Huebner School Series

HS 354 Study Outline

Sources of Retirement Income

David A. Littell

Jamie Hopkins
TABLE OF CONTENTS

HS 354 Study Outline ................................................................. i

Choosing the Optimal Social Security Claiming Age ............................ 8.1
Section 1: Introduction to Social Security ........................................ 8.2
  LO 8-1-1: The ABC’s of the Social Security system .......................... 8.2
  LO 8-1-2: Describe Social Security’s role in providing retirement security ........................................... 8.5
  LO 8-1-3: Analyze why clients are reluctant to defer Social Security retirement benefits .......................... 8.6
Section 2: Workers Benefits ....................................................... 8.6
  LO 8-2-1: Explain how the Primary Insurance Amount (PIA) is calculated ........................................... 8.6
  LO 8-2-2: Understand how and when workers benefits are paid ......................................................... 8.10
  LO 8-2-3: Understand the earnings test and voluntary suspension of benefits ...................................... 8.13
Section 3: Dependent Benefits .................................................... 8.16
  LO 8-3-1: Understand the nature and scope of spousal and other dependent retirement benefits .................. 8.16
  LO 8-3-2: Understand how survivor benefits work ................................................................................ 8.22
Section 4: Tax Treatment of Benefits ............................................ 8.24
  LO 8-4-1: Identify how Social Security benefits are taxed ........................................................................ 8.24
  LO 8-4-2: Explain the Social Security “tax torpedo” and how it can be avoided ........................................ 8.25
Section 5: Choosing the Optimal Claiming Strategy ............................ 8.26
  LO 8-5-1: Apply a strategic approach to choose a claiming age that is right for the client’s circumstances .... 8.26
  LO 8-5-2: Understand how to change a client’s perceptions through an educational program ................ 8.27
  LO 8-5-3: Understand how assessing funding adequacy factors into the claiming age decision ................ 8.28
  LO 8-5-4: Understand how to use the net present value break-even approach for fully funded clients .... 8.29
  LO 8-5-5: Analyze the process of framing the claiming age decision as insurance against longevity risk .... 8.32
  LO 8-5-6: Compare claiming late and liquidating 401(k) assets versus claiming early and preserving 401(k) assets ................................................................. 8.34
  LO 8-5-7: Assess the client’s Social Security options based on their unique situation ............................ 8.35
  LO 8-5-8: Solve case studies concerning choosing the optimal Social Security claiming age that is appropriate for your client’s situation ........................................ 8.37
  LO 8-5-9: Understand how to use software to choose the client’s Social Security claiming age ................ 8.41
Resources for Competency 8: Choosing the Optimal Social Security Claiming Age ...................................... 8.42

Choosing the Optimal Retirement Age .......................................... 9.1
Section 1: What a Retirement Consultant Needs to Know About the Factors Influencing the Choice of a Client’s Retirement Age ................................................................. 9.2
  LO 9-1-1: Analyze the factors influencing the client’s choice of a retirement age .................................... 9.2
  LO 9-1-2: Analyze the age at which clients are currently retiring .......................................................... 9.8
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>LO 9-1-3: Understand the perceptions of current workers about their potential retirement age</td>
<td>9.12</td>
</tr>
<tr>
<td>LO 9-1-4: Examine different ways to look at the optimal retirement age</td>
<td>9.15</td>
</tr>
<tr>
<td>Section 2: What A Retirement Consultant Needs To Know About The Client's Financial Preparedness For Retirement</td>
<td>9.16</td>
</tr>
<tr>
<td>LO 9-2-1: Identify the age at which the vast majority of households will be able to retire</td>
<td>9.16</td>
</tr>
<tr>
<td>LO 9-2-2: Analyze the ability to work longer as a solution to a lack of retirement resources</td>
<td>9.19</td>
</tr>
<tr>
<td>LO 9-2-3: Understanding the transition into retirement: 15 tasks the client must complete</td>
<td>9.21</td>
</tr>
<tr>
<td>Section 3: What A Retirement Consultant Needs To Know About Phased Retirement</td>
<td>9.22</td>
</tr>
<tr>
<td>LO 9-3-1: Understand the basics of phased retirement</td>
<td>9.22</td>
</tr>
<tr>
<td>LO 9-3-2: Identify the types of phased retirement</td>
<td>9.23</td>
</tr>
<tr>
<td>LO 9-3-3: Identify the possible characteristics that may be in a phased retirement program</td>
<td>9.24</td>
</tr>
<tr>
<td>LO 9-3-4: Assess the reasons a client may opt for phased retirement</td>
<td>9.25</td>
</tr>
<tr>
<td>LO 9-3-5: Understand how you may convince an employer to offer your client phased retirement</td>
<td>9.26</td>
</tr>
<tr>
<td>LO 9-3-6: Impediments to phased retirement</td>
<td>9.27</td>
</tr>
<tr>
<td>LO 9-3-7: Examine examples of phased retirement</td>
<td>9.28</td>
</tr>
<tr>
<td>LO 9-3-8: Identify some design elements of a phased retirement system</td>
<td>9.29</td>
</tr>
</tbody>
</table>

Resources For Competency 9: Choosing The Optimal Retirement Age .......... 9.29

Choosing Appropriate Annuities for the Retirement Income Plan .................. 10.1

Section 1: Regulation ................................................................. 10.2
| LO 10-1-1: Understanding and applying annuity suitability standards | 10.2 |
| Section 2: Annuity Taxation ..................................................... 10.7
| LO 10-2-1: Identify important considerations in the tax treatment of nonqualified annuities | 10.7 |
| LO 10-2-2: Determine the tax implications of distributions to beneficiaries from nonqualified annuities | 10.10 |

Section 3: Product Options for Retirement Income Planning ........................ 10.13
| LO 10-3-1: Choosing appropriate uses of single premium immediate annuities | 10.13 |
| LO 10-3-2: Choosing appropriate uses of deferred income annuities. | 10.16 |
| LO 10-3-3: Choosing appropriate uses of deferred variable annuities with GLWB riders | 10.18 |
| LO 10-3-4: Choosing appropriate uses of deferred fixed and indexed annuities | 10.24 |
| LO 10-3-5: Understanding fixed indexed annuity contract terms | 10.25 |

Section 4: Annuity Applications .................................................... 10.38
| LO 10-4-1: How to build an income floor with annuity products | 10.38 |
| LO 10-4-2: Understand the efficiencies created with nonqualified income annuities used early in retirement | 10.39 |
| LO 10-4-3: Choosing appropriate income annuity strategies that address longevity risk | 10.41 |
| LO 10-4-4: Compare fixed indexed annuities (FIAs) and deferred income annuities (DIAs) | 10.42 |
| LO 10-4-5: Case study: Building a retirement income plan with a floor of income annuities | 10.43 |

Resources for Competency 10: Choosing Appropriate Annuities for the Retirement Income Plan .......................................................... 10.43

Section 3: Product Options for Retirement Income Planning ........................ 10.43
Retirement Income Process, Strategies, and Solutions

Evaluating Other Sources of Retirement Income ............................................................. 11.1

Section 1: Executive Benefits ................................................................................................. 11.2
LO 11-1-1: Understand the role of nonqualified deferred compensation in retirement planning for executives .............................................................................................................. 11.2
LO 11-1-2: Identify the types of executive welfare benefits that are commonly offered today ................................................................................................................................. 11.8
LO 11-1-3: Understand how Sec. 162 bonus life insurance programs can benefit an executive ................................................................................................................................. 11.9
LO 11-1-4: Understand the types of equity-based compensation offered to executives today ................................................................................................................................. 11.11

Section 2: Life Insurance ........................................................................................................ 11.12
LO 11-2-1: Understand the role of life insurance death benefits in retirement planning ................................................................................................................................. 11.12
LO 11-2-2: Understand the role of life insurance cash value benefits in retirement planning ................................................................................................................................. 11.14
LO 11-2-3: Identify specific strategies for using life insurance in a retirement income plan ................................................................................................................................. 11.15

Section 3: Federal Civilian and Military Benefits ................................................................. 11.17
LO 11-3-1: Understand the types of retirement benefits available to federal civilian and military employees ................................................................................................................................. 11.17
LO 11-3-2: Identify the pension benefits and planning opportunities under the Federal Employee Retirement System (FERS) ................................................................................................................................. 11.19
LO 11-3-3: Identify the pension benefits and planning opportunities under the Civil Service Retirement System (CSRS) ................................................................................................................................. 11.21
LO 11-3-4: Advise clients regarding their opportunities under the Thrift Savings Plan ................................................................................................................................. 11.23
LO 11-3-5: Advise long-term retiring military personnel about their retirement pay options ................................................................................................................................. 11.24
LO 11-3-6: Identify when retiring military personnel are entitled to disability benefits ................................................................................................................................. 11.25
LO 11-3-7: Understand nonpension military benefits that can improve retirement security ................................................................................................................................. 11.26

Section 4: Planning For Business Owners .......................................................................... 11.28
LO 11-4-1: Determine ways to maximize the value of a business and identify other retirement planning strategies for small business owners ................................................................................................................................. 11.28
LO 11-4-2: Choosing a tax-advantaged retirement plan for a small business ................................................................................................................................. 11.30

Section 5: Other Approaches ............................................................................................... 11.37
LO 11-5-1: How can an advisor evaluate nontraditional approaches to retirement planning ................................................................................................................................. 11.37

Resources For Competency 11: Evaluating Other Sources of Retirement Income ................. 11.39

Building a Retirement Portfolio ........................................................................................... 12.1

Section 1: Portfolio Building Blocks ..................................................................................... 12.2
LO 12-1-1: Understand how risk tolerance affects the planner’s options to allocate assets ................................................................................................................................. 12.2
LO 12-1-2: Understand how to minimize portfolio risk ................................................................................................................................. 12.3
LO 12-1-3: Analyze the implications of modern portfolio theory (MPT) on retirement investing ................................................................................................................................. 12.4
LO 12-1-4: What is tactical asset allocation and why is it popular ................................................................................................................................. 12.6

Section 2: Selected Issues in Building A Retirement Portfolio ............................................. 12.9
LO 12-2-1: Identify how human capital affects savings decisions ................................................................................................................................. 12.9
LO 12-2-2: Understand paying off a mortgage as part of the retirement portfolio ................................................................................................................................. 12.11
LO 12-2-3: Choosing a portfolio rebalancing discipline ................................................................................................................................. 12.14
Section 3: Transitioning into Retirement ................................................................. 12.14
  LO 12-3-1: Characterizing the change in the risk/return paradigm that occurs at retirement ........ 12.14
  LO 12-3-2: Understanding the interface between preretirement saving and postretirement spending .......... 12.16
  LO 12-3-3: Choosing the appropriate portfolio adjustments for an aging client ........................................ 12.19
Section 4: Retirement Income Research ............................................................... 12.20
  LO 12-4-1: Understanding research methodology and its role in evaluating retirement income research. ...... 12.20
  LO 12-4-2: Modifying safe withdrawal rates based on recent research ................................................ 12.22
  LO 12-4-3: Modifying safe withdrawal rates based on current market conditions ................................. 12.24
  LO 12-4-4: Understanding the implications of life-cycle theory research on retirement income planning .... 12.26
  LO 12-4-5: Understanding the implications of choosing a cash-reserve (buffer-zone) strategy ................ 12.29
Section 5: Creating an Income Floor with Investment Products ...................................... 12.31
  LO 12-5-1: Analyze how to create an income floor ........................................................................... 12.31
Section 6: Tax Efficient Withdrawal Strategies .......................................................... 12.33
  LO 12-6-1: How to improve portfolio longevity through a tax efficient sequencing of withdrawals ............ 12.33
  LO 12-6-2: Identify key practical tax considerations in retirement income planning ................................. 12.39
Competency 8

Choosing the Optimal Social Security Claiming Age
SECTION 1: INTRODUCTION TO SOCIAL SECURITY

LO 8-1-1: The ABC’s of the Social Security system

1. Social Security is also known as the Old Age, Survivors and Disability Insurance system (OASDI). Combined with the Medicare system, it provides a level of retirement security for the vast majority of Americans.
   a. 165 million workers are covered by Social Security.
   b. Nine out of ten individuals age 65 and older receive Social Security benefits.
   c. Social Security benefits represent about 39 percent of the income of the elderly.

2. Who receives Social Security?
   a. 39.5 million retired workers
   b. 3 million dependents
   c. 9 million disabled workers
   d. 2 million dependents of disabled workers
   e. 6.1 million survivors

3. Funding the system
   a. There is a 6.2 percent Social Security payroll tax (also known as FICA tax) up to the taxable wage base. Both the employer and employee pay this tax.
   b. There is also a 1.45 percent FICA tax on all income to fund Medicare benefits.
   c. There is a 12.4 percent Social Security self-employment tax (also known as SECA tax) up to the taxable wage base. Half of the tax is deductible from income.
   d. There is a 2.9 percent SECA tax on all income.
   e. Employee pays .9 percent additional tax on wages in excess of wage income threshold
      (1) Threshold
         (a) Single, head of household: $200,000
         (b) Married filing jointly: $250,000
         (c) Married filing separately: $125,000
      (2) Example: Jose, a single taxpayer, earns $225,000. The Medicare tax is 1.45 percent x $225,000 + .9 percent x $25,000 = $3,487.50

4. There are two Social Security trust funds and two Medicare funds.
   a. Old-age and survivors insurance
   b. Disability insurance
   c. Medicare Part A
Sources of Retirement Income

d. Medicare Part B

5. Eligibility for the worker's retirement benefit
   a. The basic retirement benefit paid by Social Security is the retirement benefit paid to qualifying workers. To qualify, the worker must earn 40 coverage credits (also referred to as quarters of coverage).
   b. Earn $1,260 (2016) and earn a coverage credit, earn $5,040 (2016) or more and earn the maximum of four coverage credits.
   c. This means that to earn benefits a worker needs just 10 years of substantial employment.
   d. This is a bit misleading, though, as the benefit formula is applied to what is referred to as average indexed earnings looking at the 35 highest years of wage history.
   e. If a worker works fewer than 35 years, zeros go into the calculation of the average. Clearly, a person in that situation benefits significantly from additional years of work.
   f. Full benefits are payable at full retirement age, but reduced benefits can begin as early as age 62 and benefits can be delayed and earn deferral credits up to age 70.

6. Additional retirement benefits can be paid once an eligible worker claims benefits.
   a. Benefits are available for nonworking spouses who have attained age 62, and if the spouse has a modest benefit based on his or her own work history, he or she will get the greater of the worker's benefit or the spousal benefit.
   b. The spouse who is caring for a child under 16 can receive full benefits regardless of the spouse's age.
   c. Dependent, unmarried children under 18 (under 20 if in secondary school) are entitled to benefits.
   d. Unmarried children 18 or older and disabled from a disability that started before age 22 are eligible for benefits.
   e. When more than two additional benefits are paid based on the one worker, there is a family maximum that applies to the benefits paid to dependents.
   f. There is one other benefit that can be paid on a worker's wage history without affecting benefits paid to the family. That is the divorced spousal benefit that is paid to an unmarried divorced spouse as long as the marriage lasted 10 years or more.

7. Amount of retirement benefits
   a. The benefit formula discriminates in favor of lower paid workers.
   b. The more affluent a client is, the lower the percentage of final salary that is replaced by Social Security (the amount of final salary that Social Security replaces is called the Social Security replacement ratio).
   c. Illustration
      (1) A "low" earner who made about $18,800 in 2016 and would attain age 66 in 2016 would receive a full retirement benefit of about $9,400 a year, which would replace about 50 percent of final earnings.
(2) If a same aged worker earned $120,000 in 2016, he or she would receive a full retirement benefit of about $26,900 a year, which would replace about 22 percent of final earnings.

(3) A same aged individual earning $250,000 receives the same benefit, and the replacement ratio drops to 11 percent.

d. Planning Point: Affluent clients need to save more themselves for retirement because Social Security provides them with a lower replacement ratio. Those earning more than the taxable earnings base receive no Social Security benefits at all for earnings over the base.

8. The Social Security benefit statement

a. From the late 1990's to 2011, the SSA mailed annual benefit estimates to all beneficiaries age 25 and older. As a cost savings measure in 2012 the mailing of benefit statements stopped.

b. Current rules

(1) Since 2012, the SSA has renewed sending some statements but the primary goal is to encourage workers to sign up for online statements at the Social Security website “My Social Security.”

(2) Clients initiate the online Social Security statement by signing up at “My Social Security” and providing information about themselves including their Social Security number, mailing address, email address, birth date, phone number, etc. The account is protected by a username and password.

(3) Those who sign up get periodic reminders to go back and update the estimate.

(4) Workers who do not sign up today are mailed written statements at ages 25, 30, 35, 40, 45, 50, 55, and 60 and over as long as they are not yet receiving Social Security benefits.

9. What does the online Social Security statement provide?

a. The online statement provides:

(1) The worker’s full retirement age

(2) Benefit estimates at full retirement age, as well as estimates if benefits are claimed early at age 62 or late at age 70

(3) Disability benefits if a disability were to begin today

(4) Survivor benefits that would be provided to your family upon death

(5) A separate page shows wages, including wages subject to Medicare taxes and wages subject to Social Security taxes. If an individual earns more than the taxable wage base for the year, only the wages up to the current taxable wage base will show up as Social Security wages.

(6) The version of the statement that can be printed also shows estimated taxes the client has paid into Social Security and Medicare.

b. The online statement includes information about:

(1) How the client qualifies for benefits

(2) How Social Security estimated the client’s benefits
(3) What happens if you work in a job where you are not paying Social Security taxes?
   (a) This is important as the windfall elimination provision can reduce worker’s benefits and the
government offset provision can reduce spousal and survivor benefits.
   (b) Note that the statement only provides general information about the rules. It does not provide
benefit estimates taking these rules into consideration—that is due in part to the fact that the
adjustments cannot be estimated accurately until the individual claims benefits.

(4) The Social Security and Medicare systems

(5) Considerations before deciding to collect benefits
   (a) Social Security provides information about the impact of different claiming decisions, but they
do not provide advice to consumers about when to claim.
   (b) This is a good thing because claiming decisions have to be based on the individual’s unique
situation.

(6) Other retirement publications
   c. Additional actions that can be executed from the online statement
      (1) Apply online for retirement or disability benefits
      (2) Print benefit statement
      (3) Download personal data
      (4) Request a Social Security replacement card
      (5) Set security settings
      (6) Find answers to FAQs
      (7) Download relevant publications

LO 8-1-2: Describe Social Security’s role in providing retirement security

1. Social Security is the major source of retirement income for the majority of retirees. (Video: What is Social
   Security’s Role in Retirement Security? Littell, Tacchino, Sass)
   a. For 1 in 5 retirees, Social Security is their only source of income.
   b. For 1 in 3 retirees, Social Security is 90 percent of their retirement income.
   c. For 2 in 3 retirees, Social Security is more than 50 percent of their retirement income.
   d. These ratios are not expected to change over time.

2. As people age, they become more dependent on Social Security.

3. Widows, in particular, are very dependent on Social Security.
LO 8-1-3: Analyze why clients are reluctant to defer Social Security retirement benefits

1. Theory 1: Married men are “cads” who only think about themselves and ignore their wives (this theory is not too likely because research shows retired men have healthy relationships with their wives). (Video: Why are Clients Reluctant to Defer Social Security Benefits? Littell, Tacchino, Sass)

2. Theory 2: Financial ignorance—people who are more financially literate are more apt to delay Social Security benefits.

3. Theory 3: Social convention—refers to the standards and norms practiced by a majority of the population.

4. Theory 4: For clients with only a defined-benefit plan, Social Security claiming is based on the retirement age from the defined-benefit plan. This may be the only rational excuse for early claiming since the defined-benefit plan does not provide enough of a replacement ratio to support the client during any period of Social Security deferral.
   a. Planning Point: Clients with only defined-benefit plans will likely need to claim Social Security when they retire and absent other significant savings may not be able to delay claiming.
   b. Clients in a 401(k) may have the option of using 401(k) funds to delay claiming.

5. Theory 5: Fears of Social Security failing—this represents irrational thinking. Social Security will change, but it will not end.

6. Theory 6: The break-even analysis might encourage early claiming because people will “gamble” that they will not live long. This break-even thinking misdirects people because it ignores the insurance value of the benefit. The only way to “win” this gamble is to die young!

7. Theory 7: Misunderstanding about what the Social Security system is supposed to be
   a. Is it old age insurance?
   b. Is it longevity insurance?
   c. Is it an entitlement program?
   d. Is it a salary continuation program?
   e. If there is an entitlement program or salary continuation mindset, people will claim early.
   f. If it is an insurance or longevity program mindset, people may claim later.
   g. Historically, Social Security was thought of as an insurance program. However, it has come to be inaccurately perceived as salary continuation.

SECTION 2: WORKERS BENEFITS

LO 8-2-1: Explain how the Primary Insurance Amount (PIA) is calculated

1. Primary insurance amount (PIA)
Sources of Retirement Income

a. A worker who is eligible for a retirement benefit is entitled to the primary insurance amount at full retirement age.

b. The PIA formula changes each year with inflation adjustments and the formula used to calculate the PIA is the formula in effect in the year in which a worker attains age 62.

c. An individual is deemed to have attained the next age on the day before their birthday. So an individual with his or her 62nd birthday on January 1 is deemed to have attained age 62 in the previous year—and would use the previous year’s PIA formula when calculating benefits.

d. When benefits are deferred past age 62, benefits are increased for cost of living adjustments. The COLA applies whether an individual claims or defers benefits.

2. PIA formula for 2016

a. The PIA formula, which is used to calculate benefits for a worker attaining age 62 in 2016, is the sum of three amounts:

   (1) 90 percent of the first $856 of his or her average indexed monthly earnings (AIME), plus

   (2) 32 percent of AIME over $856 and through $5,157, plus

   (3) 15 percent of AIME over $5,157

b. Benefits are rounded to the next lower multiple of $.10

3. Full retirement age

a. Full retirement age depends upon the year of birth.

b. If born between 1950 and 1954, full retirement age is 66

c. If born in 1960 or later, full retirement age is 67

d. If born between 1955 and 1959, add two months to the full retirement age for each year (1955—66 and 2 months, 1956—66 and 4 months, 1957—66 and 6 months, 1958—66 and 8 months, 1959—66 and 10 months)

4. Average indexed monthly wages (AIME)

a. The first of three steps to determining AIME is to determine covered earnings for each year.

