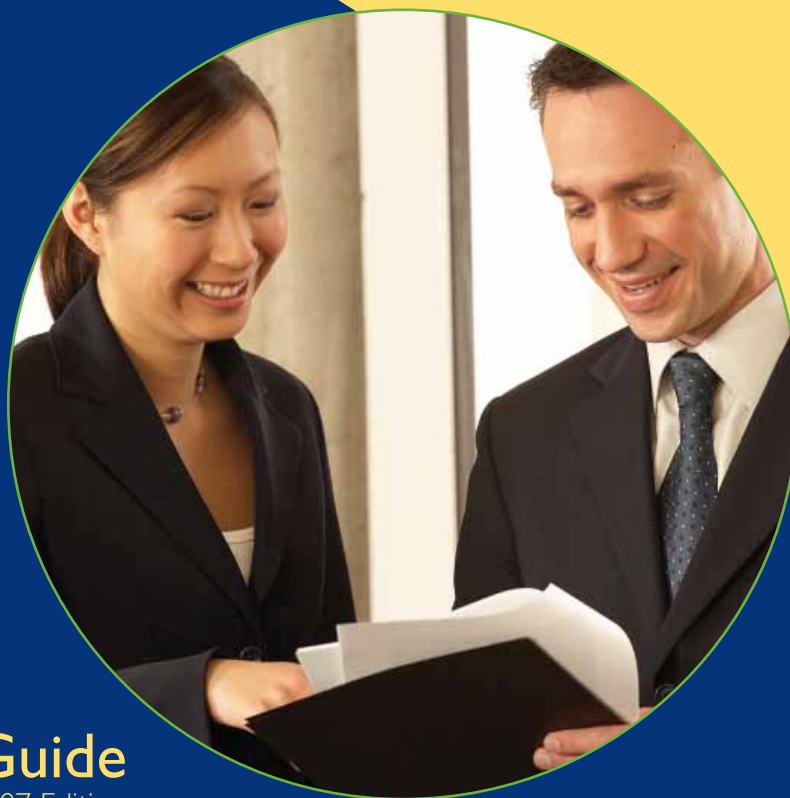


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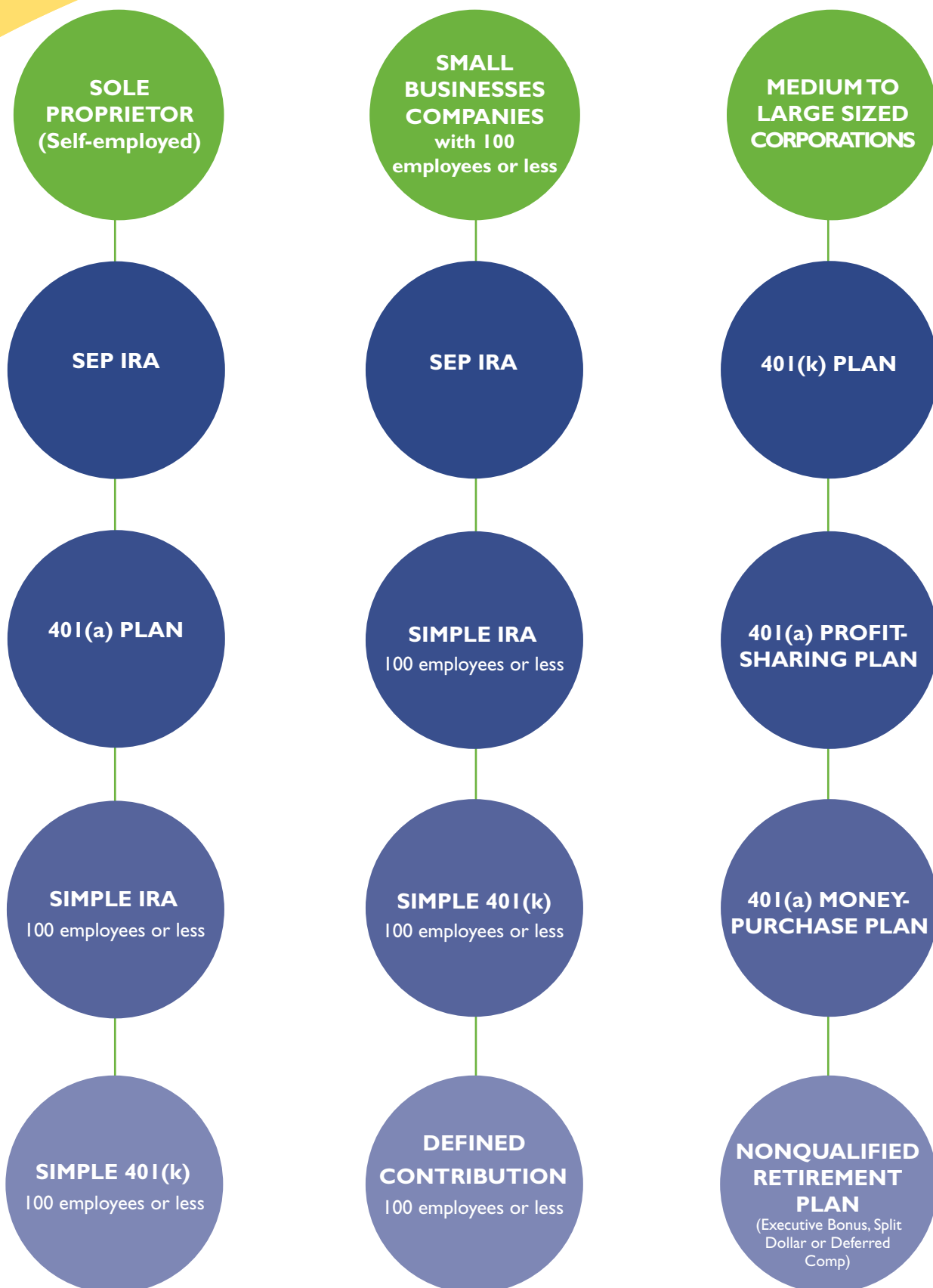
# Retirement Planning Guide

