available to anyone with earned income
         a. Funding an IRA has nothing to do with age, but instead has to do with earned income
         b. A 16-year old with earned income may fund an IRA
      2. Traditional IRA may or may not be tax deductible
         a. Depends on client's income and whether or not he or she is covered by another qualified plan
      3. Earns tax deferred interest, even if not tax deductible
      4. If you have a non-working spouse a Spousal IRA is allowed
      5. Life insurance may not be used to fund an IRA
      6. IRA's may be established up until April 15th for preceding year
      7. ROTH IRAs are always funded with after tax dollars
      8. Qualified ROTH IRA distribution earnings are federally income tax free
         a. Qualified distributions
            1. Account open for 5 years or longer
            2. Paid out on or after 59 ½
   b. SEP IRA - Simplified Employee Pension IRA
      1. Used by small employers in lieu of pension plans
   c. Keogh Plan (HR-10)
      1. For self-employed, partners and their employees
         a. Corporate officers are not eligible

d. TSA - Tax Sheltered Annuity
   1. Only type of annuity that is considered qualified
   2. Two types of eligible employees
      a. IRC 403b employees
         1. Employees of public educational institutions
            a. Schools teachers, administrators and staff
      b. IRC 501c-3 employees
         1. Employees of nonprofit organizations
            a. Charities, etc.
         2. Employees of religious affiliated organizations
            a. Religious affiliated hospitals, etc.

e. 401k
   1. Qualified retirement plan, generally set up by large employer

3. Nonqualified plans

   a. Are not required to follow ERISA
   b. Funded with after tax dollars (not tax deductible)
   c. Usually no vesting until retirement - often discriminatory
   d. Often not funded by the employer until retirement
   e. If employer goes broke, employee gets nothing
   f. Usually set up as deferred compensation plans by small companies
   g. Not illegal, but most retirement plans are qualified
      1. Employer can then deduct all contributions from taxes

D. Life Insurance Needs Analysis/Suitability

1. Personal insurance needs

   a. There are two approaches to determining how much life insurance your clients needs
      1. The Capital Needs Approach
         a. Here you need to make sure that your client has enough insurance to meet his needs, should he die tomorrow, for things like paying off the house, putting the kids through college, funeral expenses, etc.
      2. The Human Value Approach
         a. This approach has to do with what would be the loss, income-wise, if your client was to die today, times how many more years the client is expected to live
         b. This approach generally results in a higher need than the capital needs approach

2. Business insurance needs

   a. Key Employee Life Insurance
      1. Purchased by business on the life of a key employee
      2. Business is the beneficiary
         a. Proceeds used to hire and train a new key employee
      3. Premiums paid are not tax deductible
      4. Proceeds paid are not taxable
      5. An example of third-party ownership

6. In the event that the key employee no longer works for the employer, yet the premiums are still paid, if the ex-employee then dies, the policy proceeds would go to the old employer

b. Partnership Life Insurance
   1. Requires a buy-sell agreement drafted by lawyer
      a. Agreement signed by each partner plus their spouses
      b. Each partner buys a policy on the life of the other
         1. Naming themselves as beneficiary
      c. If a partner dies, the policy pays the proceeds to the surviving partner
         1. The surviving partner uses the money to buy out the spouse of the deceased partner
      d. Sometimes called a cross purchase buy-sell agreement
      e. If there are three partners
         1. A total of 6 policies would have to be sold
         2. Each partner would have to buy policies on the other two partners
      f. May also be used by small closed corporations
         1. The corporation buys a policy on each stockholder
            a. Naming the corporation as beneficiary
   2. If a stockholder dies, the proceeds are paid to the corporation tax free
      a. The corporation uses the proceeds to buy out the stock of the deceased stockholder from his heirs
   3. Premiums paid are not tax deductible

c. Split Dollar Life Insurance
   1. Used to help a valued employee buy whole life coverage
   2. The employer pays part of the premium
      a. The portion equal to the increase in cash value
   3. The employee pays the balance of the premium
   4. If the employee dies
      a. The employer recovers the amount of premium paid
      b. The balance goes to the employee's beneficiary
   5. A type of non-qualified plan

E. Social Security Benefits

1. OASDHI (Old Age, Survivor, Disability, Health Insurance) = Social Security
2. Social Security has a small death benefit - ONLY $255.00
   a. Not based upon PIA
3. Social Security also has survivors' benefits
   a. Paid to surviving children if under age 18
4. Social Security benefits are indexed for inflation
   a. Benefits will increase along with the Consumer Price Index
5. Some Social Security benefits are based upon the PIA
   a. The Primary Insurance Amount
      1. The amount a person would receive if he or she elects to begin receiving retirement benefits at his/her normal retirement age
         a. At this age, the benefit is neither reduced for early retirement nor increased for delayed retirement

b. Other Social Security benefits are a percentage of the PIA
   1. Early retirement benefits
   2. Delayed retirement benefits
   3. Disability income benefits
   4. Survivor benefits

c. The PIA is determined using a standard formula
   1. Most social security benefits <u>are not</u> the same for everyone