   (1) These amounts are shown on the Social Security statement.

   (2) Note that covered earnings are limited to each year’s taxable wage base.

b. The second step is to index earnings up to age 60.

   (1) Covered earnings for years prior to age 60 are indexed based on the average wage index for the year of attainment of age 60 divided by the wage index for the specific year.

   (2) The resulting indexing factor is multiplied by actual covered wages to determine indexed wages.

   (3) Since wages are only indexed to age 60, the indexing factor for the year of attainment of age 60 and later is one, meaning that nominal wages are used for those years.
c. The third step is to determine AIME. To do this, identify and add together the annual indexed wages for the highest 35 years and divide by 420 months (rounded down to the next lower dollar amount). The resulting amount is AIME.

d. Example: Determine the indexed wages from 1976 for a worker who attains age 60 in 2014.

   (1) The average wage index in 2014 was $46,481.52.

   (2) If nominal wages in 1976 were $8,627 and the average wage index was $9,226.48, the first step is to identify the indexing factor. That is determined by dividing the 2014 average wage index by the 1976 wage index, or $46,481.52 divided by $9,226.48, which results in a factor of 5.0378.

   (3) Now multiply the 1976 actual wages by this factor and the indexed wages are $43,461 (5.0378 x $8,627).

5. Cost of living increases (COLAs)

   a. COLAs are an integral part of the benefit structure as a worker who delays benefits past age 62 is entitled to a COLA for each year of deferral.

   b. Cost of living increases are measured by changes in the Consumer Price Index for Urban Wage Earners and Clerical Workers (referred to as the CPI-W).

   c. The COLA is determined by comparing the average CPI-W for the third calendar quarter of the previous year to the average CPI-W for the third calendar quarter of the current year.

   d. The resulting percentage increase, if any, represents the COLA beginning for December of the current year, which means the beneficiary sees the increase in January as benefits are paid in the next month.

   e. An increase in the CPI-W of at least one-tenth of one percent results in COLA.

   f. Social Security had COLAs every year from 1975 to 2009. Recently, we have had three years with no COLAs: 2010, 2011, and 2016.

6. The impact of wages on benefits

   a. Social Security recipients cannot control the formula used to calculate benefits, but they do have some ability to control how much and how long they work. Here are some key concepts about wages used to determine benefits.

   b. An individual’s covered Social Security wages can be found on the online Social Security statement.

   c. If a beneficiary questions the wages on the statement, they should notify the Social Security Administration.

   d. An absence of covered wages if the client has noncovered service could result in a reduction in benefits under the windfall elimination or government offset provisions.

   e. Wages are limited to the taxable wage base. This means that there is a maximum benefit payable for all those individuals who have earned the taxable wage base or more for at least 35 years and who attain age 62 in the same year.
Sources of Retirement Income

f. For example, the maximum benefit for those retiring at full retirement age in 2016 is $2,639 (remember this is calculated by determining the 2012 PIA formula—the year in which they attained age 62, plus COLAs).

g. It is also important to note that an individual is penalized for fewer than 35 years of earnings as this results in one or more zeros included in determining the average compensation over 35 years.

h. It also means that one more year of work for someone with less than 35 years is likely to have a meaningful impact on benefits.

7. Windfall elimination provision (WEP)

a. The windfall elimination provision can result in lowering benefits for a worker with employment both in and outside of the Social Security system.

b. Those with a pension from noncovered service and who are eligible for Social Security benefits (have at least 10 years of covered service) are subject to the windfall elimination provision.

c. The reason for this provision is that those with only part of their working history in the Social Security system will appear to be low-income individuals because AIME is calculated averaging 35 years of service.

d. Example: An individual works as a teacher in California for 25 years (which is not covered by Social Security) and then leaves and spends 12 years with a private employer. The 12 years is enough to be eligible for Social Security benefits, but when calculating AIME and averaging 35 years, 23 years will have zero earnings.

8. Change in the PIA when the WEP applies

a. If the WEP is applicable, the first part of the PIA calculation that normally replaces 90 percent of the lowest AIME is simply adjusted downward depending upon the number of years paying into the Social Security system.

b. If an individual has 20 or fewer years of substantial earnings in the Social Security system, the 90 percent is a much lower 40 percent. If the worker has 30 or more years of service, the windfall provision has no impact as the percentage is again 90 percent.
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<tr>
<td>30 or more</td>
<td>90 percent</td>
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<td>29</td>
<td>85 percent</td>
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<td>80 percent</td>
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<td>22</td>
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<td>21</td>
<td>45 percent</td>
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<td>20 or less</td>
<td>40 percent</td>
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9. Windfall elimination rules and considerations
   a. Only count years covered by Social Security with “substantial earnings.” In 2015 and 2016, substantial earnings is defined as at least $22,050.
   b. There are some exceptions to the rule. One is that the WEP provision does not apply to those with a Railroad pension.
   c. To protect those who have only earned modest pensions from their noncovered service, a rule states that the Social Security benefit will not be reduced by more than half of the value of the pension.
   d. Even though the Social Security statement does not calculate the impact of the WEP, the Social Security detailed calculator can be used to get an accurate estimate of benefits for a client that is subject to this provision.

LO 8-2-2: Understand how and when workers benefits are paid

1. Claiming Social Security benefits
   a. To receive Social Security retirement benefits, the worker must apply for benefits.
   b. Applying online requires that the worker:
      (1) Is at least 61 years and 9 months old
      (2) Is not currently receiving benefits on their own Social Security record
      (3) Has not already applied for retirement benefits
      (4) Wants benefits to start no more than 4 months in the future
   c. Other ways to apply (same timing requirements apply as online)
      (1) By phone (1-800-772-1213)
      (2) In person at a local Social Security office (it is best to make an appointment)
Sources of Retirement Income

2. Withdrawal of application
   a. An individual who has claimed retirement workers benefits has the ability to withdraw the application, leaving them free to make another claiming decision later.
   b. This option only applies to retirement benefits (not to disability or survivor's benefits).
   c. The request can only be made once and requires that benefits be paid back (without interest) within 12 months of the first month for which the retiree was entitled to benefits.
   d. All benefits have to be paid back including any spousal or other dependent benefits. This also includes payments for Medicare benefits that were withheld from Social Security benefits.
   e. In reality, not many choose this option, but the withdrawal of an application can be helpful in a number of circumstances.
      (1) The client who loses a job after attaining age 62 and is forced to claim Social Security benefits to make ends meet. If they get a new job within a year, they have the opportunity to pay back benefits and start over later.
      (2) The new client who, prior to meeting you, claimed Social Security benefits. After explaining the benefits of deferring and learning that the client really does not need the money, you help them file to withdraw the application.
   f. It is also worth mentioning that another more common option for someone who wants to reconsider is called voluntary suspension. This allows a beneficiary to voluntarily elect to stop workers benefits at or after full retirement age and begin again later, giving them the ability to increase benefits based on the period that benefits

3. Retroactive filing—a person who files for benefits can in some cases file for benefits retroactively
   a. If filing for retirement benefits, the individual can request that benefits begin up to six months prior to the filing date.
   b. However, the rule is not quite this simple, as retroactive benefits are only allowed on unreduced benefits.
   c. This means that you cannot file retroactively prior to full retirement age, and if filing occurs less than 6 months after full retirement age, benefits can only be retroactive to the full retirement age.
   d. *Example:* If a beneficiary files 11 months after full retirement age, benefits can begin 6 months earlier. The beneficiary would receive a lump sum payment for six months of benefits. It also means that subsequent benefits are based on the retroactive filing date.
   e. If filing occurred 3 months after attaining full retirement age, they can be paid retroactively for only 3 months.
   f. The same rule applies to retroactive filing for survivor benefits.
   g. In addition, the Social Security Operations Manual indicates that anyone filing after full retirement age will be presumed to want retroactive benefits unless they specifically indicate that they do not want this.
h. For example, a retiree defers benefits to age 70 to receive deferral credits. When they apply for benefits, they have to clarify that they want benefits at 70, not six months prior to the filing date.

4. Actuarial reduction for early filing
   a. All workers can claim retirement benefits as early as age 62, regardless of full retirement age.
   b. To be eligible for the benefit, the individual has to be eligible for benefits for the entire month.
      (1) Most people are not actually eligible for benefits exactly at age 62. They have to wait until the first day of the following month.
      (2) An individual would have to be born on the first or second day of the month to be eligible (remember that Social Security considers you attaining the next age on the day before your birthday).
   c. Benefit reduction
      (1) If benefits begin early, the benefit is permanently reduced based on the length of time prior to full retirement age.
      (2) The benefit is reduced $5/9$ of one percent of the PIA for each month before full retirement age up to 36 months and if the number exceeds 36, then the benefit is further reduced $5/12$ of one percent of the PIA per month.
   d. Earnings test
      (1) Note that if benefits begin prior to full retirement age they are subject to the earnings test, which could result in a current loss of benefits if the individual earns too much.
      (2) This provision essentially stops those that are still working from claiming benefits before full retirement age (the earnings test will be discussed later).
   e. Early claiming example 1
      (1) Jamie retires four full years (48 months) prior to attaining full retirement age.
      (2) The reduction factor is determined as follows: $5/9 \times 36 = 20$ percent reduction $+ 5/12 \times 12 =$ another 5 percent reduction—a total reduction of 25 percent
      (3) Jamie will receive a benefit of 75 percent of her PIA when she claims benefits.
   f. Early claiming example 2
      (1) Patty, born January 9, 1960, is a schoolteacher and wants to retire and claim benefits after the school year when she is 62 and 6 months.
      (2) Her full retirement age is 67. This is 4 years and 6 months (54 months) prior to her full retirement age.
      (3) Patty will receive a monthly benefit equal to 72.5 percent of her PIA, determined as follows: $(5/9 \times 36 = 20) + (5/12 \times 18 = 7.5)$ (total 27.5) $(100 - 27.5 = 72.5)$

5. Actuarial increase for deferred claiming
Sources of Retirement Income

8.13

a. Workers can also benefit from deferring benefits beyond full retirement age.
b. The workers benefit is eligible for deferral credits for deferral up to age 70.
c. Deferring beyond full retirement age results in an increase of 2/3 of one percent of the PIA for each month of deferral up until age 70.
d. Since there is no increase after age 70, there is no advantage to delay benefits once an individual reaches age 70.
e. Note that only the workers benefit is eligible for deferral credits. Spousal and other dependent retirement benefits and survivor benefits do not get credits—so there is no reason to defer these benefits beyond full retirement age.

6. Deferred claiming example
   a. Kim is a schoolteacher who was born in January of 1950. She wants to retire and claim benefits after the school year when she is 67 and 6 months.
   b. This is 18 months after her full retirement age of 66. Kim will receive a monthly benefit equal to 112 percent of her PIA, determined as follows: $\frac{2}{3} \times 18 = 12$

7. Impact of additional work
   a. One issue that is important to understand is that continued work always counts when calculating Social Security benefits.
   b. More specifically, continued work usually increases the AIME and this means an increase in the PIA.
   c. Whether the worker is in pay status or not does not matter. Social Security automatically adjusts benefits when AIME increases.

LO 8-2-3: Understand the earnings test and voluntary suspension of benefits

1. Suspension of benefits
   a. There are three situations in which Social Security benefits can stop or be reduced currently, often in exchange for larger benefits later.
   b. The first situation that has already been discussed (the withdrawal of an application) is a one-time withdrawal of the original application of benefits made within 12 months of the initial benefit payment which requires the pay back of benefits.
   c. The second is that if benefits are claimed prior to full retirement age, an individual who earns more than the earnings limit will have benefits withheld. When this happens there is an increase in benefits at full retirement age to reflect the withheld benefits. This is essentially a system of forced suspension of benefits.
d. Between the ages of 62 and full retirement age, there is no opportunity to voluntarily suspend benefits. Say the beneficiary starts benefits at 62. Unless the individual withdraws the application and pays back benefits, or goes back to work and earns too much, they will continue to full retirement age.

e. At full retirement age, a retiree is allowed to voluntarily suspend benefits. What some have misunderstood is that the law change concerning file and suspend that became effective May 1, 2016 does not eliminate the strategy—it simply eliminates its use as a way to trigger spousal or other dependent benefits.

f. Voluntary suspension of benefits is still available for the individual who is willing to forgo current benefits in exchange for larger benefits later.

2. Social Security earnings test
   a. Social Security withholds benefits if a beneficiary has not yet attained the full retirement age and earnings exceed what is called the earnings test exempt amount.
   b. There are actually two exempt amounts depending upon whether the beneficiary is going to attain full retirement age in the current year. These amounts are indexed each year. For 2016, Social Security will:
      (1) Withhold $1 of benefits for every $2 earned in excess of $15,720 for those who will attain full retirement age after 2016
      (2) Withhold $1 of benefits for every $3 earned in excess of $41,880 for those who attain full retirement age in 2016
      (3) The earnings test applies to workers benefits, other dependent retirement benefits, and survivor benefits paid prior to full retirement age.

3. Earnings test examples
   a. Facts: Beneficiary files for Social Security benefits at age 62 in January 2016, benefits of $600 per month ($7,200 for the year), and plans to work in 2016 and earn $20,800 ($5,080 above the $15,720 limit)
   b. Results: Social Security withholds $2,540 ($1 for every $2 earned over the limit), benefits are withheld from January 2016 through May 2016 and begin again in June 2016, remaining amount held in May paid in 2017
   c. Facts: Individual with the same $600 benefit will reach full retirement age in November 2016 and will earn $42,900 in the 10 months from January through October. Earnings in November and December do not count under the earnings test.
   d. Results: Withhold the first check of 2016 ($1 for every $3 you earn above the $41,880 limit, or $340). Regular $600 payments begin in February and the remaining $260 will be paid in January 2017.

4. Earnings
   a. Earnings for a taxable year consist of:
      (1) Sum wages for services performed in the year, plus
      (2) Net earnings from self-employment, minus
Sources of Retirement Income

(3) Any net loss from self-employment for the year

b. What counts as earnings?
   (1) For the most part it is wages and self-employment income subject to Social Security taxes.
   (2) The earnings limit does not count income such as other government benefits, investment earnings, interest, pensions, annuities, and capital gains.

5. Special rule in the year of claiming
   a. A special rule covers people who retire in the middle of the year.
   b. Benefits can be paid if the annual earnings limit is exceeded as long as the individual is “retired” when they start receiving benefits.
      (1) For a wage earner under full retirement age, retired means that for a month the individual earns less than 1/12 the annual earnings limit. For 2016, that would be $1,310 or less.
      (2) For a wage earner in the year of attainment of full retirement age, the limit is 1/12 of the higher limit. For 2016, that would be $3,490 or less.
      (3) The definition of retired for a self-employed person is tied to the amount of work. A self-employed person is considered retired if he or she does not perform substantial services (not more than 45 hours a month).
   c. Example: Walt (age 63) retires in September having earned a $200,000 salary prior to that date. Walt does not go back to work. He may receive Social Security benefits for the remainder of the year without being subject to the earnings test.

6. Earnings test as forced suspension
   a. If benefits are withheld, they are recalculated (increased) at full retirement age.
   b. The benefit recalculation is tied to the number of months benefits are lost under the earnings test.
   c. Example: Collin claims benefits at age 62 and due to the earnings test he has lost 6 months of benefits by the time he attains full retirement age. In his case, benefits are recalculated at full retirement age assuming that retirement began at 62 and 6 months.

7. Dependent benefits
   a. Earnings of the worker can also result in the withholding of dependent benefits paid (not to ex-spouse).
   b. Example: If the earnings test results in a withholding of $5,000 in benefits, the amount is taken in equal proportion from the worker’s benefit and the spouse’s benefit.
   c. Earnings of a spouse receiving a spousal benefit before full retirement age will reduce benefits.
   d. Example: A 67-year-old worker claiming benefits has a 63-year-old spouse receiving a spousal benefit. If the spouse has excess earnings, the spouse’s benefits will be withheld.
   e. Earnings of a survivor receiving a survivor benefit before full retirement age will reduce benefits.

8. Voluntary suspension
a. Once a worker attains full retirement age, forced suspension ends under the earnings test and a worker can receive benefits and work full-time without it impacting benefits.

b. The law does allow, however, that a worker in pay status who then reaches full retirement age can voluntarily suspend benefits. Taking this action is a way to increase benefits, as suspended benefits earn deferral credits.

9. File and suspend example

a. Joe, your new client who is approaching age 66, comes in and you learn that he had started Social Security benefits at 62. His friends told him that he should take his benefits as early as possible, but the reality is that he does not really need the benefits right now.

b. Joe’s full retirement age is 66 and his PIA was $2,000. Since he claimed at 62 his PIA was reduced by 25 percent and he has been receiving $1,500 a month.

c. If Joe voluntarily suspends benefits at 66 and begins again at 70 he receives deferral credits of 8 percent for each year of deferral. When he claims at age 70 he receives 132 percent of $1,500 and he gets $1,980 back (almost all his benefits).


a. This video summarizes the points made in this learning objective about withdrawing an application, the earnings test, and voluntary suspension of benefits.

b. For individuals wanting to change their election to increase benefits later, they have three options:
   (1) Withdraw the application within 12 months and pay back benefits.
   (2) If claiming before full retirement age, go back to work and use the earnings test as forced suspension.
   (3) At or after full retirement age, suspend benefits to age 70 in order to earn deferral credits.

SECTION 3: DEPENDENT BENEFITS

LO 8-3-1: Understand the nature and scope of spousal and other dependent retirement benefits

1. Spousal benefits (Video: Social Security Spousal and Divorced Spousal Benefits: Hopkins, Franklin)

a. This benefit is available to spouses and qualified ex-spouses of a worker who claims retirement benefits.

b. At full retirement age, the spousal benefit is worth 50 percent of the worker’s PIA. A spouse without dependent children may claim as early as 62, but this will permanently reduce the benefit to 35 percent of the worker’s PIA.
Sources of Retirement Income

c. Under grandfathered provisions, a spouse of full retirement age who qualifies for both spousal benefits and their own worker benefits can file for a restricted claim for spousal benefits. This allows them to accumulate deferred benefit credits on their worker benefits, which they can switch to at age 70.

   (1) Remember that new legislation limits the use of this strategy to those who are at least age 62 by December 31, 2015.

   (2) The legislation forbids all others from using this strategy, and they will simply receive the higher of the two benefits at the time of their claim.

   (3) If a claimant activates benefits prior to full retirement age, they will receive the higher of the reduced worker benefit or the reduced spousal benefit (under the grandfathered restricted filing rule, the claimant cannot file prior to that date).

d. Under current law, one must claim worker benefits before their spouse can claim spousal benefits.

   (1) Under prior law, a worker could claim and then suspend benefits to trigger the spousal and other dependent benefits. Spousal benefits can continue for a worker who filed and suspended prior to May 1, 2016.

   (2) Except for those grandfathered, the current law mandates that a worker must claim and actually be receiving retirement benefits for a spouse to receive spousal benefits.

e. If a spouse who has never worked is 70 years old and the worker is 60 years old, can anyone collect benefits?

   (1) Answer: No, the worker is too young to claim Social Security worker benefits, and therefore cannot trigger spousal benefits for the older spouse who has no worker benefits of their own.

   (2) Looking at Social Security in this case makes it clear that if the clients want to retire, they will need to earmark other sources of income. This is a great example of why advisors should view Social Security as part of a comprehensive plan and not treat it as a separate matter.

2. Social Security considerations for married couples

   a. For couples who are closer in age, the higher earning spouse should delay collecting benefits until as close to age 70 as possible to maximize worker benefits, which in turn will maximize survivor benefits.

   b. It may also make sense for the spouse with smaller worker benefits to claim them early, despite the reduced entitled amount. This can help provide additional income as the higher earning spouse waits until age 70 to claim their increased worker benefits.

      (1) Advisors should consider the claiming decisions available to each spouse in the context of their effect on total household income.

      (2) These are especially important decisions for retirees who need to offset the loss of income that comes with retirement, but wish to accumulate deferral credits before claiming their highest worker benefits.

3. Spousal benefits for ex-spouses
a. Generally, an ex-spouse who was married to a worker for at least 10 years, divorced, and is currently single, may collect spousal benefits as if they were still married.
   
   (1) This has been especially valuable for divorced individuals who have been eligible to submit a restricted filing for divorced spousal benefits and defer workers benefits.
   
   (2) This opportunity is going away, subject to the same grandfathering rules that apply to spouses.

b. Multiple prior marriages
   
   (1) An ex-spouse who remarries cannot claim spousal benefits from a previous partner, unless the ex-spouse's new marriage ends in divorce as well.
   
   (2) An individual who is a qualifying ex-spouse from multiple marriages will collect only the highest of the spousal benefits available.
   
   (3) However, an ex-spouse is also eligible for survivor benefits from a former spouse. For survivor benefits, a remarriage after age 60 (after age 50 if they are disabled) will not disqualify them from survivor benefits.
   
   (4) An ex-spouse may switch from spousal benefits of one partner to the higher survivor benefits of a different partner, and again to an even higher survivor benefits of the original partner.

c. While an ex-spouse is entitled to the highest spousal benefits or survivor benefits available, one should ensure that the Social Security Administration (SSA) is in possession of all the relevant information.
   
   (1) The SSA may not necessarily go out of their way to alert or update an ex-spouse to changing circumstances regarding potential benefits. For example, they may not inform an ex-spouse they are entitled to survivor benefits now that a previous partner has passed away.
   
   (2) Due to obvious privacy concerns, an ex-spouse cannot access their previous partner's Social Security benefit information, even for calculating the value of their own potential benefits.
   
   (3) An ex-spouse can contact the SSA and provide them with the necessary documentation and information regarding previous marriages. The SSA can then determine what benefits are available and will provide the biggest benefit.
   
   (4) To establish the 10-year marriage requirement, be prepared to provide marriage certificates and divorce decree.