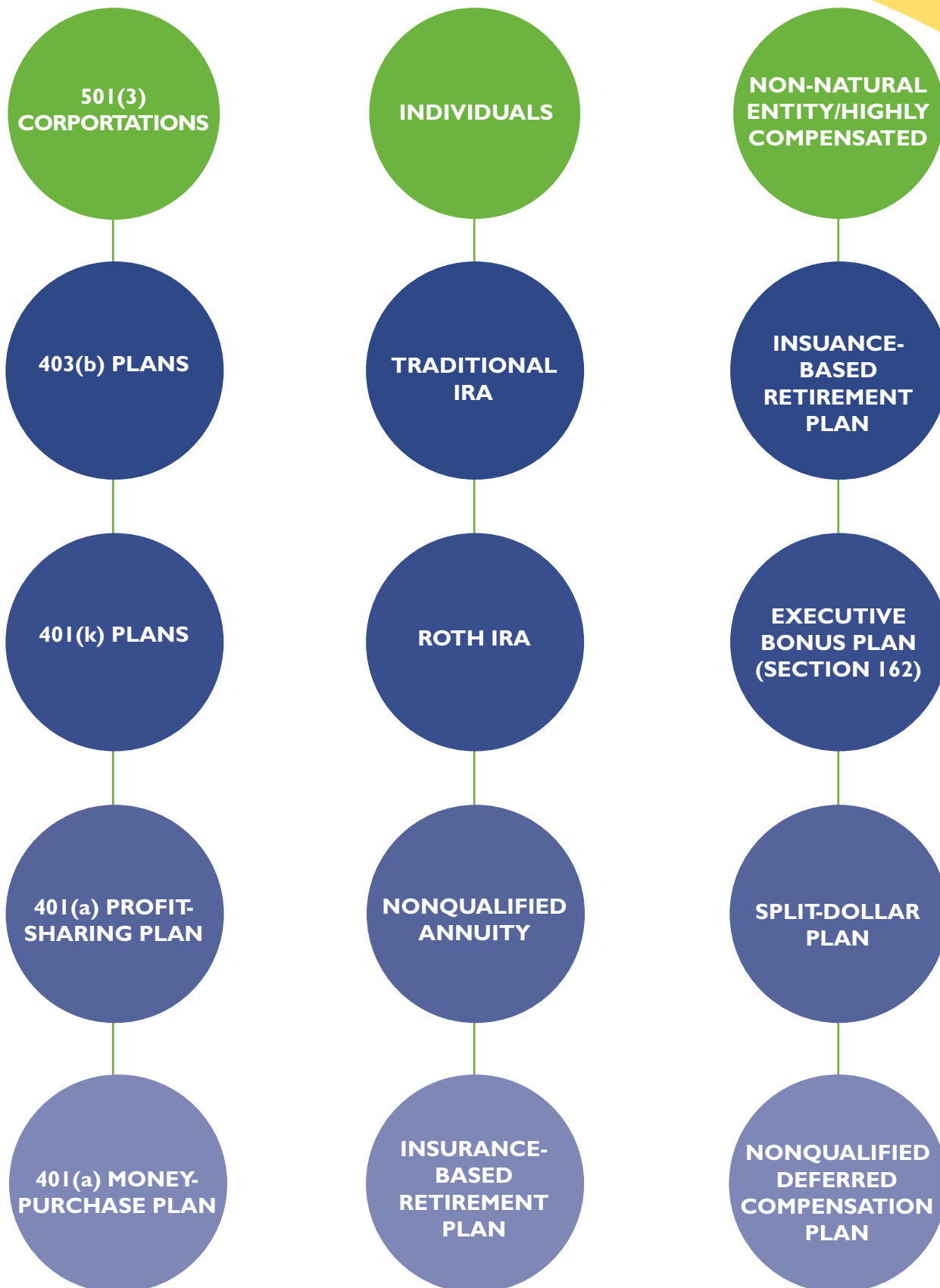
2007 Edition



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# PLAN POSITIONING





# TRADITIONAL IRA

## IRA – Individual Retirement Account

**DEFINITION: A TAX-FAVORED SAVINGS PLAN THAT ENCOURAGES ACCUMULATION OF SAVINGS FOR RETIREMENT**

### Contribution limits

- Annual contribution limit for individuals is the lesser of \$4,000 or 100% of compensation; the \$4,000 limit includes contributions for both a traditional IRA and Roth IRA combined
- Married couple's maximum annual contribution is lesser of \$8,000 or 100% of compensation; each spouse must maintain his or her own separate IRA, and the \$4,000 limit applies to each spouse separately
- Catch-up provision: Workers age 50 (by the end of the calendar year) or older are permitted to make an additional \$1,000 contribution for 2007

### IRA eligibility and deductibility

- Any U.S. citizen under age 70½, who receives compensation, can make an IRA contribution
- If neither the taxpayer nor the taxpayer's spouse is an active participant in an employer-maintained retirement plan, all their IRA contributions are deductible
- If an individual is not an active participant in a retirement plan but the individual's spouse is, then the non-active participant's IRA contributions are deductible if the couple's income is below a certain limit (i.e., \$156,000 or less for full deduction; more than \$156,000 but less than \$166,000 for partial deduction indexed for 2007)
- If an individual is an active participant in a retirement plan, then the IRA contributions are deductible if the taxpayer's adjusted gross income (AGI) falls below a certain limit (see chart below)

### 2007 indexed limits for deductible IRA contributions

FILING STATUS	FULL IRA DEDUCTION	REDUCED IRA DEDUCTION	NO IRA DEDUCTION
<b>Married, filing Separate return</b>	None	Less than \$10,000	\$10,000 or more
<b>Individual</b>	\$52,000 or less	More than \$52,000 to \$62,000 or more	\$62,000 or more
<b>Married, filing jointly</b>	\$83,000 or less	More than 83,000 to \$103,000 or more	\$103,000 or more