F. <u>Tax treatment of insurance premiums, proceeds and dividends</u>

1. <u>Individual Life Insurance</u>

   a. <u>Premiums are not tax deductible</u>
   b. <u>Proceeds are not taxable</u>
   c. <u>Proceeds are included in the value of the deceased's estate</u> for estate tax purposes
      1. Estates over the threshold are subject to estate taxes
   d. Dividends paid to policyholders of a mutual insurance company <u>are not taxable</u>
      1. Considered by the IRS to be a return of premium

2. <u>Group Life Insurance</u>

   a. Any portion of the premium paid by the employer
      1. <u>Tax deductible as a business expense</u>
   b. Proceeds paid to beneficiary <u>are not taxable</u>

3. <u>Modified Endowment Contracts</u> (MEC)

   a. <u>A tax category created by the IRS</u>, regulated by federal regulation called TAMRA
      1. Technical and Miscellaneous Revenue Act of 1988
   b. Law applies to all cash value life policies
   c. Requires insurers to have a <u>certain amount of risk</u>
   d. Affects Single Premium policies the most
      1. Such as Universal life
   e. Requires policies <u>to meet the 7-pay test</u>
      1. Test administered when policy is first issued
   f. If a policy fails the test, it is a MEC
   g. MEC policies <u>lose their favored tax treatment</u>
      1. Interest earned is no longer tax deferred
      2. Loans taken are considered taxable
      3. 10% IRS early withdrawal penalty applies to cash surrenders under age 59 ½
   h. A policy will fail the 7-pay test if:
      1. <u>During the first 7 years of the policy the cash value exceeds the sum of the premiums paid</u>

LIFE SECTION 4
Taxation, Retirement and Other Life Insurance Concepts

KEY FACTS

- Group life rates and forms do NOT have to be filed with the Insurance Commissioner.
- Conversion from a group life policy to an individual policy, when you terminate employment, is permitted for 31 days regardless of your health.
- In a contributory group life plan (employee pays part of premium), 75% of those eligible must participate. In a noncontributory plan (employer pays total premium), 100% must participate.
- Experience rating is for large groups only. Rates are based on claims experience.
- Premiums paid for individual life insurance are NOT tax-deductible, but the proceeds are NOT taxable. This is true of key person life insurance as well.
- Examples of third-party policy ownership include key person and partnership insurance, as well as a policy written on the life of a spouse or minor child.
- Stockholders in closed corporations (small, privately held) often enter into buy-sell agreements with the corporation that are funded by life policies.
- Qualified plans have early-withdrawal penalties. The IRS levies a 10% penalty for cash surrenders (all or part) on annuities, IRAs, 401ks, TSAs, and Keogh plans prior to age 59 1/2, unless the client has died or become disabled. This is a bottom-line penalty in addition to income taxes due.
- Anyone with earned income may contribute to an IRA up to 100% of earned income or the current contribution limit (subject to change by the IRS), whichever is LESS.
- IRA contributions may be tax-deductible, even though the client is an active participant in another qualified plan, if income is below a certain level.
- Keogh plans are available to self-employed sole proprietors, partners, and their employees; they are NOT available to corporate officers. They are also known as HR-10s.
- IRAs may be funded with annuities, but NOT with whole life policies.
- Most annuities are used for retirement purposes.
- Modified Endowment Contracts (MECs) are classified that way for the life of the contract, if they fail the 7-pay test.
- Modified Endowment Contracts (MECs) have a 10% penalty for premature distributions.
- Gross life insurance premiums are based on mortality and expenses minus interest earned.
- Third-party administrators (TPAs) are more common now due to the growth of self funded plans.
- Individual policies are usually more expensive than group.
- You can't form a group just to buy insurance.
- Group life policy is convertible for 31 days after job termination, without a physical exam.
- On cash surrender, amounts paid in excess of premiums paid are taxable.

- Upon death, amounts paid to beneficiaries in excess of premiums are tax free.
- Amounts contributed to qualified plans are limited by the IRS.
- Children cannot buy an IRA unless they have earned income.
- There is a maximum annual contribution to an IRA (subject to change by the IRS), there is no minimum.
- Small firms often use SEP IRAs as tax qualified plans for employees.
- Death benefits paid to beneficiaries are tax free on all life insurance.
- Unpaid death benefits continue to earn interest for the beneficiary. The interest is taxable.
- Distributions from qualified plans may be rolled over into an IRA (no $ limit).
- A trustee to trustee roll over eliminates the withholding tax requirement.
- Life insurers may discriminate based upon physical hazards of the client.
- Life insurance advertising may stress honest contract differences.
- Experience Rating (based upon past claims) is often used in Group Insurance.
- Acquisition costs of life insurance companies are highest the 1st policy year.
- A Keogh Plan is sometimes also referred to as an HR-10 plan.
- There is no 10% IRS penalty for annuitizing an annuity prior to age 59 1/2. The penalty only applies to cash surrenders.
- TSAs are also called 403b plans.
- In a life insurance contract the beneficiary never has to sign anything.
- Deferred compensation is an example of a non-qualified plan.
- A Keogh is a qualified retirement plan for the self-employed.
- OASDHI includes coverage for old age (social security), survivor benefits, disability income and health insurance (Medicare). It does not include Medicaid coverage.