4. Summary of the spousal benefit rules
   
   a. The worker must claim the worker’s benefit to trigger the spousal benefit.
   
   b. At full retirement age, the spousal benefit is 50 percent of the worker’s PIA.
   
   c. The amount of the spousal benefit is not affected by the worker claiming early or late.
   
   d. The spousal benefit is reduced if the spouse claims before attaining full retirement age.
   
   e. Deferring benefits beyond full retirement age does not increase benefits. Only worker benefits receive deferral credits. Spousal and survivor benefits do not increase past full retirement age.
   
   f. Benefits claimed prior to full retirement age are subject to the earnings test.
5. Early claiming for spousal benefits
   a. When the spousal benefit is claimed early, the benefit is reduced 25/36 for each month that benefits are claimed early up to 36 months and an additional 5/12 for each additional month if retirement is more than 36 months prior to full retirement age.
   
   b. Example: George is 70 and claims Social Security benefits. His wife Gina is 62 and has a full retirement age of 66. George's PIA is $2,000, but he deferred and received a larger benefit. What is Gina's spousal benefit at age 62?
   
   c. Solution: The spousal benefit at full retirement age is 50 percent of the PIA—not the benefit George is getting, so it is $1,000 reduced for early taking. The benefit is reduced by 30 percent, which is calculated by multiplying (25/36 x 36 + 5/12 x 12). The spousal benefit is $700.

6. Summary of divorced spousal benefit
   a. To be eligible, the marriage must have lasted for at least 10 years.
   
   b. Eligible ex-spouses are entitled to both a spousal benefit and, at the death of the ex-spouse, a survivor benefit.
   
   c. Note that the divorced spousal benefits do NOT affect benefits of worker and current family—meaning that they are not subject to the family maximum rules.
   
   d. There are differences between eligibility for a spousal benefit and a divorced spousal benefit. Divorced spousal benefits can begin as early as age 62, even if the former spouse has not claimed benefits, as long as the worker is eligible for retirement benefits—meaning that they have attained age 62—and the couple has been divorced for at least two years.
   
   e. An individual has to be unmarried to claim ex-spousal benefits. For survivor benefits there is an exception to the rule about remarriage. An ex-spouse can still be eligible for survivor benefits if remarried after age 60 (age 50 if disabled).

7. Restricted filing grandfathering provision
   a. Those eligible for a worker's and a spousal benefit who are 62 or older by 2015 can still claim a spousal benefit at full retirement age and switch to a worker's benefit later.
   
   b. If one's 62nd birthday is January 1, 2016, they are considered age 62 in 2015.
   
   c. Must be eligible to receive the spousal benefit and not dependent upon file and suspend to receive it
   
   d. May impact more divorced individuals because they are not dependent upon spouses filing and suspending to receive the benefit

8. Grandfathering provision example
   a. John is age 65 on January 1, 2016, and his wife Mary is 65 on March 1, 2016. Both have long work histories. John is entitled to the maximum Social Security benefit and Mary's PIA is $2,000 a month at full retirement age.
   
   b. They both expect to live long lives. Under the old planning strategies, they were planning to have John file and suspend when he attained 66 and Mary would submit a restricted filing for her spousal benefit
when she attained 66. Mary then would switch to her deferred worker’s benefit at age 70 and John would also claim at 70.

c. Because of the grandfather rule, what they may do is have Mary claim her worker’s benefit at 66, and John would do a restricted filing for a spousal benefit because he had attained age 62 before 2016. At age 70, John, with the larger benefit, would claim his workers benefit, which would still maximize the survivor benefit.

9. Grandfather rule and divorce
   a. Note that the restricted filing grandfather rule impacts more divorced individuals as filing for spousal benefits is not dependent on file and suspend like it generally is for a married couple.
   b. Eligibility only requires that the ex-spouse is age 62, the marriage lasted 10 years, and the divorce was two years ago.
   c. Also, unlike a currently married couple, both spouses are entitled to claim a spousal benefit on each other’s work record.
   d. Example: Gerry, age 65, and Gina, age 64, in 2016 were divorced in 2012 after 35 years of marriage. Both work and are entitled to the maximum Social Security benefit.
      (1) Assuming they have not remarried, both will be able to do restricted filings for spousal benefits when they attain full retirement age and then switch to the worker’s benefit at full retirement age, earning deferral credits.

10. Combination of spousal and workers benefits
    a. For everyone not subject to the grandfathering rules, when an individual is eligible for both a workers benefit and a spousal benefit and the workers benefit is larger, Social Security simply pays the workers benefit.
    b. Technically, when the law changed to prohibit restricted filing, what happened is that the deemed filing rule was extended to age 70.
    c. The deemed filing rule is what requires a retiree who is eligible for both worker and spousal benefits to receive the larger benefit.
    d. If the spousal benefit is larger than the workers benefit and the individual is currently eligible for both benefits, the larger benefit is still paid, but it is important to note that Social Security considers the amount of the PIA to be considered the workers benefit and the remainder to be the spousal benefit.
    e. Example: Assume Sarah has a workers benefit of $800 and a spousal benefit of $1,000 if she first claimed at full retirement age. Technically, $800 is considered the workers benefit and $200 is considered the spousal benefit in this case.

11. Claiming workers benefits early
    a. Example: Assume Sarah’s husband is the same age as Sarah and he plans on claiming his benefit at full retirement age. Sarah is not working and she wants to claim her workers benefit as early as possible and the spousal benefit when she is eligible for it.
b. Solution: In this case, Sarah can claim her workers benefit at age 62 since she is not yet eligible for the spousal benefit. The key here is that she is not currently eligible for the spousal benefit. If she was, if she claimed at 62 she would receive the reduced spousal benefit.

(1) At age 62, Sarah’s reduced workers benefit will be 75 percent of $800 (or $600) if her full retirement age is age 66.

(2) When she becomes eligible for the spousal benefit after her husband claims the workers benefit at full retirement age, she will receive the reduced workers benefit ($600) plus the unreduced spousal benefit ($200) (assuming she has attained full retirement age when she begins benefits) for a total of $800.


a. Those with young families may be eligible for additional survivor benefits if the worker dies young, or even retirement benefits if an older parent retires with younger children.

b. In most cases, the additional benefits are paid to children.

(1) To qualify they must be dependent, unmarried children under 18 (under 20 if in high school).

(2) In addition, benefits can be paid to unmarried children 18 or older and disabled from a disability that started before age 22.

(3) Children include biological children, adopted children, and stepchildren. It can also include grandchildren if the grandparents are caregivers and the parents are deceased.

c. Survivor benefits paid to minor children as survivor benefits are 75 percent of PIA.

d. When more than two benefits are paid based on the one worker, there is a family maximum that applies to the total benefits payable to dependents. The maximum that can be paid is generally between 150 percent and 180 percent of the PIA.

e. Example: An older parent that has a younger family claims retirement benefits.

(1) Can have benefits paid to dependent children as described above

(2) Spouses who are caring for a child under 16 can receive full benefits regardless of the spouse’s age.

(3) Retirement benefits paid for each dependent are 50 percent of the PIA, subject to the family maximum.

f. Claiming strategies are affected by younger family members.

(1) Claiming early can allow for maximizing family benefits—remember the earnings test could reduce benefits for the entire family of the worker claiming before full retirement age.

(2) At the same time it reduces retirement benefits for the worker and the survivor benefit available to the spouse.

13. Summary of dependent benefits

a. Social Security benefits can be paid to dependent children as well as the spouse.
b. This is more likely to occur when a worker dies at a young age and Social Security is paying out survivor benefits to family members.

c. But in some cases a worker retires with a young family, and now in addition to the workers benefits, a benefit of 50 percent of the worker's PIA will be paid for each child until they are 17 (19 if still in high school), as well as spouses caring for children under age 16. These benefits are subject to a family maximum if more than two dependent benefits are paid. The family maximum in a specific case needs to be calculated but it is usually 150 percent to 180 percent of the PIA. If you are interested, click here to learn more about the family maximum.

d. Availability of these benefits affects the claiming decisions of the worker as they provide an incentive for the worker to claim earlier to trigger these additional benefits. At the same time, this has to be weighed against the effect that claiming can have on income later in retirement and after the death of the worker.

14. Government offset provision

a. Those who receive a pension from a federal, state, or local government based on work not subject to Social Security taxes will have an offset (reduction) in spousal benefits as well as widow(er) survivor benefits.

b. Social Security benefits are reduced by two-thirds of the government pension. For example, a worker who receives a monthly civil service pension of $600 will have two-thirds of that amount ($400) deducted from Social Security benefits.

c. There are some exceptions. For example, if the government pension is not based on the individual's earnings then the offset does not apply.

LO 8-3-2: Understand how survivor benefits work


a. Survivor benefits are payments made primarily to a surviving spouse (although other dependent family members may be eligible as well).

b. The spouse is entitled to 100 percent of the benefit that the deceased worker was collecting or was entitled to collect at the time of death if they had not yet claimed benefits.

c. The full benefit is only available at full retirement age. However, benefits are payable as early as age 60, subject to a reduction factor.

d. If the worker has deferred benefits past retirement age and dies before claiming benefits, the survivor benefit is the PIA plus any deferral credits earned at the time of death.

(1) Example: Worker with a full retirement age of 66 dies at age 68. Spouse receives 116 percent of PIA because of the two years of 8 percent deferral credits.

e. Additional survivor benefits are paid.
Sources of Retirement Income

(1) Minor dependent children and disabled children (who are disabled before age 22) are entitled to a benefit of 75 percent of PIA (subject to the family maximum).

f. Divorced ex-spouses are entitled to survivor benefits without affecting the benefits of the current family.

2. What benefit options does the survivor have?
   a. If the survivor has not yet claimed benefits and their spouse dies, they will be eligible for a survivors benefit and possibly a workers benefit. These benefits are unrelated and provide an opportunity to choose one then later switch to the other.
      (1) The survivor benefit is available as early as age 60, but is subject to a benefit reduction (71.5 percent of the PIA at age 60) and is subject to the earnings test.
      (2) The workers benefit is available at age 62, again subject to a benefit reduction if claimed prior to full retirement age, as well as the earnings test.
   b. Example with a modest workers benefit
      (1) Scenario: A woman age 62 loses her spouse. She is entitled to workers benefits, which is much smaller than the survivor benefit that she is entitled to. She is working part-time and earns slightly more than the earnings limit.
      (2) Advice: Claim a reduced workers benefit until full retirement age. Some of the benefit may be lost due to the earnings test, but not claiming just means leaving this benefit on the table. At full retirement, she switches to the full survivor benefit. There is no reason to wait longer as the survivor benefit is not entitled to deferral credits. Also, the full benefit is paid; the early filing for the workers benefit has no impact on the amount of the survivor benefit.
   c. Example with a workers benefit larger than the survivor benefit
      (1) Scenario: A woman, age 62, loses her spouse. She is currently working full-time, and her workers benefit is slightly higher than the survivor benefit.
      (2) Advice: In this case it makes sense to defer the workers benefit to 70 in order to earn the deferral credits. Because she is currently working with significant wages, she would lose the survivors benefit to the earnings test if she filed now. She should wait until full retirement age to claim the survivor benefit, and then switch to the workers benefit at age 70 and earn deferral credits.
   d. Additional options for those who are divorced
      (1) Divorced individuals are entitled to a survivor benefit from an ex-spouse. The planning options available to the spouse are available to the ex-spouse as well.
      (2) In addition, a divorced person who remarries after age 60 (50 if disabled) continues to be available for a survivor benefit based on that prior marriage—giving that individual multiple options.

3. Deferral credits and other planning concerns
   a. Survivor benefits are not eligible for deferral credits. Benefits do not increase if claimed later than full retirement age, so there is no reason to defer benefits past full retirement age.
b. Remember that the survivor benefit is based on the benefit that the worker was entitled to, so if the worker with the larger benefit claimed benefits at 70, this maximizes the survivor benefit.

c. Also, remember that if the survivor had already claimed benefits and had the larger of the two workers benefits, the retiree continues to receive the same benefit and the other lower benefit ceases.

d. This also reminds us that at the death of a spouse, there is always a reduction in benefits as the smaller benefit ceases.

4. Summary of survival benefits
   a. If a married couple is already receiving benefits, the smaller benefit stops at the first death.
   b. If a spouse dies before benefits begin, a surviving spouse can elect a survivors benefit or a workers benefit and at a later time switch benefits.
   c. Spousal survivor benefits paid prior to full retirement age are subject to a reduction factor and the earnings test.
   d. Survivor benefits are also subject to the government offset provision.

SECTION 4: TAX TREATMENT OF BENEFITS

LO 8-4-1: Identify how Social Security benefits are taxed

1. Social Security is taxed if a client’s provisional income exceeds thresholds provided in Code Sec. 86. In order to determine the taxable amount of Social Security, we must first calculate a client’s provisional income. (Video: How are Social Security Benefits Taxed? Littell, Tacchino)

2. Provisional income is equal to AGI, plus one half of the Social Security income, plus other nontaxable interest (such as interest on tax-exempt bonds).

3. Example: Virginia has an AGI of $50,000, plus $10,000 in municipal bond income, plus Social Security income of $20,000. Her provisional income is $70,000 ($50,000 AGI + $10,000 Bond Income + ½ x $20,000 in Social Security, or $10,000).

4. A single person with $25,000 or less in provisional income will pay no taxes on his or her Social Security income.

5. A married couple filing jointly with $32,000 or less in provisional income will pay no taxes on their Social Security income.

6. A single person whose provisional income is $25,000 to $34,000 may have up to 50 percent of his or her Social Security income taxed.

7. A married couple who file jointly whose provisional income is $32,000 to $44,000 may have up to 50 percent of their Social Security income taxed.

8. If a single individual has a provisional income of $34,000 or greater, up to 85 percent of his or her Social Security is taxed, leaving at least the remaining 15 percent tax exempt.
9. If a married couple who file jointly has a provisional income of $44,000 or greater, up to 85 percent of their Social Security is taxed, leaving at least the remaining 15 percent tax exempt.

   a.  

<table>
<thead>
<tr>
<th>Percentage of Social Security Benefits Taxes</th>
<th>Single Threshold</th>
<th>Married Filing Jointly Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>$25,000</td>
<td>$32,000</td>
</tr>
<tr>
<td>Up to 50%</td>
<td>$34,000</td>
<td>$44,000</td>
</tr>
<tr>
<td>Up to 85%</td>
<td>Above $34,000</td>
<td>Above $44,000</td>
</tr>
<tr>
<td>A few dollars over a threshold will not trigger all Social Security to be taxed at the higher rate.</td>
<td>The closer to the floor, the less the percentage of Social Security that is taxed.</td>
<td>The closer to the ceiling, the more the percentage of Social Security that is taxed.</td>
</tr>
</tbody>
</table>

10. **Planning Point**: Municipal bonds are not tax-advantaged when it comes to determining the percentage of Social Security benefits taxed.

11. **Planning Point**: Roth IRA distributions are tax-exempt and will not increase provisional income.

12. **Planning Point**: Use an IRS worksheet\(^1\) to run the numbers. A few dollars over a threshold will not trigger all Social Security benefits to be taxed at the higher rate. The closer the client is to the floor, the less the percentage of Social Security that is taxed. The closer the client is to the ceiling, the more the percentage of Social Security that is taxed.

13. **Example**: John is 66 and single. During the current year, he has an AGI of $24,000. He has no tax-exempt interest and has received $8,500 of Social Security benefits. Therefore, his provisional income is $28,250 ($24,000 plus $4,250). Code Sec. 86 says to calculate his taxable benefit as the lesser of A or B:

   a. One half of the benefit received = $8,500/2 or $4,250, or

   b. One half of the excess of provisional income over the first tier base amount ($25,000); $3,250/2 or $1,625. Therefore, $1,625 of John's benefits is taxable.

**LO 8-4-2: Explain the Social Security “tax torpedo” and how it can be avoided**

1. 68 percent of beneficiaries do not pay tax on their Social Security benefit. (Video: *What is the Social Security Tax Torpedo and How Can it be Avoided?* Tacchino, Sass, Schobel)

   a. 16 percent pay taxes on 85 percent of their Social Security benefit—they are known as “fully phased in.”

   b. 16 percent pay taxes on up to 50 percent of their Social Security—they are known as “partially phased in.” This is the group that is most vulnerable to the “tax torpedo.”

2. Tax torpedo—each dollar coming out of the 401(k) is taxed and it also results in more Social Security to be taxed.

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\(^1\) IRS worksheet: https://www.irs.gov/pub/irs-pdf/p915.pdf
a. If we keep income down to the threshold level, the tax torpedo will not apply.

b. While the Social Security benefit tax is phasing in, every additional dollar of non-Roth income has a higher marginal rate of return. In other words, as income increases, the proportion of Social Security benefits subject to taxation also increases.

3. Reverse tax torpedo—take more income before Social Security begins to stay below the thresholds. The way to minimize the effects of the tax torpedo is to minimize the years a client is exposed to it. Trading retirement asset income for Social Security income can create a reverse tax torpedo and reduce taxes.

a. **Planning Point**: Allow clients to stay below the threshold and this will allow Social Security benefits to be taxed at the lowest possible level.

b. **Planning Point**: Claiming at 70 instead of 62 uses up the 401(k) plan, raises Social Security, and may lower the tax on Social Security.

c. Remember only one-half of Social Security counts toward provisional income.

d. When trading a retirement asset dollar of income for a Social Security dollar, not only is the retirement asset dollar no longer present (and thus no tax is due), but less Social Security income is subject to taxation.

4. Advantages of delayed claiming

a. Insurance protection

b. Spousal death benefit

c. Reverse tax torpedo

**SECTION 5: CHOOSING THE OPTIMAL CLAIMING STRATEGY**

**LO 8-5-1**: Apply a strategic approach to choose a claiming age that is right for the client's circumstances

1. Thoughts concerning the claiming age decision in the past have focused on recommending discrete solutions based on how the issue is framed.

2. In the past, one of the most common approaches was to frame the issue using the net present value (or money’s worth) model. This focuses on making a decision based on an assessment of life expectancy. It identifies how long a retiree would have to live to be better off deferring benefits than taking benefits early.

3. Another approach that is gaining favor is looking at the claiming decision in terms of how it protects against longevity risk. One way to test whether deferring Social Security benefits provides longevity protection is to consider how this decision affects the longevity of a portfolio with an assumed goal of combining Social Security and portfolio withdrawals to generate after-tax income.
4. Making a claiming decision also impacts the client’s available Social Security claiming options. Prior to May 1, 2016, claimants had more options—in some cases there are still meaningful options that affect claiming decisions.

5. A final consideration is how deferring benefits affects the overall retirement income plan. If the objective is to build a plan that has an income floor, then a key question will be ‘What is the cost of deferring Social Security against the cost of purchasing a commercial annuity?’

6. The suggested model below includes consideration of all these approaches.
   a. Step one: Change client perceptions through an educational program.
   b. Step two: Assess the client’s funding adequacy, then conduct a break-even analysis for those that are well funded for retirement, and an insurance analysis for those more marginally funded.
   c. Step three: Assess the client’s options under Social Security.
   d. Step four: Integrate the claiming decision into a cohesive retirement income plan.

**LO 8-5-2: Understand how to change a client's perceptions through an educational program**

1. In order to properly choose a claiming age, it may be necessary to change client attitudes.

2. Two faulty perceptions:
   a. “The claiming age and the retirement decision are inexorably linked”—they are not. In the vast majority of cases, the retirement age and the claiming age do not have to be the same.
   b. “The client should avoid losing out on years of payments from Social Security.” In actuality, losing out on payments is a secondary concern to running out of money in retirement.

3. Except where absolutely necessary because of lost work and no meaningful savings, the desire for a specified retirement age should not drive the claiming decision.
   a. Deferring Social Security claiming, even if retirement has begun, could increase retirement income substantially.
   b. A delayed claiming decision may be one of the few planning tools available to an individual with insufficient savings.
   c. Fiscal concerns for many may make the claiming decision more likely to be an “insurance by necessity” issue and thus a delayed claiming age is typically the best alternative.

4. The concept of passing up “free money” at age 62 is a shortsighted way to view a complex issue.
   a. The issue of when to claim is effectively an annuity purchase date choice, and purchasing a larger annuity at an advanced age absent, for example, knowledge of a terminal illness for a single client, will lead to greater insurance protection in the later years for the vast majority of clients.
b. The “free money” that needs to be focused on is not the dollars of low marginal utility at 62, but the dollars of high marginal utility at advanced ages. Which is more important: a sailboat at 62 or food and shelter at 85?

5. Key components of a Social Security educational program
   a. Use a comprehensive planning approach. Social Security claiming decisions involve a thorough evaluation of whether the individual has adequate retirement income (as well as addressing risks posed by retirement) and should be part of a comprehensive retirement income plan.
   b. Focus on the desired replacement ratio. A major part of the retirement income plan is replacing lost income. For low- and middle-income families relying heavily on Social Security benefits in retirement, it is critical to understand that Social Security can replace a much higher percentage of employment income if benefits are deferred.
   c. Care for the surviving spouse. Married couples need to be concerned about securing adequate income while both spouses are alive as well as after one dies. The timing of when the higher wage earner in a couple begins retirement benefits has an impact on the spouse’s survivor benefits. Beginning early saddles the surviving spouse with a lower benefit for the rest of their life.
   d. Understand the Social Security annuity advantage. Social Security is a unique and desirable type of annuity since it is eligible for CPI increases.
   e. Prepare to live long and prosper. Some take benefits early because they think that they will not get their money’s worth unless they live a long life. For many, this is a bad gamble—losing means living longer than expected and having financial problems late in life at a time when it is extremely difficult to rectify the situation.
   f. Avoid irrational thinking. Some take benefits because they think that if Social Security has insufficient funds they will lose their benefits. It is difficult to imagine that Social Security will be allowed not to pay its promised benefits. This program is just too important to the retirement security of seniors and its financial problems are solvable with modifications to the program. Historically, changes to Social Security affect future retirees, not current ones. This is the most likely course of action.

LO 8-5-3: Understand how assessing funding adequacy factors into the claiming age decision

1. Do a preliminary assessment of whether the client has adequate resources for retirement.
   a. A Social Security claiming decision needs to be made in the context of the client’s financial situation.
   b. This helps frame the appropriate way to evaluate the claiming decision.

2. In some instances, clients will possess sufficient assets and income in relation to their projected expenses that they will not be concerned with the possibility of running out of money or having to reduce their lifestyle as they age. This is known as a fully funded client.
   a. The fully funded client is most likely to frame the issue as a net present value break-even analysis.
b. Clients should be careful because a married person claiming early may leave the widow(er) with a permanently reduced benefit.

3. A vast majority of clients will fall into the category of marginally or underfunded clients and their focus will be more on financial security in their later years, portfolio failure, and the need to insure their future standard of living.
   a. Deferring Social Security and replacing the lost income from earnings from employment should be a strong consideration.
   b. Some will not have the option of continuing to work. Planners will often find this to be the most effective solution for marginally funded or underfunded clients.
   c. In this case, the claiming age analysis will entail an analysis of how best to deal with the bridge period. The period between the discontinuance of a paycheck and the commencement of Social Security is sometimes called the "bridge period."