## Distributions from traditional IRAs

- Participants may take a withdrawal from their IRA at any time; however, they will be subject to a 10% excise (penalty) tax, in addition to paying ordinary income taxes on their withdrawal, unless their distribution qualifies under one of these exceptions:
  - Age 59½ or older
  - Substantially equal periodic payments over life or life expectancy
  - Death or disability of participant
  - Medical expenses in excess of 7.5% of adjusted gross income
  - Qualified higher education expenses (i.e., tuition, fees, books, supplies, etc.)
  - First home purchase (\$10,000 lifetime limit)
- Required minimum distribution (as defined by the IRS) must begin no later than when participant attains age 70½

## Target market

- Individuals who aren't currently participating or contributing to an employer-sponsored retirement plan
- Individuals using an IRA as a rollover vehicle for retirement plans, such as 401(k)s, 457s, 403(b)s, SEP IRAs and SIMPLEs

**DEFINITION: NONDEDUCTIBLE IRA WITH THE POTENTIAL OF EARNINGS BEING DISTRIBUTED INCOME TAX FREE**

## Differences between Roth IRAs and traditional IRAs:

- Roth IRA contributions are made on an after-tax basis; contributions to traditional IRAs may be tax deductible; depending on the individual's retirement plan and AGI, contributions to Roth IRAs are never deductible
- Roth IRA earnings can qualify to be distributed tax free; traditional IRA earnings won't qualify
- Withdrawals from Roth IRAs come out on a first-in, first-out basis; traditional IRAs use a last-in, first-out basis
- Pre-death minimum distribution rules do not apply to Roth IRAs but do apply to traditional IRAs

## Contribution limits (for Roth IRAs and traditional IRAs)

- Annual contribution limit for individuals is lesser of \$4,000 or 100% of compensation; the \$4,000 limit includes contributions for both a traditional IRA and Roth IRA combined

**Caveat:**

- Full contribution is permitted for single taxpayers with AGI up to \$99,000
- Contributions are phased out for single taxpayers with AGI between \$99,000 to \$114,000
- Married couple's maximum annual contribution is lesser of \$8,000 or 100% of compensation; each spouse must maintain his or her separate Roth IRA, and the \$4,000 limit applies to each spouse separately.

**Caveat:**

- Full contribution is permitted for married joint filers with AGI up to \$156,000
- Contributions are phased out for married joint filers with AGI between \$156,000 to \$166,000
- Contributions are phased out for a married filer who files separately between \$0 to \$10,000 AGI
- Catch-up provision: Workers age 50 (by the end of the calendar year) or older are permitted to make an additional \$1,000 contribution for 2007

## Two requirements for Roth IRA earnings to be distributed tax free:

- Distribution must be made after the five-year tax period has been satisfied
- Distributions must be made under one of four conditions:
  - Participant is at least 59½ years old
  - Distribution is paid to a beneficiary at death of participant
  - Participant has become disabled
  - Withdrawal is made to pay qualified first-time homebuyer expenses (\$10,000 lifetime limit)

## Penalty-free withdrawals

- Participants can withdraw money prior to age 59½ from their Roth IRA (or traditional IRA) and avoid the 10% excise (penalty) tax on the portion of the distribution, if any, that is taxable for any of the following reasons:
  - Death
  - Disability
  - Substantially equal periodic payments over life or life expectancy
  - Medical expenses in excess of 7.5% of adjusted gross income
  - New home purchase (\$10,000 lifetime limit)
  - Qualified higher education expenses (i.e., tuition, fees, books, supplies)

## Conversions from traditional IRA to Roth IRA

Money can be converted from a traditional IRA to a Roth IRA if the AGI of the single taxpayer, or married filing jointly taxpayers, is less than \$100,000. (Married filing separately is not eligible). However, this conversion is taxable when made.

## Target market

The Roth IRA is best when the individual will be in a higher tax bracket at retirement than at the time of the contribution:

- Tax-free source of income allows owner greater flexibility in liquidating taxable assets at retirement
- No need to take distributions during owner's lifetime
- Individual expects to defer the start of distributions for a long time

## SEP – Simplified Employee Pension

**DEFINITION: SMALL EMPLOYER RETIREMENT PLAN USING AN IRA AS THE FUNDING/INVESTMENT VEHICLE**

### Contribution limits

- Employer contribution limit: lesser of 25% of employee's salary (\$225,000 salary cap as indexed for 2007) or \$45,000 (this amount may be less for highly compensated employees)
- Employer must contribute an equal percentage to all eligible employees with immediate vesting; if the owner contributes 8% to their account, they must contribute 8% for all eligible employees, if using 5305 form
- Employer contributions only; employee salary deferrals are not permitted (exception: SAR-SEP plan); SAR-SEP plans, established prior to January 1, 1997, permit employee salary deferrals (see next page)
- Employer contributions, which are determined on a year-to-year basis, are typically discretionary

### Employer eligibility requirement

- 50% of eligible employees must participate in a SEP IRA plan

### Employee eligibility requirement

- Participant must be employed with the company in at least three of the last five preceding years
- Employee must typically be age 21 or older (however, employer can set age at 18) and have received at least \$500 in compensation (as indexed for 2007)

### Key points

- Loans are not permitted
- Distributions are treated the same as an IRA, as ordinary income

### Target market

- Small nonprofit organizations, small employers or sole proprietors with a limited benefit budget looking to establish their first retirement plan, which is easy to administer
- Additional factors that favor a SEP IRA are: no filing requirements, limited fiduciary liability and less cumbersome, cost-effective administration (relative to a qualified plan)

## SAR-SEP – Simplified employee pension with employee contributions

### SAR-SEP

- SAR-SEP plans, which allowed for employee salary deferrals, were permitted to be established prior to Jan. 1, 1997

### Contribution limits

- Employee deferral limit (SAR-SEPs only): lesser of \$15,500 or 25% of employee's compensation
  - Employee's compensation for purposes of calculation is capped at \$225,000 (indexed for 2007)
  - Employees age 50 (by the end of the calendar year) or older are permitted an additional \$5,000 catch-up contribution for 2007

### Penalty tax

- Distributions prior to age 59½ will be subject to a 10% early withdrawal penalty unless it qualifies for one of the following exceptions:
  - Death
  - Disability
  - Substantially equal periodic payments over life or life expectancy
  - Medical expenses in excess of 7.5% of adjusted gross income
  - Separation from service after age 55 (one-time exception)
  - Distributions to non-participants pursuant to a qualified domestic relations order