**LO 8-5-4: Understand how to use the net present value break-even approach for fully funded clients**

1. For some clients, the claiming age decision is a net present value break-even choice that attempts to maximize the net worth a client can achieve.
   a. This way of framing the problem might be correct for clients who are not in danger of sacrificing their standard of living in the later years of retirement.
   b. Essentially, the net present value break-even-age approach compares the net present value of X dollars for Y months (early start) to the net present value of “X plus” dollars for “Y minus” months (later start).

<table>
<thead>
<tr>
<th>Account 1</th>
<th>Account 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receives monthly income from age 62–70</td>
<td>Receives no monthly income from age 62–70</td>
</tr>
<tr>
<td>At age 70, monthly payments continue but are less than the money put in account 2</td>
<td>At age 70, payments commence and they are more than the money put in account 1</td>
</tr>
</tbody>
</table>

2. What do we mean when we say Social Security is actuarially fair? (Video: What is the Net Present Value Strategy? Tacchino, Reichenstein, Meyer)
   a. If someone lives an average life expectancy, they will get about the same benefits (in present value terms) if they claim at any age from 62-70.
   b. The actuaries built this into the Social Security system assuming beneficiaries will live to age 84, and they also assumed a real risk-free rate of 3 percent.
   c. When evaluating the net present value today, the appropriate discount rate is the real risk-free rate of return and the best proxy for this is the Treasury Inflation Protected Security bond (TIPS).
   d. The 10-year TIPS has approximately a zero yield, and so the appropriate discount rate is 0 percent.

3. What happens when you change the discount rate from 3 percent to 0 percent?
a. In exhibit 1 below, you see that with a life expectancy of 84, lowering the discount rate means that a person living to 84 should now wait until age 69 to claim Social Security in order to maximize cumulative benefits.

b. Since the built-in real return in Social Security is 3 percent (not 0 percent), it pays to delay taking benefits. If the client can get a “3 percent rate of return” by delaying Social Security while TIPS are at 0 percent, it will pay to delay.

4. When should the higher earning spouse claim?
   a. The higher earner’s benefits cease at the death of the second spouse.
   b. The lower earner’s benefits cease at the death of the first spouse.
   c. Example: If the higher earning husband is age 60, and the lower earning wife is 54 with a life expectancy of 85 (another 31 years), then the husband’s benefits will be expected to last until he turns (or would have turned) 91. So it pays to delay to age 70.
   d. The higher earning spouse should delay claiming until 70 since his benefits will last long beyond the break-even age of 80.
   e. If a husband and wife make it to age 62, the probability that one of them will make it to age 80 is 85 percent!

5. When should the lower earning spouse claim?
   a. Example: If the higher earning husband is age 60, and the lower earning wife is 54 with a life expectancy of 85, then the benefits based on her earnings record will stop at the death of the first spouse. If he lives to 84, she will be 78. She should claim early.
   b. The break-even age should be about age 64½ with a life expectancy of 78.

6. Break-even should be more relevant if life expectancy is significantly more or significantly less than 80. (Video: What is the Break-Even Age Under the Net Present Value Strategy: Tacchino, Reichenstein, Meyer)
   a. See Exhibit 1 below.
   b. See Exhibit 2 below.

7. Break-even is not the only consideration. Clients also need to minimize longevity risk.

8. Planners need to run the numbers to show the effect of claiming decisions on longevity risk. A client who sees that they will benefit if they live longer may be more willing to defer.
## EXHIBIT 1
### Present Values of Lifetime Benefits if Social Security Benefits Begin at Ages 62 Through 70

<table>
<thead>
<tr>
<th>Ages</th>
<th>84, 3%</th>
<th>84, 0%</th>
<th>80, 0%</th>
</tr>
</thead>
<tbody>
<tr>
<td>62</td>
<td>$289,634</td>
<td>$396,000</td>
<td>$324,000</td>
</tr>
<tr>
<td>63</td>
<td>$290,051</td>
<td>$403,200</td>
<td>$326,400</td>
</tr>
<tr>
<td>64</td>
<td>$294,361</td>
<td>$416,000</td>
<td>$332,801</td>
</tr>
<tr>
<td>65</td>
<td>$296,244</td>
<td>$425,600</td>
<td>$335,999</td>
</tr>
<tr>
<td>66</td>
<td>$295,821</td>
<td>$432,000</td>
<td>$336,000</td>
</tr>
<tr>
<td>67</td>
<td>$296,863</td>
<td>$440,640</td>
<td>$336,960</td>
</tr>
<tr>
<td>68</td>
<td>$295,272</td>
<td>$445,440</td>
<td>$334,080</td>
</tr>
<tr>
<td>69</td>
<td>$291,171</td>
<td>$446,400</td>
<td>$327,360</td>
</tr>
<tr>
<td>70</td>
<td>$284,683</td>
<td>$443,520</td>
<td>$316,800</td>
</tr>
</tbody>
</table>

Note: Primary Insurance Amount is $2,000 with full retirement age of 66. The first entry is $\text{PV}(0.25\% \text{ per month}, 12\times(84-62) \text{ months}, 0.75\times$2,000 $\text{ per month}) = $289,634, where 0.75 denotes the 25% reduction in benefits for beginning benefits 48 months before full retirement age. The entry for age 66 is $\text{PV}(0.25\%, 12\times(84-66), $2,000) / (1.0025)^{48} = $295,821, where (1.0025)^{48}$ discounts the present value from age 66 to 62. Other entries follow the same formulas.

Source: "Today's Low Interest Rate Environment and Social Security Claiming Decisions" Reichenstein and Meyer, 2012

## EXHIBIT 2
### Break-even Points for Beginning Social Security Benefits

<table>
<thead>
<tr>
<th>Beginning Dates</th>
<th>Break-even Points (Ages)</th>
</tr>
</thead>
<tbody>
<tr>
<td>62 versus 63</td>
<td>78</td>
</tr>
<tr>
<td>63 versus 64</td>
<td>76</td>
</tr>
<tr>
<td>64 versus 65</td>
<td>78</td>
</tr>
<tr>
<td>65 versus 66</td>
<td>80</td>
</tr>
<tr>
<td>66 versus 67</td>
<td>79.5</td>
</tr>
<tr>
<td>67 versus 68</td>
<td>81.5</td>
</tr>
<tr>
<td>68 versus 69</td>
<td>83.5</td>
</tr>
<tr>
<td>69 versus 70</td>
<td>85.5</td>
</tr>
<tr>
<td>62 versus 66</td>
<td>78</td>
</tr>
<tr>
<td>66 versus 70</td>
<td>82.5</td>
</tr>
<tr>
<td>62 versus 70</td>
<td>80.5</td>
</tr>
</tbody>
</table>

Note: The “62 versus 63” of 78 means the break-even point for delaying benefits from age 62 to 63 is age 78. Therefore, if the individual lives past 78, then cumulative lifetime benefits will be higher by delaying benefits from age 62 to 63. The exhibit assumes a full retirement age of 66.

Source: "Today's Low Interest Rate Environment and Social Security Claiming Decisions" Reichenstein and Meyer, 2012
LO 8-5-5: Analyze the process of framing the claiming age decision as insurance against longevity risk

1. The period between the discontinuance of a paycheck and the commencement of Social Security is sometimes called the "bridge period."

2. Each month of deferral during the bridge period is like buying an additional inflation-adjusted life annuity.

3. Planners must balance the reduction in other retirement assets against the increased Social Security "annuity."

4. The balancing act is between taking higher income from retirement savings versus taking higher income from Social Security.

5. Reasons for delayed Social Security:
   a. There is a "snowballing" effect on delaying Social Security benefits because of both the actuarial increases and the compounding of COLA increases.
   b. There is a "reverse tax torpedo" if Social Security benefits are taken later because only one-half of Social Security benefits are included in the calculation of provisional income.
   c. Some of the investment risk has been transferred by a delayed claiming because you are replacing income from 401(k) asset with Social Security annuity income.
   d. There is less money being paid to investment expenses since assets are consumed earlier in a trade-off for higher Social Security benefits.

6. Reasons for an early claiming age:
   a. There is a loss of liquidity because in most cases the retiree will need to consume retirement assets early.
   b. The desire to leave assets to heirs is jeopardized because, in most cases, the retiree will need to consume retirement assets early.
   c. The rate of return net of taxes and expenses that could be earned on invested retirement savings may outperform the higher Social Security annuity.

7. Planners are obligated to consider that superior investment performance on retirement investments may offset any mortality gain experienced by a long-lived client (and vice versa).

8. In most instances, depleting 401(k) assets to defer claiming Social Security will be superior to preserving the 401(k) and claiming Social Security early.
   a. Researchers have demonstrated the value of deferral by showing that, for several hypothetical clients retiring at 62, the cost of financing retirement income during the bridge period with a fixed annuity was less expensive than beginning Social Security early and liquidating other assets to finance the income difference. In many cases, their research weighs in favor of deferring Social Security and using other assets to fund the bridge period.
9. To answer the question of when to start Social Security retirement benefits, we must first start with the best way to frame the question. (Video: Should the Claiming-Age Decision be Framed as Insurance Against Longevity Risk? Tacchino, Sass, Schobel)
   a. The prevalent way people assess the problem is either to (1) act without planning or (2) use a break-even strategy to garner the largest possible amount from the system.
   b. However, if clients have real concerns about the adequacy of income in the later years of retirement, they need to frame the question differently.

10. Reasons why a break-even age viewpoint may be flawed
   a. The fundamental concern needs to be planning for adequate retirement income. The break-even age method ignores how the Social Security claiming age decision fits into the bigger picture of retirement income security.
   b. The break-even analysis is quite sensitive to the discount rate chosen—even a small change in the discount rate will have a significant impact on the break-even age.
   c. The break-even method incorrectly assumes that the insurance value of delayed Social Security is zero.

11. Reasons to frame the claiming age decision as an insurance decision
   a. Clients should focus on the later years of retirement. The newly retired could go back to work to make up for income gaps—the elderly cannot.
   b. For a client with a PIA of $1,000, Social Security may provide $750 per month at age 62, $1,000 per month at age 66, or $1,320 per month at age 70.
   c. Planning Point: One of the most important ways that the client can look at the claiming age decision is to focus on the replacement ratio that Social Security will provide.
      (1) Replacement ratio framing example: Married couple with one wage-earner earning $80,000
      (2) Claiming at 62, the Social Security replacement ratio is 31 percent.
      (3) Claiming at 66, the Social Security replacement ratio is 42 percent.
      (4) Claiming at 70, the Social Security replacement ratio is 57 percent.
   d. Claiming at age 70 provides more of the needed replacement ratio (e.g., 57 percent versus 31 percent).
   e. Planning Point: Another way to look at the claiming age decision is to focus on Social Security providing the basic expense for a client. A deferred claiming date will allow Social Security to provide for more of these expenses.
      (1) Real dollar framing example: To meet basic expenses
      (2) $750 per month at age 62 versus $1,320 per month at age 70
   f. Social Security dollars are the preferred way to meet basic needs (food, rent, utilities, etc.)
   g. Planning Point: Another way to envision the benefit of delayed claiming is to look at the percent increase provided by delaying:
(1) For example, if age 62 is 100 percent, then age 66 is 133 percent, and age 70 is 176 percent—that’s a 76 percent increase!

h. **Planning Point:** Another benefit of continuing to work and deferring benefits is that work beyond age 62 may raise the benefit even more (benefits at 70 could be approximately twice the benefits at age 62).

i. The Social Security COLAs cannot be duplicated in the private sector (the COLAs are another sweetener that favors the insurance framing/delayed claiming decision).

j. Benefits of delay (review)
   (1) Compounding of COLAs
   (2) Increased replacement ratio
   (3) Protection in the later years of life

**LO 8-5-6: Compare claiming late and liquidating 401(k) assets versus claiming early and preserving 401(k) assets**

1. For many clients, deferring Social Security beyond actual retirement age means choosing between using other assets first and delaying Social Security, or claiming early to preserve other assets. The instinct for many is to claim early to preserve other assets.

2. But research by Bill Reichenstein and Bill Meyer and others suggests that maybe this is not the case.


4. **Example:** Assume the following: first, the client earns a 1.22 percent real rate of return; second, the client starts to withdraw the appropriate amount from his $700,000 portfolio under the 4 percent rule; third, the client starts Social Security at age 62. With this baseline example, the portfolio is depleted after 30 years. Now this is compared to the same real rate of spending, but assuming deferring Social Security to age 64 and taking larger withdrawals from the portfolio the first two years and smaller withdrawals thereafter. This results in an extra $42,000 from Social Security. This will enable the portfolio to last between 1 and 2 years longer.

5. **Example:** Using the facts from the previous example, the client decides to wait until 70 to start Social Security. This client will get an extra $157,000 from Social Security and the retirement portfolio will last over 10 years longer!

6. With this analysis, delaying Social Security always extends the longevity of the portfolio.

7. However, how much the portfolio is extended is lower as wealth increases.

8. **Example:** If the client has $1.4 million and delays benefits from age 62 to 70 and lives 30 years, he will increase the portfolio’s longevity only slightly over 2 years. However, the portfolio longevity is enhanced!
9. The reason wealth diminishes the difference is tied to the relative value of Social Security benefits to other financial resources.

10. Also note that even though the relative value decreases with wealth, deferring can still mean getting significantly more total benefits.

11. Social Security is an important financial asset. For a husband and wife with a Primary Insurance Amount of $1,600, their cumulative benefit from Social Security is $1.1 million.

12. Planners should run the numbers for their clients.

13. Planners should account for the behavioral need to have a liquidity reserve.

14. Planners should account for the widow benefits as well.

15. There is research that says a portfolio killer (sustainability killer) is having negative returns in the first several years of retirement (sequence of returns risk). If this is correct, why won’t depleting the 401(k) act in a similar manner to hurt the sustainability despite the increased monthly Social Security at age 70?
   a. The “claiming Social Security later to increase your portfolio’s longevity” strategy is predicated on poor returns and the 4 percent rule.
   b. However, the delay in Social Security will give a substantial return of up to 8 percent.
   c. The increase in Social Security is not affected by market returns, so the issue of sequence of returns risk is not in play.

16. Take-away issues from the “claiming Social Security later to increase your portfolio’s longevity” strategy
   a. Assuming you live beyond average life expectancy, it pays to delay claiming Social Security regardless of your income level.
   b. For someone with between $200,000 and $700,000, delaying Social Security is their best opportunity to protect against longevity risk.
   c. Delayed claiming for someone in the $200,000 to $600,000 range is enhanced even further because of the reverse tax torpedo—by deferring, a smaller percentage of Social Security benefits will be taxed.
   d. It pays to delay even if you do not live 30 years, as long as you live beyond the break-even age of 80. In this case, you would be able to spend more by deferring.

**LO 8-5-7: Assess the client's Social Security options based on their unique situation**

1. Once the preliminary evaluation of the client’s funded status has identified the appropriate decision framework, the third step of the decision process is to evaluate the client’s specific situation to identify all the factors critical in making a decision.

2. Examples:
   a. Continued employment
(1) The distinction between those who work longer and those who merely delay claiming benefits without working longer is critical.

(2) Clients who continue to work are most likely to delay claiming either through a chosen delay of benefits or a forced suspension of benefits under the earnings test.

b. Marital status

(1) The claiming age decision process for a single individual is much simpler because there are no spousal or survivor benefits to muddy the waters.

(2) A married woman, in some cases, can expect to experience close to a decade of widowhood because women tend to live longer than men (by about 6 years), and wives tend to be younger than their husbands (by about 3 years on average in the U.S.).

c. Wealth/net worth/sources of income outside of Social Security

(1) Clients with high income from other sources need to plan to avoid the tax torpedo.

(2) Clients with low income from other sources do not have to be concerned about it.

d. Personal risk tolerance/degree of investment savvy

(1) Workers have differing comfort levels with break-even analysis, insurance pricing decision, and framing the claiming age decision as an insurance, strategy, or net present value question.

(2) Likewise, workers who doubt their ability to manage assets in retirement could decide to draw down assets early and claim Social Security later.

e. Financial reliance on Social Security

(1) Workers with low savings and forced workforce exits tend to be completely dependent on Social Security income and therefore have no choice as to when to claim benefits.

(2) Other workers with independent wealth will not consume Social Security income at all.

(3) The vast majority fall in the middle.

f. Ability to boost Social Security income by working past age 62

(1) If the individual continues to work, the additional covered earnings also increase the benefits in most cases.

(2) Social Security benefits are based on the 35 highest years of indexed earnings. For a worker with fewer than 35 years of covered earnings at age 62 (a common situation for women, in particular), every additional year of earnings is certain to increase the ultimate benefit.

g. Age disparity between spouses

(1) If the age disparity differs greatly from the average, this has an impact on the survivor-benefit analysis, in particular. For example, if the wife is 10 years younger than the husband, then the likelihood that she will eventually be a widow for a substantial period of time is substantially increased, making the claiming age of the husband even more critical to the financial well-being of the spouse.
h. Earnings disparity between spouses
   (1) Most husbands earn more than their wives (in addition to being older).
   (2) Therefore, the husband can expect to receive the higher Social Security benefit based on his own earnings record.
   (3) In such typical cases, the husband should defer collecting Social Security benefits as long as possible in order to maximize retirement income at age 70 and above—and especially for his widow who would be eligible to inherit his benefit, including any delayed retirement increment, if she survives him.

i. Work in noncovered employment
   (1) Workers receiving pensions based on employment not covered by Social Security (usually for a state or local government) have their own benefits calculated using the windfall-elimination provision and any potential spousal or widow(er) benefits reduced under the government-pension-offset provision. These special rules can eliminate many of the strategies otherwise available to married couples.

j. Divorce
   (1) If a prior marriage lasted 10 years or more, then each spouse may be eligible to receive a benefit based on the other spouse's earnings record, depending on whether or not either of them has remarried and at what age.
   (2) Moreover, a divorced spouse can receive spousal benefits based on a former spouse's earnings record even if the former spouse has not retired or claimed his or her own benefit, provided that the divorce occurred more than 2 years earlier.

k. Federal income taxation of benefits
   (1) Filing status and marginal rates affect any net present value analysis as well as being applicable to many claiming strategies. Close to 70 percent of Social Security beneficiaries have income low enough that they pay no income tax on their benefits. Another 15 percent have income so high that they will be taxed on 85 percent of their benefits no matter what they do in terms of claiming strategies. The remaining 15 percent of individuals and couples are in the income range where benefit taxation is phasing in, and these taxpayers are subject to the “tax torpedo.”
   (2) They can greatly reduce their federal income taxes (and marginal tax rates) by deferring Social Security benefits and drawing down other assets in the meantime. State income taxation, if applicable, should also be considered.

LO 8-5-8: Solve case studies concerning choosing the optimal Social Security claiming age that is appropriate for your client's situation
1. Overview
   a. There is no one-size-fits-all solution when it comes to discerning the claiming age.
b. A myriad of rules, strategies, client goals, and other factors come into play and must factor into the decision.

c. The rules are complex and often lead to contravening solutions. There is no right answer…there is just a better answer for the client’s situation.

d. The most important step in reaching the best conclusion is making sure the problem is framed correctly for the client’s situation.

   (1) Is it an insurance decision to hedge against longevity risk?

   (2) If it is an insurance decision, should the client claim early and preserve 401(k) benefits or claim late and liquidate 401(k) benefits?

   (3) Is a net present value break-even age decision to maximize wealth from the Social Security system a viable consideration?

   (4) How does retirement from employment, or partial retirement from employment, impact claiming (if at all)?

   (5) Is early claiming enabling a client to retire or giving the client false hope that he will maintain his lifestyle throughout retirement (because he has sufficient income to meet his spending needs at and shortly after retirement, but not in later years)?

   (6) Can the client keep working or is retirement absolutely necessary?

   (7) Does the client realize that either way they are passing up free money? By delaying, they are passing up monthly checks from 62 until the claiming age. By claiming early, they are passing up larger checks in the later years of retirement.

   (8) Have the optimal options for the surviving spouse been contemplated?

   (9) Has the planner spent enough time educating the client about the rules, strategies, and options?

e. Focus on client goals, but educate the client why their “goal” may not be in their, or their spouse’s, best interest when the claiming decision is viewed as part of the bigger retirement security picture.

2. Case one: Albert, single, never married, and fully funded with no risk of funds running out or standard of living being compromised prior to death

   a. Albert will probably make his claim based on the net present value break-even strategy.

   b. Much research has been done to perfect the perfect break-even age.

   c. Software used by many planners usually comes up with 78–80 as the trigger point (remember Professor Reichenstein said 80 or 80½).

   d. In the final analysis it probably does not matter if the software calculation is completely accurate (as long as the age range is in the ballpark) because the client’s death cannot be predicted with certainty.

   e. Recall that the actuarial tables are approximately correct except that they use unisex rates.

   f. If Albert has a family and personal health history that suggests longevity, then claim at 70. If Albert has a family and personal health history that suggests he will not live long into his 70s, claim at 62.
Sources of Retirement Income

8.39

g. If Albert is still working, delay until full retirement age.

h. Even if retired, Albert could also hedge his options by choosing an age with which he is comfortable between 62 and 70.

3. Case two: Barbara, single, never married, and underfunded with the risk of funds running out or her standard of living being compromised prior to death

a. Barbara should probably make the claim for Social Security benefits based on the desire to decrease her risk of portfolio failure and protect against longevity risk.

b. If Barbara is able to, she should be encouraged to work longer. Additional years of earnings will help her to replace any “zero years,” if applicable, and provide extra income and delayed retirement credits to her Social Security benefit.

c. Even if Barbara is unable to continue employment she is probably better off claiming at age 70.

   (1) She cannot afford to gamble on dying young because the dollars taken at age 62 have a low marginal utility, while increased monthly payments at later ages have a high marginal utility.

   (2) She must “insure herself” against extreme old age.

   (3) She is female and can expect to live longer than the unisex mortality tables indicate.

   (4) If she has a terminal illness, then claiming early would make sense. However, absent that type of specific knowledge, she should protect against longevity.

   (5) Other factors outside the Social Security rules may apply. For example, if she is looking to qualify for Medicaid coverage, she has some additional concerns. But can she really count on Medicaid being the same as she ages?