## SIMPLE – Savings Incentive Match Plan for Employees

**DEFINITION: SMALL EMPLOYER RETIREMENT PLAN USING AN IRA AS THE FUNDING VEHICLE**

### Contribution limits

- Employer contribution limit (employer must select from these two options):
  - 100% match on the first 3% of employee's salary deferral (participating employee)  
**Example: If an employee defers 5% of their salary into their SIMPLE IRA, the employer must contribute 3% in their account. If employee defers 1% of salary, the employer must contribute 1%.**
    - If employer elects this option, the maximum employer contribution is \$10,500 (indexed for 2007)
  - 2% non-elective contribution for all eligible employees (regardless of participation)
    - If employer elects this option, the maximum employer contribution is \$4,500 (\$225,000 cap x 2%)
- Employee deferral limit: \$10,500 per plan year (indexed for 2007) up to 100% of compensation
  - Employees age 50 (by the end of the calendar year) or older are permitted an additional \$2,500 catch-up contribution for 2007, if the plan permits.

### Plan eligibility requirements

- Any type of business with 100 employees or fewer may establish a SIMPLE IRA; however, no other qualified plan, 403(b), SEP IRA or 457 plan can be maintained
- Employer must notify participants of 60-day election period prior to the calendar year end to elect salary deferral or modify a prior election; hence, their adoption deadline is October 1
- Employer must provide employee with a Summary Plan Description and account statements within 30 days of the end of a calendar year (contributions must be made between 1/1 to 12/31)
- Employer must cover any employee that has earned \$5,000 in any two previous years and is expected to earn \$5,000 during current year (exception: employees subject to collective bargaining)

## Key points

- SIMPLE IRAs replaced SAR-SEP IRA plans – January 1, 1997
- Withdrawals can't be restricted; however, withdrawals in the first two years of the employee's contributions are subject to a 25% penalty tax in addition to income tax
- All contributions (employer and employee) are 100% vested immediately
- Participant loans are not permitted
- No discrimination testing, annual reporting or administration cost is required by employer
- No discrimination testing is required by the employer, meaning highly compensated employees can defer their \$10,500 without concern of what the lower paid employees are deferring

## Penalty tax

- Distributions prior to age 59½ will be subject to a 10% early withdrawal penalty unless if qualifies for one of the following exceptions:
  - Death
  - Disability
  - Substantially equal periodic payments over life or life expectancy
  - Medical expenses in excess of 7.5% of adjusted gross income
  - Separation from service after age 55 (one time exception)
  - Distributions to non-participants pursuant to a qualified domestic relations order

## Target market

- Small nonprofit organizations and small employers with limited benefit budgets looking for a first retirement plan that is inexpensive and easy to administer
- Employers with 401(k) plans in force should not switch to a SIMPLE IRA plan because 401(k)s are more flexible and allow skewing contributions to a targeted group of employees

## SIMPLE – Savings Incentive Match Plan for Employees

**DEFINITION: SMALL EMPLOYER RETIREMENT PLAN USING A SIMPLIFIED 401(k) AS THE FUNDING VEHICLE**

### Contribution limits:

- Employer contribution requirement (employer must select from these two options):
  - 100% match on the first 3% of the employee's salary deferral (participating employee)  
**Example: If the employee defers 5% of his or her salary into a SIMPLE 401(k), the employer must contribute 3% to the account. If employee defers 1% of salary, employer must contribute 1%.**
    - If employer elects this option, the maximum employer contribution is \$6,750 (\$225,000 cap x 3%)
  - 2% non-elective contribution for all eligible employees (regardless of participation)
    - If employer elects this option, the maximum employer contribution is \$4,500 (\$225,000 cap x 2%)
- Employee deferral limit: \$10,500 per plan year (indexed for 2007) up to 100% of compensation
  - Employees age 50 (by the end of the calendar year) or older are permitted an additional \$2,500 catch-up contribution for 2007

### Plan eligibility requirements

- Any nongovernmental business, with 100 employees or fewer, may establish a SIMPLE 401(k); however, no other qualified plan, 403(b) or SEP IRA plan can be maintained.
- Employer must notify participants of 60-day election period prior to the calendar year end to elect salary deferral or modify a prior election; hence, their adoption deadline is October 1
- Employee withdrawals cannot be restricted but are subject to income tax and a 10% penalty tax
- Employees are eligible to contribute if they've earned \$5,000 and are 21 years of age or have 1,000 service hours in a prior year (employer may exclude nonresident aliens and certain union employees)
- SIMPLE 401(k) plans have the ability to convert to a traditional 401(k) and vice versa
- Must be maintained on a calendar-year basis (i.e., contributions are made from 1/1 to 12/31)

## Key points

- All contributions (employer and employee) are 100% vested immediately
- Participant loans are permitted (if allowed in the plan document)
- No discrimination testing or top-heavy testing is required by the employer
- Employers of SIMPLE 401(k) plans are subject to administrative expenses for plan document filing and amendments, 5500 Schedule A governmental filing and 415 limit testing

## Penalty tax

- Distributions prior to age 59½ will be subject to a 10% early withdrawal penalty unless it qualifies for one of the following exceptions:
  - Death
  - Disability
  - Substantially equal periodic payments over life or life expectancy
  - Medical expenses in excess of 7.5% of adjusted gross income
  - Separation from service after age 55 (one time exception)
  - Distributions to non-participants pursuant to a qualified domestic relations order

## Target market

- SIMPLE 401(k) plans are more attractive than a SIMPLE IRA plan for businesses wanting loan provisions, more restrictive hours requirements for eligibility, exclusion of employees under age 21 or shelter from bankruptcy under ERISA
- Employers with 401(k) plans in force should consider amending to a SIMPLE 401(k) plan if the employer is struggling with top-heavy requirements, the employer is unable to meet the nondiscrimination testing, or highly compensated employees are not even close to deferring \$10,500