4. Case three:

a. Calvin and Doris are both age 62 and have been married for 35 years. Calvin worked for the entire marriage and Doris never worked outside the home. They have the risk of funds running out or their standard of living being compromised prior to death. Calvin’s PIA payable at his full retirement age of 66 is $1,800 a month. Doris only qualifies for a spousal benefit.

b. Knowing that their retirement funding is marginal, this couple’s best chance of more retirement security is for Calvin to defer his benefits to age 70. This is most likely true even if Calvin is retired, in which case they should look to their other resources to cover the bridge period.

c. Unfortunately, under current Social Security claiming rules, Doris cannot claim her spousal benefit until Calvin actually claims his workers benefit. If Calvin defers to 70, Doris needs to wait until 70 as well. Since the spousal benefit does not increase for deferring past full retirement age, part of the cost of Calvin deferring is giving up the four years of spousal benefits.

d. The benefit of deferring is that Calvin will continue to accrue deferral credits until age 70. His monthly benefit will be $2,376 at 70, assuming no additional years of earnings.
e. Deferring also means that Social Security replaces a larger percentage of this couple’s income, improving the sustainability of their income, and providing for the largest possible widow’s benefit if Doris outlives Calvin.

f. Their biggest challenge will be covering the bridge period if Calvin decides not to work until age 70. Given that they have marginal funding for retirement, working until age 70 provides the best option for this couple. If full-time work is not feasible or does not meet their goals, maybe there is an option for Calvin and/or Doris to work part-time. Absent the option of working, based on Dr. Reichenstein’s research, they are likely better off using their other assets during the bridge period. The primary challenge in this case may not be the numbers, but getting the clients to understand why they are better off deferring Social Security benefits.

5. Case four: Harry and Grace have been married for 40 years. He is age 66 and she is age 63.

a. For Harry, the decision to defer claiming has been made easier because he continues to work, and his personal and family health history indicate living into his 90’s.

b. Note, however, that he could receive unreduced benefits at full retirement age even though he continues to work because the earnings test does not apply after full retirement age.

c. Similarly, Grace will be able to claim her worker benefit at 66, even though she continues to work. She cannot receive her spousal benefit until Harry claims his benefit.

d. Harry’s choice seems simple.

(1) He is working, they do not need the money, he has a long life expectancy, and his younger wife may live even longer than he does.

(2) By waiting until age 70, Harry has provided the largest possible inflation-adjusted retirement benefit for both of them and the largest possible survivor benefit he could for Grace.

(3) Looking at just the actuarial increase, his benefit will be $2,640 (1.32 x $2,000) at age 70. It is probably going to be substantially higher as the benefit will increase for COLAs, and his earnings from continued employment are likely to increase his AIME.

(4) Using a break-even analysis provides the same result, given the likelihood of him or his spouse living well beyond age 80.

e. Grace’s situation is a bit more complicated.

(1) Remember we would use a break-even analysis for the smaller benefit if one of them was in bad health, since she would consider claiming as early as possible. In this case, that would mean claiming her worker benefit at age 66—she cannot take it earlier because of the earnings test. Her benefit would bump up to $1,000 at 67 when Harry claims his benefit.

(2) We do not have any evidence that either one is unhealthy. What we do know is that she is going to work until age 70 and that she has had fewer than 35 years of work history. By deferring her worker benefit to 70 (with the additional years of wages and deferral credits), her benefit should exceed $1,000 by age 70.
Sources of Retirement Income

(3) It also seems that this is the case given the facts that she was 62 before the end of 2015, which would give her the option to submit a restricted filing for spousal benefits from age 67 when she is eligible for the spousal benefit, and switch to her worker benefit at age 70.

LO 8-5-9: Understand how to use software to choose the client's Social Security claiming age

1. There are a variety of programs available to assist with navigating Social Security benefit decisions. (Video: Social Security Claiming Software Hopkins, Franklin)
   a. Social Security Analyzer—created by Social Security Solutions
   b. Social Security Timing—focuses on training advisors
   c. Social Security Pro—previously known as Social Security Explorer from Impact Technologies
   d. Some financial firms have their own proprietary Social Security programs that provide in-depth analysis and information.

2. There are simpler tools available as well.
   a. Social Security Maximizer
   b. Maximize My Social Security
   c. Social Security Choices

3. Advisors must figure out their purpose in using software.
   a. Advisors who casually provide basic Social Security claiming plans to current or prospective clients may be better off with just a small investment in the simpler programs available to them.
   b. Those who wish to focus heavily on retirement income planning will want to make a heavier investment in the tool they use. These advisors should take the time to learn the Social Security rules, learn how the software works, and learn how it integrates into their client's entire retirement income planning strategy.
   c. Advisors must be careful to track changes in Social Security rules and regulations, understand how it affects current retirement plans, and adjust their use of planning software and tools accordingly if necessary.

4. Social Security is simply one part of a retirement income plan, and planners must consider how Social Security benefits will affect other parts of their retirement strategy and vice versa.
   a. For example, many advisors are unaware that a retiree's amount of retirement income will dictate their costs for Medicare. This may influence how retirees wish to collect their retirement income from all available resources.
   b. Software programs are already starting to integrate this holistic view of retirement income to help advisors decide how to coordinate Social Security income with other sources of retirement income to minimize taxability of retirement income, maximize spendable income, and reduce Medicare costs.
5. The Social Security Administration offers their own online tools and resources to help understand your Social Security benefits.
   a. www.SSA.gov allows individuals to set up a personalized Social Security account and provides information regarding their estimated benefits and their contributions to Social Security.
   b. Individuals should help themselves by checking their Social Security information online to ensure the accuracy of reported earnings and tax information.

6. Consumer Financial Protection Bureau
   a. Tool for consumers providing a simple Social Security estimator showing income if claiming at different ages, plus individual circumstances that affect claiming decisions
   b. Before You Claim

RESOURCES FOR COMPETENCY 8: CHOOSING THE OPTIMAL SOCIAL SECURITY CLAIMING AGE

For more information on these topics, please visit:

- www.ssa.gov
- crr.bc.edu
- Journal of Financial Service Professionals
- Journal of Financial Planning
- Financial Services Review
- New York Life Center for Retirement Income
- IRS Worksheet 1. Figuring Your Taxable Benefits
Competency 9

Choosing the Optimal Retirement Age
SECTION 1: WHAT A RETIREMENT CONSULTANT NEEDS TO KNOW ABOUT THE FACTORS INFLUENCING THE CHOICE OF A CLIENT’S RETIREMENT AGE

LO 9-1-1: Analyze the factors influencing the client’s choice of a retirement age

1. Retirement age can be traditional—that is, what people do in a society or an organization. In other words, it is chosen by using an anchor point. An anchor point is a culturally defined age at which a person may make a transition into retirement (a social norm). (Video: What Should be the Retirement Age? Tacchino, Sass)

2. Retirement age can reflect that the client is tired of work and wants to enjoy leisure. In other words, it is chosen by trading-off work for leisure.

3. Retirement age can be a financial decision reflecting when the client has adequate resources to retire.

4. In the recent past, anchor points were a driving force in choosing a retirement age.
   a. The defined-benefit plan would define the age at which the pensions started. Clients just “followed the script.”

5. However, the lack of defined-benefit pensions and long career relationships has changed the nature of the decision.
   a. Anchor points can be misdirecting because they may not accurately capture the client’s situation.
   b. Other issues about the enjoyment of work and the financial readiness must now drive the decision.

6. The role of the advisor is to help the client deal with both the financial issues and personal values surrounding the retirement age decision.
   a. Planners need to be attuned to the beliefs, values, and feelings of their client.
   b. The planner may have to elicit the client’s values because the client is unclear about the issue.
   c. The planners should ask:
      (1) What does work mean?
      (2) What will the client do with leisure time?
      (3) How much money is needed?
      (4) What trade-offs should be made?

7. Choosing a retirement age is a personal decision.
   a. Where your client stands on the question of when to retire depends upon his or her unique perspectives and goals.
   b. For example, a client may value involvement in the workforce over leisure, or vice versa.

8. Choosing a retirement age requires a systematic decision-making approach which considers:
Sources of Retirement Income

a. The financial feasibility of retiring
b. The client’s ability to continue working
c. Psychological factors
d. Personal factors

9. After careful analysis, the retirement age choice comes down to one of four potential outcomes.
   a. Retirement by necessity
   b. Work by necessity
   c. Retirement by choice
   d. Work by choice

10. Choosing a retirement age is complicated.
    a. There are competing factors.
    b. There is a lack of clarity about what lies ahead since the client has no comparable life experiences to mimic.
    c. There are confusing financial and nonfinancial factors that may exceed the client’s cognitive limits.

11. Choosing a retirement age needs to factor in multiple variables. Each variable will have its own personal value or weight for the client.

12. The variables are presented as a checklist of factors. This checklist can be used at many ages (e.g., mid-career, 5-10 years from retirement, and when retirement is imminent).

13. The dialogue between the planner, client, and spouse regarding the checklist factors will help to frame the choice of an optimal retirement age.

14. Planning Point: Planners must not only understand the checklist factors, but they must be able to attach the value the client gives to each item on the list.

15. Factor 1—Calculate the available retirement income and assess adequacy. (Video: What Factors Need to be Considered in Order to Choose the Optimal Retirement Age? (Part1): Tacchino, Sass)
   a. Look at the bottom line of how much the client needs to determine income adequacy. In other words, calculate the amount of retirement income available from all sources and assess whether it is likely to provide the desired lifestyle under the proposed withdrawal strategy.
   b. Take an inventory of the client’s existing resources including Social Security, pension income, financial assets, and nonfinancial assets such as the house.
   c. The first stage is to cover the basic expenses. Then clients can increase the “adequate amount” to meet their income needs beyond the floor amount. Clients are more likely to choose a retirement age that allows them to be financially well-off in retirement.
d. When the basics are not covered, the planner will need to recommend continued work. Continued work has four benefits that can make a significant difference in helping the client be financially prepared for retirement:
   (1) The client will preserve assets.
   (2) The client will continue to build assets.
   (3) The client will minimize longevity and inflation risk because he is shrinking the retirement period.
   (4) The client will delay Social Security claiming and increase the Social Security benefit.

16. Factor 2—Consider life expectancy, expenditures, and risks.
   a. Studies consistently show that most clients underestimate longevity.
   b. A lot of the risk of running out of money in retirement lies in living a long time (longevity risk).
   c. The other risks that need to be addressed were covered in HS 353.

17. Factor 3—Perform a Monte Carlo or other type of analysis to evaluate the soundness of a retirement plan.
   a. Assess whether the “draw-down” strategy will work
   b. Annuities, longevity insurance, and other products will be used.
   c. The Social Security annuity may be the best annuity to “buy” in a low interest rate environment.

18. Factor 4—Evaluate the client’s debt situation.
   a. 39 percent of households with heads age 60–64 have primary mortgages (in 1994 it was 22 percent).
   b. 20 percent of households with heads age 60–64 have secondary mortgages (in 1994 it was 12 percent).
   c. Consider the client’s balance sheet (assets and liabilities); liabilities mean more risk for clients. Today’s “wannabe” retirees have more debt than in prior generations.
   d. In order to minimize risk in retirement, clients should extinguish their debt prior to retirement.

19. Factor 5—Determine the availability of health insurance.
   a. Researchers have found that retiree health insurance actually encourages an earlier retirement age.
   b. Researchers have found that without retiree health insurance, people retire later.
   c. This is a linchpin decision! There is an incredibly strong link between health insurance coverage and retirement age.
   d. Adequate insurance is fundamental to minimize risk.

20. Factor 6—Evaluate the impact of various Social Security claiming age decisions.
   a. Clients focus on “getting their hands on the money” and in too many cases are ignorant about the effects of delay.
   b. A delay from 62 to 70 will increase benefits by 76 percent.
   c. Planning Point: It is important to distinguish between the Social Security claiming age and the optimal retirement age and realize that the two are not inextricably linked. If a planner can only do one thing
when advising a client about the proper age at which to retire, he or she should make it clear that the Social Security claiming age is a different and separate decision from the retirement age decision.

21. Factor 7—Assess the type of retirement plan and the plan’s features.
   a. Each type of employer plan has unique features that must be examined.
   b. Is the benefit indexed for inflation?
   c. What are the survivor benefit options?
   d. *Planning Point:* Researchers have found that defined-benefit plans tend to have age-related work incentives and disincentives, that first encourage work, and then encourage retirement.
   e. *Planning Point:* Research indicates that people in a defined-benefit plan retire almost two years earlier than participants in a defined-contribution plan.

22. Factor 8—Analyze the financial status of investments.
   a. In order to choose a proper retirement age, clients must consider sequence of returns risk.
   b. Particularly important is the period before and after retirement.
   c. Clients should be more reluctant to retire when the stock market is expected to decline and vice versa.

23. Factor 9—Examine the client’s earnings prospects.
   a. Large salaries and/or the availability of nonqualified deferred compensation bonuses may make it better to wait for retirement.
   b. Balance the financial benefits of continued work versus the desire for leisure. However, when the financial benefits are greater, it will be harder to choose leisure.

24. Factor 10—Appraise the availability of a phased retirement program.
   a. The potential to work part-time may help the client to choose a retirement age.
   b. Retirement might include working part-time.

25. Factor 11—Factor in early retirement incentives.
   a. An early retirement incentive could be a tipping point.
   b. The planner needs to assess the long-term financial viability and not be blinded by the short-term sweeteners.

26. Factor 12—Consider the client’s willingness to compromise financial goals.
   a. Is it realistic to live on less? Can the client sustain it?
   b. *Planning Point:* Tell the client to live on the reduced retirement budget for 12 to 18 months prior to the actual retirement to see if it is workable.

27. Factor 13—Assess whether the client is and/or will be healthy enough to continue working. (Video: *What Factors Need to be Considered in Order to Choose the Optimal Retirement Age? (Part2)*: Tacchino, Sass)
   a. Health concerns forcing retirement are the greatest for those with lower levels of income.
b. Health limitations cause a risk of premature retirement. According to one study, 50 percent of the workforce retired earlier than planned and over one-half of those people said it was because of health problems or disability.

c. Virtually all studies show that poor health has a negative effect on the expected retirement age because it is hard for affected people to stay in the workforce.

d. According to researchers, about one-fourth of the population may find it hard to continue working past their mid-60s because of health limitations.

28. Factor 14—Assess whether the client will need to provide caregiving for a loved one.
   a. Nearly 20 percent of those who left the workforce early did so to care for a loved one.
   b. Planning Point: Planners should help clients prepare for “curve balls” that inhibit their plans for a chosen retirement age.
   c. Caregiving may require retirement so that the client can “be there” for a loved one. Caregiving, however, may also require extra work to pay for the care of a loved one.
   d. The Family and Medical Leave Act (FMLA) may entitle a client to take unpaid, job-protected, benefits-protected leave for up to 12 weeks in a 12-month period in order to care for their spouse, child, or parent with a serious health condition.

29. Factor 15—Assess whether the client’s fear of impending health problems will dictate an earlier retirement.
   a. Some clients will choose a retirement age based on their perception that they only have so many good years left and they want to enjoy some time with good health in retirement to fulfill lifelong goals.
   b. In addition to retiring earlier, the goal of retiring with good health has a secondary impact on the financial plan because it requires extra resources to maximize healthy leisure time.

30. Factor 16—Evaluate whether the client will need to raise grandchildren.
   a. Grandparenting is probably an underrecognized responsibility that may affect clients. Over 6 percent of children under the age of 18 are living in grandparent-headed households.
   b. Grandparenting may call for an earlier retirement age to provide care or a later retirement age to garner extra resources.

31. Factor 17—Assess the likelihood of your client’s job terminating suddenly and prematurely.
   a. Evaluate the industry and employer tendencies.
   b. Think of this risk as a risk that needs to be planned for.
   c. Planners should be aware that clients will change employers after age 50. It may be a “down-shifted” retirement. It needs to be planned for.
   d. Career planning and retirement planning are inseparable.

32. Factor 18—Assess job satisfaction and potential changes in job satisfaction to determine if constructive retirement or the “can’t take it anymore” syndrome will compel retirement.
   a. Clients can be constructively evicted from their jobs by an employer creating an intolerable situation.
b. Clients can also find themselves fed up with their work.

c. Research has shown that changes in the work environment (new bosses, new procedures) can drive people away from their job.

d. The positivity effect—as you get older, you have less patience for the negatives in life. There is a greater impulse to leave a bad situation.

33. Factor 19—Educate the client about the retirement decision.

a. Most clients view a retirement age as measured in their actual age.

b. Planning Point: Planners should educate clients to think about the retirement date as a ratio of work to retirement or longevity (not years from birth, but years to death).

c. Retirement at age 65 is an artifact and may mislead clients. If not 65, however, what should it be?

d. Changing the thinking from 65 to a longevity analysis or a ratio analysis can give the client a framework from which to make the decision that may make more economic sense.

34. Factor 20—Evaluate the client’s ability to adapt to retirement.

a. Planners, clients, and spouses need to evaluate what the “next phase” of life will look like.

b. It is hard to “unretire.” Clients must use imagination to set up a meaningful retirement period.

c. Too many retirees substitute work hours for hours with television.

d. Some clients will find another project on which to labor.

e. Clients need to “try out the leisure period.”

35. Factor 21—Assess the identity, fellowship, and status received from work.

a. Work is different today than in the past. People are more educated than in the past. Therefore, people get a greater identity and status from work.

b. Retirement may undermine a client’s essence and sense of self-worth.

c. Retirees need to replace the identity, fellowship, and status received from work with something else.

36. Factor 22—Identify your client’s willingness to work.

37. Factor 23—Identify your client’s desire for leisure.

a. The willingness to work and the desire for leisure must be balanced to decide on the optimal retirement age.

38. Factor 24—Balance work satisfaction and retirement satisfaction.

a. This balances the emotional component of leisure and work—what I feel.

39. Factor 25—Examine the desire for joint retirement.

a. Joint retirement (the husband and wife retire simultaneously) is highly desired by many couples.

b. Younger wives may actually keep men in the labor force longer.

c. Surveyed respondents often want to spend time with their spouses.
d. *Planning Point:* We are often not talking about the retirement of an individual; we are often talking about the retirement of a couple.

<table>
<thead>
<tr>
<th>Table 1: Checklist of Factors that the Client and Planner Must Assess</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Calculate available retirement income and assess adequacy</td>
</tr>
<tr>
<td>2 Consider life expectancy, expenditures, and risks</td>
</tr>
<tr>
<td>3 Perform analysis to model plan functionality</td>
</tr>
<tr>
<td>4 Evaluate the impact of client debt</td>
</tr>
<tr>
<td>5 Determine the availability of health insurance</td>
</tr>
<tr>
<td>6 Examine the impact of various Social Security claiming age options</td>
</tr>
<tr>
<td>7 Assess the type of retirement plan and the plan's features</td>
</tr>
<tr>
<td>8 Analyze the financial status of investments</td>
</tr>
<tr>
<td>9 Examine earnings prospects if the client remains employed</td>
</tr>
<tr>
<td>10 Appraise the availability of phased retirement</td>
</tr>
<tr>
<td>11 Factor in early retirement incentives</td>
</tr>
<tr>
<td>12 Consider the client's willingness to compromise financial goals</td>
</tr>
<tr>
<td>13 Assess whether the client is and/or will be healthy enough to continue working</td>
</tr>
<tr>
<td>14 Examine whether the client's situation will require caregiving for a loved one</td>
</tr>
<tr>
<td>15 Consider whether the client is concerned that perceived future health limitations will interfere with personal retirement goals</td>
</tr>
<tr>
<td>16 Evaluate whether the client will need to retire in order to raise grandchildren</td>
</tr>
<tr>
<td>17 Appraise the likelihood of your client's job terminating suddenly and prematurely</td>
</tr>
<tr>
<td>18 Assess job satisfaction and potential changes in job satisfaction</td>
</tr>
<tr>
<td>19 Understand and broaden your client's expectation of how to determine an appropriate retirement date</td>
</tr>
<tr>
<td>20 Evaluate the client's ability to adapt to retirement</td>
</tr>
<tr>
<td>21 Assess the identity, fellowship, and status the client receives from working</td>
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<td>22 Determine the client's willingness to work</td>
</tr>
<tr>
<td>23 Determine the client's desire for leisure</td>
</tr>
<tr>
<td>24 Weigh the balance between work satisfaction and retirement satisfaction</td>
</tr>
<tr>
<td>25 Examine the potential for joint retirement</td>
</tr>
</tbody>
</table>

**LO 9-1-2: Analyze the age at which clients are currently retiring**

1. A snapshot of the “age-65 cohort” courtesy of the MetLife Mature Market Institute study “Transitioning into Retirement” (April 2012)
   a. Current employment status
      (1) 45 percent are fully retired and not working
      (2) 14 percent are retired, but working part-time or seasonally
      (3) 24 percent are employed full-time. By way of reference, in 2009 the Bureau of Labor Statistics indicated a workforce participation rate of 17 percent for those 65 and older.
Sources of Retirement Income

(4) 4 percent are self-employed

(5) 37 percent of those who are working anticipate that they will retire within the coming year when they turn 66 and are eligible for full Social Security benefits.

(6) Key take-away: The majority of 65-year-olds are retired or planning to retire soon.

(7) Key take-away: Clients do not always define retirement as not working.

(8) Key take-away: Despite the conventional wisdom that baby boomers are ready to “work forever” and significantly expand their working career, many of the oldest boomers are well into the retirement phase.

b. Reasons for retiring

(1) 36 percent retired because they either reached retirement age or wanted to retire

(2) 18 percent retired for health reasons

(3) 14 percent retired because they needed to or because they were tired of working

(4) 6 percent retired because they were laid off and could not find work

(5) Key take-away: About 40 percent (18 percent due to health, 14 percent because they needed to retire, and 6 percent due to layoffs) retired based on circumstances beyond their control.

c. Reasons for retiring earlier or later than expected

(1) Of those 65-year-olds already retired, 51 percent report that they retired earlier than expected and 8 percent said that they retired later than planned.

(2) The major reasons for delaying retirement included the need for the salary for day-to-day expenses (27 percent) and the need to save more (11 percent).

(3) The major reasons for retiring earlier than expected were health reasons (37 percent) and fewer jobs or opportunities (16 percent)

(4) 13 percent who delayed retirement did so because they enjoyed working and/or wanted to stay active

(5) Key take-away: Almost 6 in 10 did not retire when they expected to retire.

(6) Key take-away: Of those who retired earlier than expected, 53 percent (37 percent due to health and 16 percent due to fewer jobs) retired because of circumstances beyond their control.

d. Key implications cited by the MetLife Mature Market Institute of the Transitioning into Retirement study:

(1) “The experiences of the [65-year-old] Boomers in this study reinforce that the unexpected—whether health, economic, or “other” in nature—can significantly affect the choices available and can affect staying on track for the optimal retirement choice.”

(2) “Fewer of them [the 65-year-old Boomers] have reached or are on track for reaching their retirement savings goals. Significantly more are slightly or significantly behind in this process, making continued work a necessity rather than a choice.”
   a. Employment status
      (1) 82 percent of retirees reported that they retired from their primary occupation before age 65
      (2) 38 percent of early retirees worked for pay in the past 12 months (23 percent of early retirees worked full-time!)
      (3) 15 percent reported that they retired at 65 or later
      (4) Key take-away: This study is consistent with the MetLife Mature Market Institute study and it is further evidence that the majority of 65-year-olds are retired, but clients do not always define retirement as not working.
   b. Reasons for retiring
      (1) 27 percent retired because of health problems and/or disability (slightly higher than the MetLife Mature Market Institute study)
      (2) The study pointed out that the likelihood of citing health or disability is inversely related to income: the lower the income, the more likely to cite health as an issue, and the higher the income, the less likely to cite health as an issue.
      (3) 9 percent retired because they lost their job and either could not find another or decided to not get another (slightly higher than the MetLife Survey)
      (4) Key take-away: The evidence, once again, points to the fact that a significant proportion of clients are thrust into retirement because of health and job related issues.
   c. Method of retiring
      (1) 75 percent reported that they stopped working all at once
      (2) 9 percent reported that they gradually reduced the number of hours they worked
      (3) 9 percent reported that they continue to work part-time
      (4) Key take-away: The majority of clients will retire “cold turkey” (75 percent). However, informal or formal phased retirement play a role about 20 percent of the time.
   d. Returning to paid employment
      (1) Among retirees who stopped work all at once, 34 percent eventually returned to paid employment.
      (2) The likelihood of returning to work increased with educational level and household income.
      (3) Key take-away: For the majority, retirement without paid employment is a permanent decision. For one-third of those who stopped working all at once, however, future employment income was part of their situation.
   e. Reasons for working in retirement
Reasons for Working in Retirement, Among Retirees Working for Pay in Retirement

Is this a major reason, a minor reason, or not a reason why you decided to work for pay in retirement?

<table>
<thead>
<tr>
<th>Reason</th>
<th>Major Reason</th>
<th>Minor Reason</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wanting to stay active and engaged</td>
<td>55%</td>
<td>23%</td>
<td>78%</td>
</tr>
<tr>
<td>Wanting additional income</td>
<td>51%</td>
<td>23%</td>
<td>74%</td>
</tr>
<tr>
<td>Wanting to preserve or build up savings and investments</td>
<td>31%</td>
<td>27%</td>
<td>59%</td>
</tr>
<tr>
<td>Keeping employee benefits, such as health insurance</td>
<td>24%</td>
<td>9%</td>
<td>33%</td>
</tr>
</tbody>
</table>

2011 (n=361)

(2) Key take-away: Planners should not discount work in retirement as an important goal for their clients.

(3) Key take-away: Between phased retirement (formal or informal) and work in retirement, planners must change the thought of retirement always being the cessation of work so they are better able to understand a portion of their clients.

3. A snapshot of retirement ages courtesy of the Boston College Center for Retirement Research (Video: What are the Trends Concerning the Selection of a Retirement Age? Tacchino, Sass)

a. An historical perspective of retirement age

(1) Retirement is a relatively recent innovation.

(2) Up until the 1880s, people worked as long as they could contribute. The retirement lasted only about 2 years and was marked by ill health.

(3) Changes occurred because:

(a) We got wealthier (incomes grew).

(b) We started working for an employer (we went from an agrarian society to an industrial society).

(c) Mandatory retirement started.

(d) Unions helped to expand retirement.

(e) Social Security helped to expand retirement.

(f) Employer pensions helped to expand retirement.
b. The downward trajectory of labor force participation has started to reverse since the mid-1980s. Reasons for the reversal included:
   (1) The shift from defined-benefit to defined-contribution plans
   (2) Social Security changes including the earnings test
   (3) Increased levels of education (people with more education work longer)
   (4) The decline of retiree health insurance
   (5) Improved health and longevity (healthier people work longer)

c. Average retirement age for men is 64 and for women is 62. The average age is the youngest age at which at least half of the people have left the workforce.
   (1) Averages include people who are disabled.
   (2) For people who are not disabled, the averages would be a little higher.

d. There is a large increase in labor force participation for people 65 to 69. This is typically among higher educated, higher income people.

e. Among men 65 and over, labor force participation rates hovered at about 15 percent from 1984–1999, and they are about 20 percent today.

**LO 9-1-3: Understand the perceptions of current workers about their potential retirement age**

1. What pre-retirees are thinking courtesy of the Society of Actuaries sponsored study “2011 Risks and Process of Retirement Survey”
   a. Applicability of retirement
      (1) 35 percent of pre-retirees state that retirement does not apply to their situation (in other words, they will not retire).
      (2) The propensity to say that retirement does not apply is inversely related to household income and investible assets. In other words, 54 percent of those with household income of less than $35,000 state that retirement does not apply to their situation compared with only 20 percent with assets of at least $100,000.
      (3) Key take-away: The expectation of a “non-retirement scenario” for low-income workers does not seem realistic given the physical demands of blue-collar labor and the higher replacement ratio provided by Social Security.

b. Expected retirement age
   (1) 55 percent report that they expect to retire at 65 or later
   (2) Those who expect to receive a defined-benefit plan are more likely to say that they will retire before age 60. This statistic is supported by the Towers Watson Retirement Attitudes Part 1: Confidence in Retirement Study (September 2010) which concluded that employees nearing retirement
Sources of Retirement Income

with defined-benefit plans have considerably more confidence in their resources than those with defined-contribution-only plans.

c. Timing of retirement

(1)

<table>
<thead>
<tr>
<th>Reason of Timing of Retirement, Among Pre-retirees Providing Age at Retirement</th>
<th>Pre-retirees (n=466)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Have enough money to stop working</td>
<td>24%</td>
</tr>
<tr>
<td>Start receiving pension/Social Security</td>
<td>20%</td>
</tr>
<tr>
<td>Meet age/years of service requirement</td>
<td>19%</td>
</tr>
<tr>
<td>Stop working completely</td>
<td>18%</td>
</tr>
<tr>
<td>Get tired of working/have had enough</td>
<td>9%</td>
</tr>
<tr>
<td>Switch to part-time/contract work</td>
<td>5%</td>
</tr>
<tr>
<td>Health problems/disabled</td>
<td>4%</td>
</tr>
</tbody>
</table>

(2) Key take-away: Pre-retirees listed financial triggers as their first 3 reasons to define retirement. This indicates that there is a willingness to assess financial adequacy before determining the retirement age decision.

d. Method of retirement

(1)

<table>
<thead>
<tr>
<th>Reasons for Working in Retirement, Among Retirees Working for Pay in Retirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is this a major reason, a minor reason, or not a reason why you decided to work for pay in retirement?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Reason for Working in Retirement</th>
<th>Major Reason</th>
<th>Minor Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wanting to stay active and engaged</td>
<td>55%</td>
<td>23%</td>
</tr>
<tr>
<td>Wanting additional income</td>
<td>51%</td>
<td>23%</td>
</tr>
<tr>
<td>Wanting to preserve or build up savings and investments</td>
<td>31%</td>
<td>27%</td>
</tr>
<tr>
<td>Keeping employee benefits, such as health insurance</td>
<td>24%</td>
<td>9%</td>
</tr>
</tbody>
</table>

(2) Key take-away: Pre-retirees seem willing to see work as part of retirement.

e. Reasons for work in retirement
(1) Reasons for Working in Retirement, Among Pre-retirees Expecting to Work for Pay in Retirement

<table>
<thead>
<tr>
<th>Reason</th>
<th>Major Reason</th>
<th>Minor Reason</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wanting to stay active and engaged</td>
<td>74%</td>
<td>16%</td>
<td>89%</td>
</tr>
<tr>
<td>Wanting additional income</td>
<td>51%</td>
<td>36%</td>
<td>87%</td>
</tr>
<tr>
<td>Wanting to preserve or build up savings and investments</td>
<td>48%</td>
<td>32%</td>
<td>80%</td>
</tr>
<tr>
<td>Keeping employee benefits, such as health insurance</td>
<td>44%</td>
<td>17%</td>
<td>61%</td>
</tr>
</tbody>
</table>

2011 (n=262)

(2) Key take-away: Whether or not it is plausible, almost 90 percent of pre-retirees expecting to work in retirement find work necessary to keep them active and engaged.

2. Key take-aways about choosing the retirement date from a variety of industry surveys
   a. A study from the Hartford Financial Services Group has found that many pre-retirees are still reeling from the recent economic turmoil and are pessimistic about their financial future, including when they will be able to retire.
   b. Many employees continue to doubt that their savings will carry them through a comfortable retirement. As a result, they are likely to delay retirement.1
   c. 56 percent of workers plan to work past 652
   d. 54 percent of workers plan to continue working after they retire.3 This statistic is supported by a T. Rowe Price IRA survey that found that almost three-quarters of investors age 21–50 recognize that they will continue to work either full-time or part-time during the traditional retirement years—most because they want to stay involved, some because it would be a financial necessity.
   e. Reasons for remaining in the workforce according to the MetLife Mature Market Institute include:
      (1) Having debt from educating children

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1 Towers Watson, Retirement Attitudes Part 1: Confidence in Retirement, September 2010
2 The 13th Annual Transamerica Retirement Survey
3 The 13th Annual Transamerica Retirement Survey
Sources of Retirement Income

(2) Having debt from borrowing against their homes

(3) Stretching income because of adult children living with them (this thinking is supported by an Ameriprise survey that found that 95 percent of boomers have provided some form of financial support for their adult children, including helping them pay college loans, allowing them to live at home rent-free, helping them to buy a car, helping pay for health insurance, etc.)

f. The Ameriprise survey also found that 22 percent of boomers help their parents by chipping in for groceries and 15 percent help with medical bills.

g. A Northwestern Mutual study (whose survey revealed that 65 percent of Americans aged 48–60 believe they will have to work beyond the age of 65) also shows increased longevity, falling housing prices, and diminished 401(k) accounts could be responsible for the perception of later retirement.

h. Planning Point: Industry studies reveal some important insights into retirement expectations in our current environment. There is a disconnect, however, between what retirees believe will happen to them and what is actually happening to them. Planners must be respectful of the client’s wishes, but also educate them about how realistic those wishes may be.

LO 9-1-4: Examine different ways to look at the optimal retirement age

1. Why define retirement age as years since birth? Why not use years until death (remaining life expectancy)? (Video: What are the Different Ways to View the Retirement Age? Tacchino, Sass)

2. Why not look at retirement age by using a work/retirement ratio?

3. A 65-year-old’s life expectancy was 12.81 years in 1950. It is over 16 years today, and it will be over 18 years in 2040.

4. A two-thirds work/retirement (40 years/20 years) ratio will create a burden on the employee to save enough for retirement. The 2 to 1 work/retirement ratio may not be feasible.

5. A three-quarters work/retirement (45 years/15 years) ratio will create a more manageable scenario. A 3 to 1 work to retirement ratio may be more feasible.
   a. A 70-year-old man in 2010 has a longer life expectancy than a 65-year-old man had in 1950.
   b. This justifies the 45-year work (not 40), and 15-year retirement (not 20) as being equivalent to retirement in prior generations.
   c. The 3 to 1 work/retirement ratio is not only consistent with retirement from a former era, it is more financially manageable than the 2 to 1 work/retirement ratio.

6. Clients should think and not just accept 65. Age 65 is obsolete thinking. Our improved longevity needs to be factored into the equation of when to retire.
   a. The decision about the work/leisure ratio is part financial.
   b. The decision about the work/leisure ratio is part psychological.
   c. The decision about the work/leisure ratio depends on the active (or disability-free) life expectancy.
7. People have a sense of their mortality. How they want to spend their disability-free years has to be a critical factor when choosing an optimal retirement age.

8. Planning Point: According to academic research, if Social Security got it right when it set full retirement age to 65 in 1940, then equivalent ages for today would be age 70 and for 2070 would be age 73!

SECTION 2: WHAT A RETIREMENT CONSULTANT NEEDS TO KNOW ABOUT THE CLIENT’S FINANCIAL PREPAREDNESS FOR RETIREMENT

LO 9-2-1: Identify the age at which the vast majority of households will be able to retire

1. Overview of the National Retirement Risk Index: How Much Longer Do We Need to Work? (Boston College Center for Retirement Research, June 2012) (Video: At What Age Will the Vast Majority of Households be Able to Retire? Tacchino, Sass)
   a. The National Retirement Risk Index measures the share of American households “at risk” of being unable to maintain their pre-retirement standard of living in retirement.
   b. Age of readiness—this is the age when the client is able to retire (stop working and maintain their pre-retirement standard of living). Using the NRRI, it is the age at which the household's projected replacement rate equals its target replacement rate.
   c. Working longer is the key to a secure retirement for most households. Working longer is feasible for most households, and it does not mean working forever.

2. Percentage of households ready for retirement by age
   a. Cumulative Percentage of Households Ready for Retirement Age
b. At 55, pre-retirement readiness is enhanced by defined-benefit plans.

c. At 62, only about 30 percent of households are prepared for retirement. Of those households that are ready at 62, 60 percent are covered by a defined-benefit plan.

d. At 66, about 55 percent of households are projected to be ready for retirement.

e. At 70, about 86 percent of households are prepared for retirement.

f. **Planning Point:** Many people will need to work longer than their parents, but they will still be able to enjoy a reasonable period of retirement.

g. The percentage of households ready by income at 62, 66, and 70

<table>
<thead>
<tr>
<th></th>
<th>Age 62</th>
<th>Age 66</th>
<th>Age 70</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low-income</td>
<td>20%</td>
<td>47%</td>
<td>82%</td>
</tr>
<tr>
<td>Middle-income</td>
<td>31%</td>
<td>55%</td>
<td>87%</td>
</tr>
<tr>
<td>High-income</td>
<td>38%</td>
<td>62%</td>
<td>88%</td>
</tr>
</tbody>
</table>

h. Lower-income households are more at risk than higher-income households. However, at age 70, the differences are much smaller.

3. Understand how working longer improves retirement readiness

a. The steep improvement in readiness from age 62 to age 70 reflects the importance of Social Security and the pattern of its benefit payments.
(1) Social Security increases about 8 percent per year from age 62 to age 70. In contrast, financial wealth (both inside and outside of defined-contribution plans) grows at 4.6 percent per year until retirement and then stays constant in real terms.

(2) By age 70, low-income households who derive the bulk of their retirement income from Social Security are nearly as prepared as high-income households (they went from 20 compared to 38 percent at 62 to 82 compared to 88 percent at 70).

b. In a defined-benefit plan, the monthly pension may be reduced because of the combination of a lower final average salary and insufficient years of service.

c. In a defined-contribution plan, the participant loses out on the final years of contributions—when his or her salary is normally at its highest—and loses some years of tax-deferred growth when withdrawals begin earlier than necessary.

d. The longer the retirement period, the higher the chance of portfolio failure. The shorter the retirement period, the lower the chance of portfolio failure.

(1) All things being equal, early retirement means more years in retirement and thus increases exposure to inflation.

4. Why are younger households less prepared for retirement?
   a. They are expected to live longer.
   b. Social Security replacement rates tend to be slightly lower (because of a higher full retirement age).
   c. Fewer younger households will be covered by a defined-benefit plan.

5. How much longer?
   a.
b. At 65, about 48 percent are ready to retire.
c. At 65, about 23 percent need to work an additional 1–3 years.
d. At 65, about 17 percent need to work an additional 4–6 years.
e. At 65, about 9 percent need to work an additional 7+ years.

6. What effect does working one or two more years have?
   a. It can be a giant step toward a secure retirement.
   b. Save more. Spend less. Work longer.
   c. Working longer provides greater resources.

7. The “how much, what is my number” issue.
   a. The Boston College research gives us a bird’s-eye view about how well prepared your clients are for retirement. Planners and clients, however, need to know about their particular situation. Are they financially prepared to retire? Do they have the financial resources necessary to leave their job?
   b. Although this topic was covered in HS 353, this is crucial information and a few more insights are necessary.
   c. Insight 1—Does the software the planner is using to calculate the client’s “number” factor in the client’s scheme for drawing down assets? In other words, the planner needs to integrate accumulation (how much to save to get adequate retirement resources) with decumulation (how to spend assets so the client’s required standard of living will be continued for the client’s lifetime). It would be a common mistake to separate these two issues and focus on just the accumulation goal. Planners must integrate the accumulation and decumulation processes in order to counsel clients about their retirement dates.
   d. Insight 2—Planners should model the client’s retirement budget using variable retirement dates. In other words, “this is how much you can spend per month if you retire this July”. However, “this is how much you can spend per month if you retire next July, or the July after that.” Showing the client the numbers will help to clarify their thinking about the retirement date.
   e. Insight 3—Planners should properly adjust the “number” to account for any paid work that the client is able to do in retirement. However, it might be prudent to be conservative when estimating how long the income from work in retirement will last. Better yet, the planner could look at this extra income as supplementing the client’s rainy day fund. In any case, coordination of work during retirement is crucial.

LO 9-2-2: Analyze the ability to work longer as a solution to a lack of retirement resources

1. Health is a significant issue in your client’s ability to work longer.
   a. The trend of health impeding work has improved from past years.
   b. The trend of health is concentrated more at the lower-income ranges. In other words, delayed retirement is not as likely for the blue-collar worker.
c. The disability-free life expectancy for higher income, higher educated people is better.

2. Whether a client is able to continue working will depend in part on their disability-free life expectancy (also called active life expectancy).
   a. Virtually all studies show that poor health has a negative effect on the likelihood of continuing to work and the expected retirement age.
   b. The National Health Interview Survey assessed who has “limitations of activities.” In 2000, 21.2 percent of the male population age 50–54 had limitations of activity. The number was 24.3 percent from 55–59, and 29.3 percent from 60–64.
   c. Between 1970 and 2000, while life expectancy at age 50 increased by 4.3 years (from 23.2 years to 27.5 years), disability-free life expectancy increased by only 2.7 years (from 15.2 years to 17.9 years).
   d. On average, American men can expect more disability-free years than they could in the 1960s when the average retirement age was 66.
   e. Averages may not matter in your client’s situation.
      (1) The relationship between education and mortality and health is very strong. The more education, the better the disability-free life expectancy.
         (a) Disability-free life expectancy is much better for college-educated clients (only 13.2 percent had limitations on activity), and worse for males with less than a high school education (up to 22.5 percent had limitations on activity).
         (b) With the exception of college-educated whites, disability-free life expectancy has remained virtually unchanged from 1970 to 2000.
      (2) The relationship between income and disability-free life expectancy is very strong (the higher the income, the longer the disability-free life expectancy).
      (3) Your client’s particular situation will almost definitely differ from the averages, but the averages should help to set a reasonable expectation of the unique disability-free life expectancy the client will have.
      (4) Research shows that disability-free life expectancy may not improve in the future.
      (5) Physical limitations should not inhibit the bulk of older Americans from working at least until their mid-60s. However, at least one-quarter of the population may find continued employment extremely difficult.
      (6) Men with lower skill levels and lower earnings have left employment at younger ages than their more highly skilled counterparts throughout the industrial era.
Sources of Retirement Income

LO 9-2-3: Understanding the transition into retirement: 15 tasks the client must complete

1. Well-established research indicates that there are 15 developmental tasks that need to be completed by clients while still in their working career in order to transition into retirement.4

2. The completion of these tasks does not suggest that a person should retire (see 25 factors discussed earlier). However, the client who fails to complete the tasks will put a successful transition into retirement at risk.

3. Tasks related to work:
   a. Task 1—The client must decide whether to fully retire or to work part-time in retirement.
   b. Task 2—The client must decide which of their skills could be easily transferred to a new part-time job.
   c. Task 3—The client needs to look into alternate or part-time work opportunities for themselves in retirement.
   d. Task 4—The client needs to formulate ideas about how much he or she would like to work in retirement.
   e. Task 5—The client should explore what employment possibilities are available if he or she wants to keep working full- or part-time in retirement.

4. Tasks related to leisure and activity:
   a. Task 6—The client should determine the proper balance between work and leisure time.
   b. Task 7—The client needs to identify personal goals in retirement.

5. Tasks related to relationships:
   a. Task 8—The client needs to consider the importance of coworkers when making the decision to retire.
   b. Task 9—The client needs to consider how the various aspects of retirement might positively or negatively affect the relationship he or she has with family and friends.

6. Tasks associated with income and benefits:
   a. Task 10—The client needs to assess whether full-time retirement is financially feasible.
   b. Task 11—The client needs to evaluate how changes in the economy will affect his or her pension, investments, and retirement benefits.
   c. Task 12—The client needs to determine the steps that are necessary to receive benefits.

7. Tasks associated with planning:
   a. Task 13—The client needs to determine the factors that are critical to maintaining a personally satisfying retirement.
   b. Task 14—The client needs to develop an alternative plan that could get him or her through a considerable and unexpected setback in their retirement.

c. Task 15—The client needs to evaluate whether his or her retirement plans meet the demands of personal, social, and financial changes.