# SIMPLE IRA AND SIMPLE 401(k)

## MAJOR DIFFERENCES

	SIMPLE IRA	SIMPLE 401(k)
<b>Employee Eligibility Requirements</b>	Any employee earning \$5,000 or more in any two prior years and expected to earn \$5,000 in the current year	Any employee earning \$5,000 and the later of 21 years of age or 1,000 service hours in a prior year (may be less pursuant to plan terms)
<b>Employee Deferral Limit</b>	\$10,500 per plan year up to 100% of compensation	\$10,500 per plan year up to 100% of compensation
<b>Employer Deferral Limit</b>	If the employer elects the 3% deferral option, up to \$10,500 annually	If the employer elects the 3% deferral option, up to \$6,750 annually (\$225,000 x .03) If the employer elects the 2% deferral option; up to \$4,500 annually (\$225,000 x .02)
<b>Participant Loans</b>	Not permitted	Permitted if plan document allows
<b>Rollovers</b>	Permitted to IRA only after two years – may roll into another SIMPLE IRA prior to two years	Permitted to IRA or qualified plan immediately
<b>Excise Tax</b>	Withdrawals during the first two years are subject to a 25% excise tax; 10% thereafter until 59½	Withdrawals subject to 10% excise tax on distributions prior to age 59½
<b>Competitive advantage</b>	Minimal administration expenses, and no 5500 filings or 415 limit testing required	Loans are permitted, may have more restrictive eligibility requirements, exclusion of employees under 21 and bankruptcy protection under ERISA

# DEFINED BENEFIT PENSION PLAN

**DEFINITION: A RETIREMENT PLAN IN WHICH CONTRIBUTIONS ARE BASED ON WHAT IS NEEDED TO PROVIDE DETERMINABLE, FUTURE BENEFITS TO PLAN PARTICIPANTS**

## Employer contribution limits

- Lesser of \$180,000 or 100% of the employee's highest three years' (consecutive) compensation (indexed for 2007)
- The deduction of contributions is based on actuarial assumptions and computations; consequently, an actuary must figure your deduction limit
- Gains in excess of actuarial assumptions may be used to reduce premium in the following year

## Key points

- Allows an employer to create substantial retirement benefits for employees
- Can be used in conjunction with, or in lieu of, a defined contribution plan

## 412(i) PLAN

**DEFINITION: A DEFINED BENEFIT PLAN THAT IS FUNDED EXCLUSIVELY WITH LIFE INSURANCE AND ANNUITIES TO CREATE A GUARANTEED RETIREMENT INCOME BENEFIT**

## 412(i) plan opportunities

- Exempt from minimum funding requirements because they are fully insured
- Tax-deductible contributions are not subject to the funding limitations of a traditional qualified plan, and as a result are generally larger and more flexible
- Easier to implement, less costly and administratively less complex to employ

## How it works

The employer purchases a combination of life insurance and annuities with the 412(i) plan to fund a future retirement income benefit for their plan participants.

- The plan must be level funded and must begin when the participant has met eligibility requirements and must end no later than predetermined retirement date

## Target market

Commonly used by small business (six or fewer employees) that are stable, successful and have a significant and consistent cash flow.

# DEFINED CONTRIBUTION PENSION PLANS

## Profit-sharing plan

- A qualified plan that is structured so that contributions are only made by the employer into a participant's account in years where the employer chooses (not necessarily based on profit)
  - Employer contributions must be considered substantial and recurring

## Money-purchase plan

- A qualified plan, which requires mandatory employer contributions, based on a percentage of employee's compensation
  - Given the EGTRRA improvements to profit-sharing plan deductibility, money-purchase plan's rigid contribution requirements may make them less desirable than the flexible contribution options within an employer profit-sharing plan

## 401(k) plan

- A qualified plan that allows for salary reduction and employer funding (restrictions apply)
  - Withdrawals are restricted and significant plan testing is required by the IRS

## 403(b) plan

- A tax-sheltered or tax-deferred annuity similar in structure to a 401(k), but sold only for employees of qualified 501(c)(3) tax-exempt organizations and public schools
  - Plan can be funded by either an annuity contract or mutual funds
  - Salary reductions are subject to certain restrictions

## Target-benefit plan

- A qualified plan, which uses a defined benefit formula to determine the annual contributions; the target benefit amount is not guaranteed by the employer
  - Suited for older owner/employees who haven't set up any retirement plan

## Cash-balance plan

- A qualified plan that provides a defined benefit at retirement, based on the account (bookkeeping) value at termination
  - Benefits are guaranteed by PBGC (Pension Benefit Guaranty Corporation)

## Stock plan

- A qualified stock bonus and employee stock ownership plans (ESOP), which are structured similar to a profit-sharing plan, except funds are used to purchase corporate stock
  - Once the stock is sold, participant may further defer paying taxes on the gain by purchasing qualified replacement property within defined replacement period
  - Disadvantages: lacks diversity and liquidity

# 401(a) PLANS

**DEFINITION: QUALIFIED PLAN SET UP AS EITHER A PROFIT-SHARING OR MONEY-PURCHASE PLAN**

## *Profit-Sharing Plan*

### Employer contribution limits

- Lesser of \$45,000 or 100% of employee's salary (indexed for 2007)
  - Employer contributions occur in years, where decided, and are strictly optional
  - Employer contributions can be discretionary and/or matching (based on employee's 401(k) deferral)
  - Employer contributions are deductible up to 25% of an employee's salary
  - Employer contributions depend on the plan and must be substantial and recurring

### Employee deferral limit

- Nondiscriminatory amount of after-tax contributions if plan allows
  - If employee contributions are permitted per plan document, they're 100% vested immediately

### Types of profit-sharing plans

- Age-weighted profit-sharing plan: unique type of plan designed to allow contributions to be allocated among employees in varying amounts based on each employee's age
  - Age-weighted allocations may work best when there is a good age disparity between the owner and the employees
- New comparability (cross-tested) profit-sharing plan: unique type of plan designed to allow contributions to be allocated among employees in varying amounts, based on each employee's age, compensation and/or job classification

## Money-Purchase Plan

### Employer contribution limits

- Lesser of \$45,000 or 100% of employee's salary (indexed for 2007)
  - Employer contributions are mandatory and based on a percentage of the employee's salary
  - Employer contributions only (the employee is not permitted to contribute into this plan)