SECTION 3: WHAT A RETIREMENT CONSULTANT NEEDS TO KNOW ABOUT PHASED RETIREMENT

LO 9-3-1: Understand the basics of phased retirement

1. Phased retirement
   a. There is no legal or industry standard definition of phased retirement.
   b. Phased retirement can be thought of as a broad range of employment arrangements that allows a retiree to continue working at a reduced workload while he or she gradually shifts from full-time work to full-time retirement.
   c. A large majority of baby boomers intend to continue working after they reach retirement age and a majority of those individuals want to work part-time in a different field from their previous careers.\(^5\) This most likely means that phased retirement will grow in the future. In fact, while only 21 percent of surveyed companies believe that phased retirement is critical to their company’s HR strategy today, over 60 percent believe it will be critical in 5 years.\(^6\)
   d. Phased retirement can be with jobs that require the same work, jobs that require different work, or jobs that require skills similar to the full-time job.
   e. Of the retirees working in retirement, one study found that 31 percent were working for the same employer as before retirement, 40 percent worked for a different company, and 27 percent became self-employed.\(^7\)
   f. Of the retirees working in retirement, 45 percent were doing the same type of work they did prior to retirement, 26 percent were doing different work but using the same skills they had before retirement, and 33 percent were doing work that was entirely different than before retirement.\(^8\)
   g. One paradox of phased retirement is that those employees that management most wants to retain are more likely to find it hard to limit themselves to part-time work.\(^9\)
   h. People who choose phased retirement are better educated, more likely to have a positive view of work (for example, they believe that work is by itself important apart from a means of acquiring money), have

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8 Id, at 41.
greater household wealth and income, and are often in white-collar positions. In other words, they are the same type of people who are more likely to seek the aid of a financial planner.\textsuperscript{10} 

**LO 9-3-2: Identify the types of phased retirement**

1. Phased retirement can be any of the following:
   a. **Formal phased retirement**
      (1) Formal workplace policies that allow an employee to continue working with their current employer at a reduced schedule. At the same time, the employee may or may not be receiving retirement benefits. If they exist, formal phased retirement policies often are contained in the personnel policies of the employer. They tend to be most commonly available with large employers.\textsuperscript{11} Sponsors of formal phased retirement programs have noted that they do not expect retirees to stay active for very long. One manager said, “although there are some exceptions, most people work about three years in our program.”\textsuperscript{12}
   b. **Informal phased retirement**
      (1) Informal workplace arrangements and practices that allow an employee to continue working with their current employer at a reduced schedule. At the same time, the employee may or may not be receiving retirement benefits. Informal phased retirement is more common than formal phased retirement. It is often done on a case-by-case basis. Traditionally, employers have been more inclined to accommodate wishes for informal phased retirement from high-performing workers who require little supervision.\textsuperscript{13}
   c. **Bridge jobs**
      (1) Bridge jobs are selected by the client without the support of a formal employer program. These jobs occur immediately or shortly after the employee has left his or her long-time employer and the employee may or may not yet have started receiving retirement benefits from the prior employer. Bridge jobs spanning a period from work with a full-time employer to full-time retirement out of the labor force are becoming more common.\textsuperscript{14}
   d. **Retirement and rehire**
      (1) Once an employee has retired, the former employer may rehire him or her. In order for the employer’s retirement system to be unaffected, there must be a bona fide termination of employment. However, there is no specific legal definition of bona fide termination of employment.\textsuperscript{15}

\textsuperscript{12} See DeLong, above.
\textsuperscript{13} Hutchens, at 9.
\textsuperscript{14} Chen, at 5.
\textsuperscript{15} Rappaport, at 39.
e. Part-time work with a different employer
   (1) Moving to part-time work with a different employer is at least as common as phased retirement. This type of retirement is typically a white-collar phenomenon as evidenced by better education and greater household wealth.

f. Phasing a little
   (1) Working close to a full-time schedule by only making a modest change in work schedule and conditions. When phasing a little, clients typically keep their benefits, but they are unlikely to be drawing retirement benefits from the employer. Clients who are phasing a little are often thought of as phasing pre-retirement.\(^\text{16}\)

g. Phasing a lot
   (1) Work that is dramatically different from a full-time schedule. When phasing a lot, clients will probably lose their employer-provided benefit eligibility. Clients who are phasing a lot are often thought of as phasing post-retirement.\(^\text{17}\)

h. Encore careers
   (1) A client may retire and start a new career in a different company. Occasionally, clients may retire at an early age to “double dip” and get a second pension. They may also retire to start an entrepreneurial venture. No matter what the case, an encore career is an important form of phased retirement to consider.

i. Downshifting
   (1) A client may seek an encore career that has lower pay and fewer responsibilities than the long-time career employment. It is possible for this client to supplement the lower pay with benefits from the prior job.

**LO 9-3-3: Identify the possible characteristics that may be in a phased retirement program**

1. Phased retirement may have one or more of the following characteristics:
   a. The employee or former employee reduces the hours he or she works. For example, the phased retiree cuts back from 8 hours per day to 4 to 6 hours per day.
   b. The employee or former employee reduces the amount of days per week that he or she works. For example, the phased retiree cuts back from 5 days per week to 3 days per week.
   c. The employee or former employee reduces the amount of weeks worked. This could be done through a variety of methods. For example, the phased retiree could take extended vacation time or could limit the work period to seasonal work.

\(^\text{16}\) Id, 40-42.
\(^\text{17}\) Id.
Sources of Retirement Income

d. The employee or former employee could engage in a job sharing program. For example, two or more employees could split time to do one job.

e. The employee or former employee could engage in a contract that gives her flexibility in setting hours.

f. The employee or former employee could negotiate reduced job duties.

g. The former employee could engage in a consulting relationship with his or her ex-employer, another employer, or multiple employers as an independent contractor. For example, a phased retiree who was formerly a tax accountant could work part-time during tax season.

h. The employee or former employee could limit his work to projects that he engages in on a full-time basis for a limited amount of time.

i. The employee or former employee could engage in telecommuting.

j. The employee could structure a sabbatical.

LO 9-3-4: Assess the reasons a client may opt for phased retirement

1. Clients may opt for phased retirement for a variety of reasons.

   a. It increases retirement income.
      (1) When the client is not satisfied that he can avoid running out of money or lowering his desired standard of living in retirement, he may opt for part-time work to correct the situation.

   b. Continued work is more feasible.
      (1) Some of today’s physically easier, technology-aided jobs make phased retirement more likely.

   c. The cohort effect
      (1) Today’s retirees have greater longevity, higher levels of education, and a greater occupational profile, all of which combined provides a basis for staying employed longer.\textsuperscript{18}

   d. It allows them to “try out” leisure activities that could eventually be part of full-time retirement.
      (1) It allows them to phase into an unfamiliar retirement one small step at a time. The ability to negotiate the transition a step at a time allows for better emotional preparation.\textsuperscript{19}

   e. Part-time work allows them to adjust for age-related changes in stamina or ability.
      (1) A desire to continue working may not equate to a wish to work full-time.\textsuperscript{20} It allows them to continue active involvement in the workforce at a pace with which they can be more comfortable.\textsuperscript{21}

   f. They have more to give.

\textsuperscript{19} Hutchens, at 7.
\textsuperscript{20} Chen, at 5.
\textsuperscript{21} Hutchens, at 7.
(1) When traditional retirement age arrives, some clients still have plenty of energy and a desire to contribute.\textsuperscript{22}

g. They want to try new work activities.
   (1) Semi-retirement may be a good opportunity to double back and travel down the road not taken. It may allow the client to follow her heart and not her wallet. It may tap into the client’s entrepreneurial spirit.\textsuperscript{23}

h. They want to cherry pick projects.
   (1) Semi-retirement may be an opportunity to jettison the boring and burdensome projects at work and to choose only those projects that stimulate the client.

i. They want a better life balance.
   (1) Many professions and white-collar jobs have become demanding and often require 50- and 60-hour work weeks. Phased retirement may allow for the intervention of sanity in the client’s world by enabling her to have some flexibility with her time.\textsuperscript{24}

j. They want to spend some more time with their spouse.
   (1) Phased retirement may be a great option for a client who wants to continue working, but spend more time with his or her spouse.\textsuperscript{25}

k. They want to continue health insurance.
   (1) Under the right set of circumstances, phased retirement may allow the client to continue to have employer-sponsored health care (however, this is not always the case).

\textbf{LO 9-3-5: Understand how you may convince an employer to offer your client phased retirement}

1. Employers may encourage phased retirement for a variety of reasons.
   a. It enables them to retain and recruit older workers who have unique skills and talents.\textsuperscript{26} In the survey, 72 percent of surveyed companies said that phased retirement is important for retaining the experience, knowledge, and skills of older workers.\textsuperscript{27}

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{22} Walter Edelstein. “Choosing a second career over traditional retirement.” AARP, Inside E Street (Feb. 13, 2012). http://retirementadvice.com/choosing-a-second-career-over-traditional-retirement/
\item\textsuperscript{23} Id.
\item\textsuperscript{24} Rappaport, at 44.
\item\textsuperscript{25} Id.
\item\textsuperscript{26} See DeLong, above.
\item\textsuperscript{27} Miller, at 32.
\end{enumerate}
\end{footnotesize}
b. It can create effective knowledge sharing relationships between older mentors and protégés. Whenever possible, management should make sure that returning retirees know that an important part of their role is to transfer their critical knowledge to the next generation of employees.28

c. It accommodates special projects or time-crunched scenarios because retirees make a good resource for these contingencies.

d. It responds to the potential labor force effects of an aging baby boom population (the potential labor shortage when boomers retire).29

e. It preserves human capital and lowers training costs.30

LO 9-3-6: Impediments to phased retirement

1. There may be impediments to phased retirement:

a. Loss of health insurance

   (1) Reduced hours could lead to lost health care benefits. For companies that do not offer health insurance to part-time workers, phased retirement may be difficult to implement.

b. Inflexibility

   (1) Some jobs cannot be easily restructured into flexible or part-time work. In order to allow for phased retirement, the employer must account for redefining job duties, pay structures, benefit options, schedules, support, training, performance evaluations, and other processes. However, if the client works in an establishment that contained part-time workers and permitted job-sharing, then the client is much more likely to have opportunities for phased retirement. In other words, a business process comparable with flexible hours appears to be especially important.

c. The Social Security earnings test

   (1) Clients who started Social Security will lose part or all of these benefits if they earn over specified thresholds (covered in the prior competency).

d. Loss of employer-provided life insurance

   (1) Life insurance may be contingent on the hours an employee works.

e. There may be time limits on continued employment.

   (1) Clients may be seeking an open-ended part-time employment situation. However, employers may not be willing to accommodate any long-term relationship.

f. The client may not meet the employer or former employer’s eligibility requirements for formal or informal phased retirement.

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28 See DeLong, above.
(1) It will “take two to tango.” Just because your client wants to continue working in a phased capacity does not mean that the employer will want to retain him or her. More often than not it is the highly desired and skilled employee that gets to write their own ticket, and only a small percentage of employees fall into this category.

g. The client may lack the skills or training to be hired by another firm.

(1) Clients who are thinking about part-time work with another employer, encore careers, or downshifting should make sure they have the skills, training, and opportunity to find employment after retirement.

h. The pension systems may get in the way.

(1) The evolution of U.S. pensions from defined-benefit plans to defined-contribution plans has made it easier to enter into phased retirement. However, in a defined-benefit plan the benefit is often based on the final average earnings. Part-time work at the end of a career could therefore end up in severely reduced benefits. In addition, there are restrictions on in-service withdrawals in a defined-benefit plan until age 62, so phased retirement and benefit withdrawal cannot occur simultaneously until that age (unless the plan’s normal retirement age is younger than 62).

i. The age discrimination rules may become an impediment.

(1) Phased retirement may be viewed as a way to push older workers out. In addition, it is unclear whether age discrimination will occur by allowing someone to receive an early retirement subsidy and continue working. Also, because there is no IRS guidance provided on administering in-service distributions from defined-benefit plans, employers may be put at risk for a potential nondiscrimination claim.

j. The presence of retiree health coverage may eliminate the incentive for phased retirement.

(1) Employees may see retiree health insurance coverage as a disincentive to engaging in phased retirement.

k. The ERISA nondiscrimination rules may get in the way.

(1) Phased retirement arrangements that discriminate in favor of highly compensated employees will create a problem under a federal law known as ERISA.

l. The ERISA anti-cutback rules may get in the way.

(1) If a phased retirement option is offered, it may restrict an employer’s flexibility to change the program to attain desired results or to eliminate the program when the economic conditions are not right for it.

**LO 9-3-7: Examine examples of phased retirement**

1. Examples of phased retirement programs

   a. Some companies use a retiree pool from which to hire when there is extra or peak demand for work.
b. Some third-party organizations form a pool of retirees and market their services to targeted industries. For example, a retired engineers pool may be offered to engineering firms.

c. Some companies offer “snowbird” programs allowing employees to work at different locations during the year.

d. Some companies have policies for retirement, collecting benefits, and continued part-time work.

e. The most common form of phased retirement is the hiring or rehiring of retirees, either by their prior employer or by a new employer. Rehire by a former employer requires a “bona fide termination of employment.”

f. Some companies provide flexibility for phased retirement by allowing for part-time schedules. For example, in one program employees are allowed to work 20–32 hours per week, receive prorated pay, and retain full benefits including health insurance. In another program the employer provided compressed work weeks.

**LO 9-3-8: Identify some design elements of a phased retirement system**

1. Design of a phased retirement program may include:
   a. A formal or informal phased retirement plan could allow employees to draw full or partial retirement benefits or to delay commencement of benefits while working reduced hours. If the plan has a lump sum option, the phased worker could take a lump sum, roll it into an IRA, and draw from it as needed.
   b. A formal or informal phased retirement plan could redesign the defined-benefit formula to annualize pay (give the participant the full-time equivalent compensation) in order to determine the pension from the plan (thus eliminating a lower pension when the definition of final average compensation would otherwise be affected by phased retirement).
   c. Cover part-time employees in the medical plan
   d. A retention bonus could be paid under the nonqualified plan “top hat” rules.

**RESOURCES FOR COMPETENCY 9: CHOOSING THE OPTIMAL RETIREMENT AGE**

- [Ballpark estimate](#)
- [Center for Retirement Research at Boston College](#)
- [MetLife Mature Market Institute](#)
- [New York Life Center for Retirement Income](#)
Competency 10

Choosing Appropriate Annuities for the Retirement Income Plan
SECTION 1: REGULATION

LO 10-1-1: Understanding and applying annuity suitability standards

1. What are the requirements of the annuity suitability regulations under NAIC and FINRA? (Video: What are the Requirements of the Annuity Suitability Regulations Under NAIC and FINRA? Littell, Graves)
   a. Where do advisors need to have an insurance license?
      (1) Where they have their office
      (2) Nonresident license in states where clients reside
   b. What are the state’s primary regulatory concerns with regard to annuity sales?
      (1) Is the product appropriate for the client?
      (2) Is the agent properly trained to sell annuities?
   c. What is the role of the National Association of Insurance Commissioners (NAIC)?
      (1) An organization made up of state insurance commissioners that has no direct regulatory authority
      (2) NAIC is an advisory board that issues model law and regulations that states can choose to adopt in total or in part.
   d. Has the NAIC issued model regulations concerning annuity suitability?
      (1) First issued model regulations aimed specifically at suitability for seniors in 2003
      (2) Modified those regulations, making them applicable to annuity sales to clients of all ages in 2010
      (3) 19 states have adopted the 2010 model regulations and 29 states have adopted a modified version of the model regulations (48 out of 50 states)
   e. Does the SEC have regulations for variable annuities?
      (1) The SEC delegates authority to FINRA, which has issued an annuity suitability standard for variable annuities which is quite similar to the NAIC model regulations.
   f. What are the primary requirements of the NAIC model regulations on annuity suitability?
      (1) Structure for determining suitability—separate individual reviews the application to determine
      (2) Education requirement for advisors—advisors must take a four-hour annuity course and get training on specific company products
      (3) Coordination with FINRA requirements—deemed to satisfy rules if FINRA requirements have been satisfied
   g. What are the specific requirements of the regulations?
      (1) Gather information about all of the following:
         (a) Client’s age
         (b) Annual income
Sources of Retirement Income

(c) Financial situation
(d) Financial experience
(e) Financial objectives
(f) Intended uses
(g) Financial horizon
(h) Existing assets
(i) Liquidity needs
(j) Current liquid net worth
(k) Risk tolerance
(l) Tax status

(2) No hard and fast dollar limits or ratios

(a) The advantage of a facts-and-circumstances standard is that it is flexible and can be applied to the specific individual facts.

(b) The disadvantage is that different reviewers will analyze the situation differently and it is easier to have a different opinion when the evaluation is reviewed later after circumstances have changed.

(3) The information that must be gathered is sensitive and there is an exemption from the suitability requirements if the client refuses to provide the information.

(4) Structure for determining suitability

(a) Must have someone in addition to the agent evaluate whether the suitability requirements have been satisfied (similar requirement for broker-dealers under the FINRA requirements)

(b) A third party review does help ensure that information has been documented.

(c) It is always the responsibility of the insurance company (even with variable annuities) to meet the suitability standards.

h. What are the producer training requirements under the model regulations?

(1) Must take a four-hour annuity training course that has been approved by the state regulator

(a) Covers annuities in general—types and their uses

(b) Suitability

(c) Not marketing or sales focused

i. How are state regulations different than the model regulations?

(1) 19 states have adopted the entire model regulations

(2) 29 states have modified rules—generally modifications impose more rigid suitability standards

(3) 2 states have no suitability regulations
j. FINRA requirements are quite similar and include a supervisory system, an evaluation of the same 12 categories of information, and an education requirement.

2. Summary of NAIC model regulations for determining suitability
   a. Overview
      (1) Require gathering of suitability information
      (2) Disclosure of information about the product
      (3) Reasonable determination of suitability
   b. Reasonable grounds for determining suitability
      (1) More specifically, the model regulations require that when recommending to a consumer the purchase or exchange of an annuity, the insurance producer must have reasonable grounds for believing that the recommendation is suitable on the basis of the facts disclosed by the consumer about his or her financial situation and needs and the other suitability information provided. In addition, there must be a reasonable basis to believe that:
         (a) The consumer has been reasonably informed of various features of the annuity, such as the potential surrender period and surrender charge, potential tax penalty if the consumer sells, exchanges, surrenders or annuitizes the annuity, mortality and expense fees, investment advisory fees, potential charges for and features of riders, limitations on interest returns, insurance and investment components, and market risk
         (b) The consumer must benefit from certain features of the annuity, such as tax-deferred growth or annuitization
         (c) The particular annuity as a whole must be suitable—this includes the underlying subaccounts to which funds are allocated at the time of purchase, as well as any riders and similar product enhancements
      (2) When determining whether an exchange or replacement of an annuity is suitable, it is required to consider whether:
         (a) The consumer will incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living, or other contractual benefits), or be subject to increased advisory fees or fees or charges for riders
         (b) The consumer would benefit from product enhancements and improvements
         (c) The consumer has had another annuity exchange or replacement within the preceding 36 months
   3. Why is suitability such a big concern for an older client purchasing a deferred annuity? (Video: Why is Suitability Such a Concern for an Older Client Purchasing a Deferred Annuity? Littell, Baldwin)
      a. Why does it become more difficult to demonstrate suitability for a deferred annuity as a client ages?
         (1) The number one concern of regulators is that older clients may have diminished capacity to make financial decisions.
(2) *Planning Point:* In practice, when diminished capacity is identified, be sure to involve family members and advisors in the decision-making process and make sure that everyone understands the issues involved.

(3) The second issue is that older clients may be more likely to need to take withdrawals from deferred annuities soon after purchase which can trigger surrender charges.

(a) *Planning Point:* A regulator flag is a deferred annuity that has a surrender charge period that exceeds an older client’s life expectancy.

(b) *Example:* News story of an elderly couple purchasing an annuity at an advanced age when they are already in an assisted living facility

b. When you are doing expert witness work, what kind of questions do attorneys ask about suitability?

(1) What was the consumer’s experience with financial matters?

(2) What other investments do they have?

(3) Did the advisor talk about the purpose of those other investments?

(4) What other choices or options were offered to the consumer?

c. **Suitability factors**

(1) *Are the facts, including the client’s age, health, goals, and other pertinent data consistent with the decision that was made?*

(2) Did the client get enough information about the product and could he or she process that information to make a reasonable decision to purchase the product?

(3) *Planning Point:* Documentation is critical—remember the saying, “If you didn’t document it, you didn’t say it.”

(4) The underlying question with a variable annuity is often, “Was the registered representative taking advantage of these people (turning client assets into commission dollars) or doing what was right for the client?”

(5) *Planning Point:* For those with somewhat diminished capacity, it is best to have the client’s family or advisors agree that the purchase is the best course of action for the client.

d. What factors are important in determining suitability?

(1) Generally, regulators are trying to establish more objective “bright line” rules. However, suitability decisions must be based on all of the facts and circumstances of the case.

(2) One clear “red flag” that regulators will look for is whether the client’s remaining life expectancy equals or exceeds the period in which surrender charges are applicable.

(3) Regulators will want to see that there are other assets available to meet the client’s liquidity needs so that the client is not likely to have to withdraw funds that could trigger surrender charges or result in the client losing benefits of the contract such as bonus payments.
(4) Regulators are always looking for confirmation that the client has purchased an annuity as a long-term investment.

(5) **Planning Point:** Be careful when determining suitability for products that have limitations on guarantees.

   (a) **Example:** Bonus payments that are defaulted if withdrawals are taken or the product is not annuitized. It is imperative that clients fully understand the terms of the annuity.

**e. How do we ensure that clients understand the annuity product that is selected?**

(1) Consider walking the client through the state’s annuity booklet and have them note surrender charges for the particular annuity, fees involved, and other key features of the annuity.

(2) Consider having them sign or initial key points.

(3) Photocopy the client’s annotated booklet for the advisor’s file.

**4. What factors are critical to consider when exchanging one annuity for another?** (Video: **What Factors are Critical to Consider When Exchanging One Annuity for Another?** Littell, Baldwin)

   a. **What are the regulatory concerns about Sec. 1035 exchanges of annuities?**

      (1) The primary concern is that a second commission will be paid based on the same dollars of premium.

      (2) A second concern is that a 1035 exchange could result in surrender charges.

   b. **What are appropriate circumstances for making a 1035 exchange?**

      (1) For many years, newer annuities offered both better benefits and more attractive guarantees than older products.

      (2) In that environment, an exchange for a newer product provided clear value to the client—in fact, you were serving the client’s best interest by making an exchange under those circumstances.

   c. **What has changed in today’s environment that can impact the decision to exchange one annuity for another?**

      (1) The downturn in the market beginning in 2008 has resulted in insurance companies pulling back on guarantees.

      (2) Today, newer annuity products may not be better than the older ones.

         (a) Guaranteed minimum interest rates have been reduced. For example, an older contract may have guaranteed rates as high as 4.5 percent and the contract may allow additional contributions to earn that rate, while a newer contract may have a minimum rate as low as one percent.