### Key points

- Loans are permitted if allowed in the plan document
- If employee separates from service, the vested portion may roll over to an IRA to a new employer if permitted by new employer's plan
- Distributions may be made under specific conditions, including:
  - Participant (employee) must be at least 59½ years old
  - Participant (employee) becomes disabled (as defined by the Internal Revenue Code)
  - Distribution is paid to the beneficiary as a result of participant's death
- Less desirable than money-purchase plans due to lack of deductibility and mandatory contributions

### Penalty tax

- Distributions before age 59½ will be subject to a 10% early withdrawal penalty except when due to:
  - Death
  - Disability
  - Substantially equal periodic payments over life or life expectancy
  - Medical expenses in excess of 7.5% of adjusted gross income
  - Separation from service after age 55 (one-time exception)
  - Distributions to nonparticipants pursuant to a qualified domestic relations order

### 401(k) sales opportunities

- Great way for employers to enhance retirement benefits, as well as attract and retain employees
- Small businesses (less than 100 participants) may be eligible for a tax credit up to 50% of the first \$1,000 of start-up administration and education expenses for the first three years of a new retirement plan

## DEFINITION: TYPE OF QUALIFIED PROFIT-SHARING PLAN WITH A SALARY DEFERRAL FEATURE

### Employer contribution limits

- Lesser of \$45,000 or 100% of employee's salary (indexed for 2007)
  - This limit is inclusive of what the employee is permitted to contribute into their account
  - Employer contributions can be discretionary and/or matching (based on employee's 401(k) deferral)
  - Employer contribution is not mandatory unless specified in the plan document or if plan is top heavy; however, if it's considered top heavy, the most the employer would need to contribute is 3% to all eligible employees
  - Employer contribution's vesting schedule is in accordance to their plan document

### Employee deferral limit

- \$15,500 per plan year (indexed for 2007) up to 100% of compensation
  - Employee contributions are 100% vested immediately and cannot be forfeited
  - Employees age 50 (by the end of the calendar year) or older are permitted to make an additional \$5,000 catch-up contribution for 2007

### Key points

- Loans are permitted if allowed in the plan document
- If employment changes, participant's vested portion may roll over to new employer if new employer plan permits
- If employee separates from service, the vested portion may roll over to an IRA
- Withdrawals from 401(k) plans are substantially restricted since its purpose is retirement
- Distributions may be made under specific conditions, including:
  - Participant (employee) must be at least 59½ years old
  - Participant (employee) becomes disabled (as defined by the Internal Revenue Code)
  - Distribution is paid to the beneficiary as a result of participant's death
  - In-service withdrawals
  - Qualified Domestic Relations Orders
  - Separation from service

## IRS required testing

- **Top-heavy Test:** a plan is considered to be top heavy if the employer's contributions to key employee accounts are greater than 60% of the employer contributions to non-key employee accounts
- **Actual Deferral Percentage (ADP) Test:** an extra nondiscrimination test required by 401(k) plans that restricts highly compensated employees from deferring a percentage of their annual salary far above non-highly compensated employees; the plan must satisfy either the 1.25% or the 200/2% test.
- **Safe Harbor Opportunity:** if a 401(k) plan satisfies one of the following safe harbor requirements, the highly compensated employees may contribute the full \$15,500 deferral limit permitted for 2007
  - Matching contribution by the employer of 100% of the first 3% deferred and 50% of the next 2% deferred
  - 3% non-elective contribution to all eligible employees (this option is the default selection for top-heavy plans)

## Penalty tax

- Distributions prior to age 59½ will be subject to a 10% early withdrawal penalty unless it qualifies for one of the following exceptions:
  - Death
  - Disability
  - Substantially equal periodic payments over life or life expectancy
  - Medical expenses in excess of 7.5% of adjusted gross income
  - Separation from service after age 55 (one-time exception)
  - Distributions to non-participants pursuant to a qualified domestic relations order

## 401(k) sales opportunities

- Great way for employers to attract and retain employees
- Small businesses (less than 100 participants) may be eligible for a tax credit up to 50% of the first \$1,000 of start-up administration and education expenses for the first three years of a new retirement plan

## Roth 401(k) contributions

401(k) designated Roth contributions are a new type of contribution that can be accepted by new or existing 401(k) plans.

- If a plan adopts this feature, employees can designate some or all of their elective contributions as designated Roth contributions, which are included in gross income, rather than traditional, pretax elective contributions
- Designated Roth contributions must be kept completely separate from previous and current 401(k) pretax elective contributions; a separate account must be established for each participant making designated Roth contributions
- Once a payment is designated as a Roth contribution, it cannot later be changed to a pretax elective contribution

**Employee Contribution:** An employee can make contributions to both a Roth 401(k) account and a pre-tax 401(k) account in the same year in any proportion they choose. However, the combined amount contributed in any one year is limited by the 402(g) limit - \$15,500 for 2007 (plus an additional \$5,000 in catch-up contributions if age 50 or older).

**Employer Contribution:** Although the employer can make matching contributions on designated Roth contributions, only an employee's designated Roth contributions can be made to Roth 401(k) accounts.

**Penalty-free Withdrawals:** Earnings will be included in gross income unless you have had the Roth 401(k) account for five years and are either disabled or over age 59½.

## 401(k) mirror deferred comp plan

A non-qualified plan, often used in conjunction with a 401(k) plan. A corporate-owned life insurance plan is designed to allow highly compensated employees to reduce their taxable wage base by contributing pretax to this plan without being restricted by qualified plan rules. The employer does not get a deduction for the amount deferred into the plan – the deduction comes when the employer pays the benefit to the employee.

- Primary goal is to retain, reward and recruit key employees by providing an additional deferral option above the traditional 401(k) plan
- A Rabbi Trust is often used to protect the assets in the event of a company takeover
- Participants cannot make up more than 25% of overall employees

**DEFINITION: TAX-SHELTERED INVESTMENT USED TO ACCUMULATE SAVINGS (TYPICALLY THROUGH SALARY DEFERRAL) FOR RETIREMENT**

## Eligibility

- Available to 501(c)(3) tax-exempt organizations and public schools (corporations are prohibited)
  - 501(c)(3) organization: a nonprofit group, with special tax exemptions, organized and operated for religious, charitable, scientific or educational purposes at a zero-profit level
  - Public schools: institution must maintain a faculty, curriculum and student body (i.e., no home schooling)

## Employer contribution limits

- Lesser of \$45,000 or 100% of employee's salary (indexed for 2007)
  - Employer contributions can be discretionary and/or matching (based on employee's 403(b) deferral)
  - Employer contribution's vesting schedule is in accordance to their plan document

## Employee contribution limits

- \$15,500 per plan year (indexed for 2007) up to 100% of compensation
  - Employee contributions are 100% vested immediately and cannot be forfeited
  - Employees age 50 (by the end of the calendar year) or older are permitted to make an additional \$5,000 catch-up contribution for 2007
  - Prior to January 1, 2002, an MEA (maximum exclusion allowance) calculation was required for each employee to determine the maximum annual contribution permitted; it has been repealed

## ERISA vs. Non-ERISA

ERISA 403(b) plans	Non-ERISA 403(b) plans
Allows for both employee and employer contributions	Usually allows for employee contributions only, unless permitted by plan document
Employee may be subject to a vesting schedule	Limited to employees with voluntary salary reduction
Employee may be subject to age and service requirements	Individual accounts (participants direct their investments)
An administrator is responsible for plan and IRS reporting	Commonly referred to as a tax-sheltered annuity (TSA)

# 403(b) PLANS

(Continued)

## Key points

- Loans are permitted if allowed in plan document
- If employment changes, participant's vested portion may roll over to an IRA
- If employee separates from service, his or her vested portion may roll over to an IRA
- Withdrawals from 403(b) plans are substantially restricted per the 1986 Tax Reform Act
- Distributions (other than loans) may be made under these conditions:
  - Participant (employee) must be at least 59½ years old
  - Participant (employee) becomes disabled (as defined by the Internal Revenue Code)
  - Participant (employee) becomes separated from service (employer)
  - Financial hardship withdrawal (10% excise tax may apply if employee is under 59½)
  - Distribution is paid to the beneficiary as a result of participant's death

## Penalty tax

- Distributions prior to age 59½ will be subject to a 10% early withdrawal penalty unless it qualifies for one of the following exceptions:
  - Death
  - Disability
  - Substantially equal periodic payments over life or life expectancy
  - Medical expenses in excess of 7.5% of adjusted gross income
  - Separation from service after age 55 (one-time exception)
  - Distributions to non-participants pursuant to a qualified domestic relations order

## Target markets

- Schools
- Hospitals
- Religious organizations
- Charities
- Colleges/universities

# NON-QUALIFIED LIFE INSURANCE SALES CONCEPTS

1. Insurance-based Retirement Plan
2. Executive Bonus Plan (Section 162)
3. Split-dollar Life Insurance Plan
4. Deferred Compensation Plan – SERP

All of these sales concepts can involve the use of a variable life policy to fund a captivating benefit for key employees – the key is how the employer is going to fund/pay for this benefit.

## Goal

To pay for the retirement benefit in the most tax-efficient manner

## Benefits to the employer

- Attract, retain and reward talented and valuable employees
- Selective participation – employer may pick and choose who may participate
- Supplements existing retirement plans without IRS approval or costly administration
- Depending on the plan, the premium paid by the employer may be deductible
- Plan design is flexible to meet the employer's intention and employee's needs
- May solve estate planning and other business needs (e.g., buy/sell agreements)
- Tax advantages of a life insurance policy: grows in a tax-deferred manner, principal can be withdrawn on a tax-free basis and the survivor benefits are generally received income tax free by the beneficiary

## Benefits to the employee

Tax-free retirement income can be attained (via partial surrenders and loans) if set up properly (excluding SERPs)

- Survivor benefits are received income tax free by the beneficiary of the policy (excluding SERPs)
- Assets in the policy accumulate tax deferred
- Increased retirement benefits for employee and survivor benefits for beneficiary
- Does not impact an employee's fringe benefits or qualified plan contributions

# NON-QUALIFIED LIFE INSURANCE SALES CONCEPTS

## I. Insurance-Based Retirement Program

**DEFINITION: INDIVIDUALLY OWNED LIFE INSURANCE PLAN STRUCTURED TO PROVIDE SUPPLEMENTAL RETIREMENT ASSETS AND FAMILY PROTECTION**

### Goal

Supplementing retirement income and providing life insurance protection in the event of premature death

### Target market

Ideal for sole proprietors, small business owners, or high-net-worth individuals who have maximized other retirement plan contributions and are looking to supplement their retirement in a tax-advantaged manner

### How it works

- Individual pays the premium to fund a variable life insurance policy
- At retirement, the individual may take partial surrenders (up to the amount of premiums paid) and loans from the policy on a tax-advantaged basis (if set up properly) to supplement his or her retirement income

Assumes contract remains in force and qualifies as life insurance under section 7702 of the Internal Revenue Code, and is not a modified endowment contract (MEC) under section 7702(A). Loans and partial surrenders from a MEC are generally taxable and, if taken prior to age 59½, may be subject to a 10% penalty tax. Loans and partial surrenders will reduce any death benefits payable.

- At the participant's death, the beneficiaries of the policy will receive the death benefit proceeds income tax free

## Benefits/advantages

- Tax advantages: withdrawal method (i.e., first-in, first-out), which depletes principal in the policy (tax free) first, followed by subsequent earnings

### **Caveat:**

In order for the life insurance policy to retain its tax advantages, it has to stay in force and avoid being classified as a MEC. If the policy does lapse, the gain/earnings are taxed as ordinary income\*:

- Partial surrenders on a first-in, first-out basis (after-tax premiums first, as long as policy remains a non-MEC)
- Provide beneficiaries with replacement income in the event of premature death
- Provide beneficiaries with income tax-free death benefit proceeds (IRC section 101(a))
- No additional fees, administration or discrimination testing is required
- Liberal funding levels (unlike a qualified plan)
- Cash value grows tax deferred, providing greater growth potential
- Cash value in the policy is available for emergencies or financial planning needs (e.g., college funding, mortgage acceleration)

\* Assumes contract remains in force and qualifies as life insurance under section 7702 of the Internal Revenue Code, and is not a modified endowment contract (MEC) under section 7702(A). Loans and partial surrenders from a MEC are generally taxable and, if taken prior to age 59½, may be subject to a 10% penalty tax. Loans and partial surrenders will reduce any death benefits payable.

# NON-QUALIFIED LIFE INSURANCE SALES CONCEPTS

## 2. Executive Bonus Plan – IRC Section 162

**DEFINITION: AN EXECUTIVE BONUS PLAN IS A METHOD OF COMPENSATING SELECTED KEY EMPLOYEES BY PAYING THE PREMIUMS OF A LIFE INSURANCE POLICY ON THE EMPLOYEE'S LIFE**

### Goal

Retain and reward key employees by making a taxable contribution that is tax deductible by the employer into a variable life policy for executives as a taxable bonus

### Target market

- C Corporations
- S Corporations
  - In light of the recent changes in taxation of split-dollar plans (i.e., IRS Notice 2002-8), S Corporation may want to consider an executive bonus plan, as an alternative to split dollar
- Small business owners

### Estate planning

If the employee desires to exclude the policy from his estate upon death, the initial applicant and owner of the policy must be a third party (e.g., spouse), and the employee must make sure that he doesn't have any incidents of ownership in the policy

### Benefits to employer

- Reward and retain key employees, while supplementing their retirement
- Selective participation: avoidance of non-discrimination (ERISA) rules
- Premiums paid by employer may provide an immediate tax deduction
- Administration cost is minimal due to simplicity of setup/implementation
- Amounts of coverage on various employees/executives can differ
- Plan can be terminated without IRS approval or restrictions

## Benefits to executive

- Supplemental retirement assets can be accumulated
- Provide beneficiaries with income tax-free death benefit proceeds (IRC section 101(a))
- Key employee/executive controls and own the policy
- Cash value grows income tax deferred

## Key points

- Employer cannot be the owner or beneficiary on the insurance policy
- The premium paid by the employer is considered additional compensation to the executive and will be taxed as ordinary income
- The premium paid by the employer must be considered reasonable compensation when added to all other compensation for the employer to receive the tax write-off
- If the goal of this plan is to retain key personnel for a set period of time, there should be a written agreement in force between the employer and employee, such as a REBA (Restricted Employee Benefit Agreement)

# NON-QUALIFIED LIFE INSURANCE SALES CONCEPTS

## 3. Split-Dollar Plan

**DEFINITION: SPLIT-DOLLAR IS A METHOD OF SHARING THE COST AND BENEFIT OF A LIFE INSURANCE POLICY BETWEEN THE EMPLOYER AND A KEY EMPLOYEE/EXECUTIVE**

### Goal

Retain and reward key employees by splitting the cost of the life insurance while accumulating a cash value on a tax-deferred basis

### Target market

Excellent vehicle for C Corporations or a closely held business that wants to provide additional life insurance or supplemental retirement resources for a limited and select group of key employees

### Benefits/advantages

- Discrimination in favor of owners and key employees is permitted
- The corporation's share of premiums is secured/protected in the policy
- The plan is exempt from vesting, funding and ERISA participation rules

## Policy ownership

- Endorsement method: the employer owns the policy and the employee's interest is noted as an endorsement to the policy
  - A written endorsement may be filed, the original beneficiary designation or a reference to the endorsement agreement may be used in lieu of the filing
  - Employer is also required to provide a plan summary to all participants
  - Under recently adopted regulations, the endorsement method will be taxed under the traditional split-dollar agreement; economic benefits process (listed below):
    - Employer pays the premiums required
    - Employee will be taxed on the economic benefit to the extent that the employer pays the premium and is not repaid by the employee
    - The economic benefit includes the value of current life insurance protection (Table 2001, which replaced PS 58 rates), and current access to cash surrender value to the extent that such access has not previously been taxed
- Collateral assignment: the employee owns the policy, and the employer's interest is secured by an assignment of the contract
  - Under recently adopted regulations, funds provided by the employer under the collateral assignment method will be treated as a series of below-market-rate loans if the employee is obligated to repay the funds (if the employee is not obligated to repay, the funds will be treated as compensation in full to the employee)

# NON-QUALIFIED LIFE INSURANCE SALES CONCEPTS

## 4. Deferred Compensation Plan – SERP

**DEFINITION: A METHOD OF COMPENSATING A SELECT GROUP OF KEY EMPLOYEES/EXECUTIVES BY PURCHASING A LIFE INSURANCE POLICY IN THE COMPANY'S NAME TO BE PAID OUT AT A FUTURE DATE IF CERTAIN CONTRACTUAL OBLIGATIONS ARE MET BY THE KEY EMPLOYEE**

### Goal

Retain and reward talented/valuable key employees by providing an additional incentive (i.e., deferred compensation) to them (and their family) for remaining employed with the company

### Target market

Most commonly used by C Corporations that are considering this benefit for their executives and want maximum control over the policy, cost recovery for the life insurance and a tax deduction when the benefits are paid out to the key employee

- Also popular among closely held businesses that wish to provide a substantial benefit to its owners without including all employees

### How it works

The corporation is simply purchasing the life insurance policy to help fulfill the contractual arrangement to their key employees. The cash value and death benefit of the policy are used to offset the obligation.

- The contractual agreement is typically designed to guarantee key employees a prearranged payout at retirement (or to their survivors if they die prior to retirement) if they remain gainfully employed and fulfill their contractual obligation to their employer
- The corporation (employer) owns the life insurance policy and uses it to informally fund the deferred compensation benefits
- The corporation (employer) is required by contract to provide future benefits to the key employee (or the employee's survivors) if they meet their contractual obligation to the employer
- If key employees do not fulfill their commitment, they forfeit the deferred compensation to their employer

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Earnings and pre-tax premium payments are subject to income tax at withdrawal. Withdrawals prior to age 59½ are generally subject to a 10% IRS penalty tax.

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