         (b) Since 2009, there has been a general reversal in the trends of products.

         • Newer products have cut back on guarantees.

         • Guaranteed living benefit riders generally have lower guarantees today.

         • Expense ratios may have increased.
Planning Point: With lower guarantees and higher expense ratios in today's products compared to the recent past, it may be much more difficult today to demonstrate that an annuity exchange is suitable for the client.

d. When considering an exchange, it is imperative to consider the following factors:
   
   (1) Will the transaction result in any surrender charges?
   (2) Will the contract holder be giving up a higher guaranteed interest rate?
   (3) Will the contract holder be giving up other valuable contract provisions?
   (4) Is the new product better than the old one?

SECTION 2: ANNUITY TAXATION

LO 10-2-1: Identify important considerations in the tax treatment of nonqualified annuities

1. What is the "non-natural person" rule for annuity contracts and how is it applied? (Video: What is the “Non-Natural Person” Rule for Annuity Contracts and How is it Applied? Littell, Tacchino, Ivers)
   
   a. In order for an annuity to obtain the basic tax attributes of a nonqualified annuity (including the deferral of tax on earnings), the general rule is that it must be owned by a natural person as opposed to an entity such as a corporation or trust.
   
   b. Certain types of trusts and other entities may be permitted to own annuities and not violate the non-natural person rule.
   
   c. Example: A corporation purchasing a nonqualified annuity will not be eligible for annuity tax treatment unless the corporation meets one of the exceptions to the general rule such as the corporation is holding the contract as an agent for a natural person.
   
   d. The non-natural person rule does not apply under the following circumstances:
      
      (1) The estate of the deceased contract owner becomes the beneficiary of the contract
      (2) The annuity is held within a qualified plan
      (3) Immediate annuities are not subject to the requirement
   
   e. Another exception states: “The annuity will be treated as being held by a natural person if an entity holds it as an agent for a natural person.”
   
   f. What are some of the reasons annuities are held by entities and not directly by a natural person?
      
      (1) Might be using a grantor trust so the income from the trust is taxable to the grantor, but for estate planning purposes you are trying to use an annuity as a funding asset for a transfer.
(2) A trust or corporation may hold a group annuity certificate as a mechanism to manage the annuity, and the participants in the annuity plan each receive certificates for their portion of the interest in the annuity.

g. What are some of the issues that have been addressed in IRS Private Letter Rulings about the agent exception?

(1) Can a partnership be permitted to hold a deferred annuity without violating the non-natural person rule?
   (a) Theory being that a partnership for some purposes is not a separate entity
   (b) Rulings generally have not allowed a partnership to hold an annuity.

(2) Can an annuity held in trust be eligible for the agent exception?
   (a) Funeral trust was approved when it was a grantor trust and the grantor had control over distributions
   (b) The question is whether the trustee has more than nominal powers over the disposition of trust assets. If the trust is a grantor trust in which the grantor has control, or the trust has clear provisions with regard to the disposition to beneficiaries (leaving little control to the trustee), then an exception is generally granted.

h. Planning Point: The IRS letter rulings have not been entirely consistent and tax payers cannot rely on private letter rulings. This means it is prudent to obtain legal advice when considering using a trust or corporation to hold an annuity contract as an agent.


a. Tax consequences

(1) Assuming that the contract was issued after April 22, 1987, the gifting of the contract generally results in an income taxable event.

(2) The transaction is treated as if the contract is surrendered and then the cash is gifted to the donee.
   (a) Example: An annuity contract has a $20,000 cash surrender value and a $15,000 basis in the hands of the contract owner, and the contract was gifted. There would be a $5,000 taxable income event to the donor.
   (b) Correspondingly, if there was a taxable portion to the donor at the time of the gift, generally the donee gets—for income tax purposes—the donor's basis in a gifted asset.
   (c) The donee's basis is increased by $5,000 because of the taxable event (donee has a $20,000 cost basis).
   (d) The situation is more complicated if the value at time of transfer is less than the cost basis. There is no taxable event at the time of the transfer. The subsequent cost basis when the donee surrenders the contract later depends on whether or not the donee is trying to claim a loss.

b. Gift tax consequences
Sources of Retirement Income

(1) Once you have the income tax event, the gift tax value is the cash surrender value of the contract.

c. Rules for contracts purchased on or before April 22, 1987

(1) There is no income taxable event at the time of the gift. But later on, if the donee surrenders the contract, then the donor will have an income taxable event when the donee surrenders the contract.

(2) The donor is taxed at that time based on the value of the contract at the time of the gift, not at the time of the surrender.

d. Gifting to a charitable organization

(1) Income tax rule applies even with a gift to a charitable organization

(2) The donor will have an income taxable event when the deferred annuity is gifted to a charity.

(a) If there is taxable gain in the contract, then that gain would be taxed at the time that the gift to the charity was made.

(b) The donor would receive a full fair market value deduction for the cash surrender value of the contract.

e. Exception to the rules for taxation of the gain when an annuity contract is gifted

(1) The rules do not apply to a transfer between spouses or former spouses.

3. Tax treatment pre- and post-annuitization

a. For annuities purchased after August 13, 1982, any distributions in the pre-annuitization phase are taxable earnings until all earnings have been distributed. Only after all earnings are withdrawn are distributions considered a return of principal (premium).

b. In contrast, when a contract has been annuitized, the tax treatment is quite different. Now a portion of each payment (based on the exclusion ratio) is treated as a return of principal and the remaining distribution is treated as taxable income.

c. Planning Point: This difference becomes a critical tax planning consideration when comparing income annuities and deferred annuities with guaranteed withdrawal benefit riders. Distributions made under the terms of the withdrawal benefit riders are considered in the deferral phase of the contract—subject to the less favorable tax treatment.

4. Early withdrawal penalty tax

a. The 10 percent early withdrawal penalty applies to the “taxable portion” of any distribution from a non-qualified annuity made prior to attainment of age 59½.

b. One broad exception to this rule is that the penalty does not apply to immediate annuity contracts.

c. Example: An immediate 5-year term certain annuity purchased for a 50-year-old is not subject to the penalty. In contrast, a deferred 5-year term income annuity purchased at age 50 to make payments from 54 to 59 would be subject to the penalty unless one of the other exceptions to the penalty tax apply.
d. **Planning Point:** This becomes an important consideration when comparing single premium immediate annuities (SPIAs) and deferred income annuities (DIAs).

**LO 10-2-2: Determine the tax implications of distributions to beneficiaries from nonqualified annuities**

1. Income tax treatment (Video: *How do the Required Minimum Distribution Rules Apply to a Nonqualified Annuity?* Littell, Kitces)
   a. When the annuity contract owner dies, a death beneficiary will still be responsible to pay income taxes on any gain in the contract. In other words, annuity beneficiaries are not eligible for the step up in basis rules that generally apply to capital appreciation.
   b. The tax rules are essentially the same as during lifetime. If the beneficiary elects a lump sum settlement option, taxes are paid to the extent that the account exceeds the remaining principal.
   c. If the annuity remains in deferred status with the beneficiary electing periodic withdrawals, the account continues to be taxed using the method that withdrawals are considered taxable earnings until all earnings have been with withdrawn.
   d. If the contract had been annuitized prior to the owner’s death, payments will continue under the terms of the contract and the exclusion ratio will continue to apply until all investment in the contract has been recovered.
   e. If the policy was in deferred status at the owner’s death and the beneficiary chooses to annuitize, an exclusion ratio will be calculated and will apply to determining the tax treatment of subsequent distributions.

2. How do the required minimum distribution (RMD) rules apply to a nonqualified annuity?
   a. What happens if the contract had been annuitized prior to the contract holder’s death?
      (1) Payments continue under the terms of the contract—and taxed using the exclusion ratio until all investment in the contract has been recovered.
      (2) Satisfying the RMD requirements
   b. What happens if the contract has not been annuitized?
      (1) Rules are quite similar to the RMD rules that apply to Roth IRAs—no required distributions during the life of the contract owner or a surviving spouse beneficiary
      (2) RMDs are required for nonspousal beneficiaries
   c. What are the RMD requirements with a nonspousal beneficiary?
      (1) As with Roth IRAs, distributions can be distributed over five years or over the life expectancy of the beneficiary. However, because there are no regulations, the statutory language is taken literally and there is some difference in the application of these rules.
(2) Under the five-year rule, the account must be liquidated five calendar years from the actual date of death.

(3) Distributions can be stretched over the life expectancy of the beneficiary—as long as distributions begin within one year of the date of death.

   (a) Without regulations, the clearest approach to satisfying the life expectancy exception is to annuitize the benefit—and some insurance companies require annuitization.

   (b) The IRS has issued a private letter ruling providing that the RMD requirement for a deferred annuity can be satisfied using the same methodology as with an IRA or Roth IRA.

   (c) Planning Point: Remember that under those rules, with a nonspousal beneficiary, the RMD rules require dividing the account balance by a life expectancy factor each year. With a nonspousal beneficiary, the life expectancy is calculated in the year following death and is reduced by one for each subsequent year.

   (d) Since there are no regulations, in some cases other insurance companies have followed the guidance of the private letter ruling while others require annuitization in order to stretch payments over the beneficiary's life expectancy.

   (e) Planning Point: If stretching out payments to the beneficiary is an important consideration—and the beneficiary may not want to annuitize the death benefit—then it is important to review the contract terms when selecting the product or at least during the life of the contract owner.

d. What other issues come up when addressing death benefits in nonqualified annuities?

   (1) Problems can arise when the contract owner and the annuitant are different individuals.

      (a) Owner—person who has control over the rights under the contract

      (b) Annuitant—simply the measuring life if the contract is annuitized

   (2) Example: If the husband is the owner and names the spouse as the annuitant and the child as the beneficiary, at the husband's death:

      (a) The benefits become payable to the beneficiary (child)

      (b) RMD requirements that apply to the nonspousal beneficiary apply at this point in time

      (c) The spouse, who may have expected to inherit the contract, does not. In order to ensure this would happen, the spouse would have to be the named beneficiary.

   (3) Another problem occurs if there are joint owners.

      (a) Example: The husband and wife are joint owners and the child is the beneficiary.

      (b) When any owner dies (for example, the husband), benefits become payable to the beneficiary and the RMD requirements apply.

      (c) The spouse, in this case again, does not benefit from the contract and has actually made a gift of half the contract to the child.
Planning Point: Some contracts protect joint owners in this case by providing that if one owner dies the joint owner is automatically the beneficiary—overriding the beneficiary form.

   a. There are no minimum distribution rules during the life of the participant.
   b. However, contracts have maturity rules that may require a payout at maturity.
   c. Under the required minimum distribution rules, when the contract owner dies, payouts must be made.
      (1) Lump sum
      (2) Payout over five years
      (3) Annuitized
      (4) Spousal step-in
      (5) Stretch option based on private letter rulings
   d. Annuitant-driven or owner-driven contracts
      (1) Since 1985, contracts to comply with the minimum distribution rules must pay out a death benefit upon the owner’s death—these contracts are referred to as owner-driven.
      (2) Before 1985, many insurance companies paid out death benefits upon the annuitant’s death—these contracts are referred to as annuitant-driven.
      (3) Today, some annuity contracts are both annuitant- and contract-driven, so a death benefit is paid upon the death of the owner or annuitant.
   e. Planning Point: Contracts vary considerably with regard to death benefits and it is critical to read and understand the contract so that the owner’s intentions can be carried out.
   f. Example: John is the owner and Mary, his wife, is the annuitant. If Mary dies, a death benefit will have to be elected. John, the owner, may not be able to continue the contract.
   g. Spousal step-in rules
      (1) A spouse that is the sole primary beneficiary can continue the contract—this is often referred to as a step-in as the spouse steps in and is treated as if he or she is the contract owner.
      (2) This is not allowed with multiple beneficiaries.
   h. Stretch option
      (1) More and more insurance companies are allowing the stretch option.
      (2) With this option (like in an IRA), the account has to be distributed over the lifetime of the beneficiary.
      (3) The contract remains in deferral status—is not annuitized—so that the beneficiary has the flexibility of taking more than the required minimum.
      (4) Unlike an IRA, the insurance company will automatically make the required distribution.
(5) To take advantage of the stretch, the death beneficiary cannot do a 1035 exchange to another annuity contract.

(6) Some companies relying on private letter rulings are allowing the use of an exclusion ratio to determine the tax treatment even though the contracts are not annuitized.

(7) Some companies allow the owner to select an irrevocable beneficiary and elect the form and timing of post-death distributions, giving the owner control over those future distributions.

i. Guaranteed lifetime withdrawal benefit riders can pay benefits over a joint lifetime for married participants, but they have to be structured so that the spouse is the sole beneficiary to allow the spouse to continue the contract.

SECTION 3: PRODUCT OPTIONS FOR RETIREMENT INCOME PLANNING

LO 10-3-1: Choosing appropriate uses of single premium immediate annuities

1. What is the definition of a single premium immediate annuity (SPIA)? (Video: How are Single Premium Immediate Annuities Used in Retirement Income Planning? Littell, Cloke)
   a. An annuity which begins income payments within 13 months of the initial premium deposit date (many products require the income start date to begin within 12 months of the premium payment)
   b. Annuity payments must provide for a series of substantially equal periodic payments to be made no less frequently than annually during the annuity period.

2. How do SPIAs differ from income annuities that defer payment?
   a. A SPIA has a blanket exception from the 10 percent early withdrawal penalty tax, meaning that a SPIA is exempt from that tax, regardless of the age of the contract owner.
   b. Planning Point: Deferred income annuities are not eligible for this same blanket exception to the 10 percent early withdrawal penalty, although other exceptions may apply.

3. What is unique about single and joint life annuities?
   a. Lifetime income annuities provide insurance against the risk of outliving your money.
   b. Payments are made for as long as the annuitant (or one of the joint annuitants) is still alive.
   c. When the public discusses annuities they are often referring to life income annuities.
   d. Planning Point: Because benefits cease at death, pure life contingent annuities are not commonly used. To guarantee a minimum payout (in the case of an early death), the contract holder is typically more comfortable with a term certain payment or a refund provision.
The term certain period can be used to ensure payouts of at least the principal and a guaranteed minimum rate of return.

A refund feature at a minimum ensures the payout of at least the premium payment. A cash refund pays the beneficiary the difference between payments received and the premium as a single sum. An installment refund continues making payments to a beneficiary until the payments equal the initial premium.

Are fixed term certain annuities (without a life contingency) used in retirement income planning?

a. Yes, term certain annuities are used quite often for a number of reasons.
   (1) Payments continue for the specified period regardless of how long the annuitant lives, ensuring a clear and specified internal rate of return.
   (2) The tax benefits of the exclusion ratio (a portion of each payment is a return of principal) apply to term certain annuities and the benefits continue to the beneficiary.

b. A strategy may be to combine term certain income annuities with other annuities to create an income floor while minimizing the risk that an early death would significantly reduce the return. For example, a solution for a 65-year-old client might involve:
   (1) A five-year term certain SPIA to meet the client’s immediate income needs
   (2) Ladder in three additional five-year term certain deferred income annuities that lock in an income for 20 years
   (3) Purchase a deferred income life annuity that begins payments at age 85 (referred to as a longevity tail)

b. Planning Point: The choice between life contingent and term certain annuities is tied to the interest rate environment. With low interest rates today, life annuities may be more attractive. Term certain annuity returns are tied solely to current interest rate assumptions, while life contingent annuity payout rates are tied in part to mortality pooling.

Can SPIAs include inflation protection?

a. Even though inflation riders have been available for SPIAs for a long time, a common misconception is that inflation protection is not available.

b. Other than TIPS (Treasury Inflation-Protected Securities), income annuities may be the only other product that provides the ability to provide a pinpointed inflation-adjusted level of guaranteed income.

c. Inflation rider options
   (1) Can purchase incremental annual increases in payments from .1 percent each year up to 6.5 percent, based on current products.
   (2) A few policies offer riders that provide a direct tie to increases in the CPI index. Some have caps on the maximum annual increase and some do not.
   (3) Planning Point: Products with inflation protection tied to a CPI index can be quite expensive because of the uncertainty of the liabilities. It may be more cost effective to purchase a specified...
Sources of Retirement Income

annual increase and use the difference in premium to invest for the possibility of periods of higher than average inflation.

6. Can a life annuity that allows for some liquidity be purchased?
   a. Some products offer a living commuted value rider.
   b. These benefits will be discounted somewhat, but may provide the peace of mind that allows a consumer the comfort level to purchase a life annuity.

7. What is the tax treatment of an income annuity?
   a. Deferred annuities are subject to first-in last-out tax treatment—meaning that distributions are taxable earnings until all earnings have been distributed.
   b. Income annuities are subject to the exclusion ratio rules, meaning that a portion of each distribution is treated as a nontaxable return of premium until the entire premium has been recovered.
   c. Exclusion ratio determines the tax-free portion of the distribution and it is based on a fraction. The numerator is the premium and the denominator is the expected total payout from the annuity.
   d. This can also be referred to as FIBO(t) tax treatment (first-in blend-out).

8. Can you compare building income with an income annuity versus using a bond ladder?
   a. Bond ladder
      (1) With a bond ladder, taxes are paid on earnings every year—even during the accumulation period.
      (2) As a bond matures, assuming it will be used to generate income over a period of time, the maturing bond is invested in a cash equivalent, such as a money market account. This means a much lower rate of return during the distribution period and additional taxable income.
   b. Income annuity
      (1) With a deferred income annuity, no taxes are paid during the accumulation phase and distributions are subject to exclusion ratio tax treatment.
      (2) The rate of return during the distribution phase will be the same as during the accumulation phase—providing a much higher return than the money market account.

9. What is the tax treatment of an annuity held in a qualified tax environment?
   a. The annuity has to satisfy the required minimum distribution (RMD) rules at the time of purchase.
   b. Almost all forms of annuities satisfy the RMD requirements.
   c. The determination is one time—there is no required calculation each year.
   d. **Planning Point:** Inflation riders are allowed, and do give the annuitant the opportunity to reduce required distributions in the early years of RMDs (generally required at 70½).

10. What do you look for in a carrier with an income annuity?
    a. Good ratings and a strong balance sheet
    b. Safety of income annuities
(1) The reserve requirements for income annuities are quite high, which provides a source to continue income payments if the insurance company has financial difficulties.

(2) *Example:* Executive Benefit Life Insurance Company failed in 1989 and as of 2012 there have been no defaults on Executive Life benefits.

(3) If the reserve pool cannot satisfy the annuity claims, the state insurance pool provides another layer of security.

c. Comparing income and deferred annuities

(1) If an insurance company fails with a deferred annuity, payouts are frozen for a period of time—unless a petition of hardship is granted. The bankruptcy court may also revise the contract.

(2) If an insurance company fails with an income annuity, payments continue and the contract terms will not change.

11. Are interest rates too low today to purchase income annuities?

   a. Lower interest rates do lower the available payout rates.

   b. Rates of return are competitive as compared with suitable alternatives (bonds, CDs, money market accounts).

   c. Mortality credits are not available with other investments.

**LO 10-3-2: Choosing appropriate uses of deferred income annuities**

1. What is a deferred income annuity (DIA)? (Video: *How are Deferred Income Annuities Used in Retirement Income Planning?* Littell, Cloke)

   a. An annuity that provides specified income payments at some point in the future

   b. Only different from a SPIA in that the start date is 13 or more months from the time of purchase—and can be well out into the future

   c. Deferred income annuities allow the advisor to create income beginning at a specified point in the future with a precision cost that also can:

      (1) Include the option of including inflation protection

      (2) Provide liquidity during the deferral period

      (3) Allow for the change in start date

   d. Longevity insurance (a life annuity with an advanced starting age) is one type of deferred income annuity

      (1) Products referred to as longevity insurance may have limitations on start dates, types of payouts, or other restrictions.

      (2) Other deferred income annuities give the advisor full control over the start date, types of distribution options, and other features.
2. How do DIAs help determine whether a client has enough to afford retirement?
   a. Deferred income annuities allow you to project with quite a bit of certainty the cost of providing a specified income.
   b. Can show clients the portion of their assets required to meet their income needs or whether assets will be insufficient to meet income needs
   c. Provide concrete answers to the question of whether the client has enough—providing a comfort level for the client

3. What is different about a DIA and a SPIA?
   a. The timing of when payments begin
   b. A SPIA is eligible for a total exemption from the 10 percent early withdrawal penalty tax while a DIA is not.
   c. There are some differences in the application of the required minimum distribution rules with a DIA when the owner dies while the contract is still in the deferral stage.

4. What is the difference between a DIA and purchasing a deferred annuity and annuitizing at a later date?
   a. Example: Client needs $2,000 a month ($24,000 a year) for a 10-year period but beginning in 10 years. (Example uses actual annuity rates available in November 2009.)
   b. A fixed deferred annuity at the time paid a 4 percent return with a 10-year guarantee. The best return on a 10-year payout annuity at the time was 2.63 percent. Based on these rates, the cost would be $142,256.
   c. With a DIA, the best rate was higher—4.54 percent because of the 20-year time horizon. The rate of return is the same during both stages: accumulation and payout. The cost for this approach is $124,037 ($18,218 less than the other approach).

5. How do annuity returns compare to other investments?
   a. When considering returns on equities, we tend to consider the nominal rate of return. Returns are much lower if adjusted for:
      (1) Fees
      (2) Inflation
      (3) Taxes
   b. In addition, an income portfolio with the variability of equity returns creates another risk—sequence of returns.
   c. With these considerations, the internal rate of return for income annuities that have no variability, can be adjusted for inflation, and are calculated without fees (no fee drag) compare more favorably with equities.

6. How do we calculate an internal rate of return with an income annuity?
   a. With a term certain annuity, the internal rate of return can be calculated with accuracy.
b. With a life contingent annuity, you can only calculate implied yields because you are estimating how long payments are made—based on an expectation of how long payments will be made based on life expectancy.

c. The life expectancy estimate should be tied to the client’s own expectation of the longest possible life expectancy based on health and family history. Any alternative strategies should also be tied to that same estimate of life expectancy.

7. When choosing a carrier, are the considerations different than choosing a SPIA?

a. Both have the same issues around choosing a carrier with good ratings and a strong balance sheet.

b. The product options vary from company, so it is important to understand the products.

(1) Some DIAs require a life contingency—only a limited number allow a pure term certain.

(2) Some DIAs do not allow payment before an advanced age.

(3) Some products are single premium while others allow continuing deposits.

8. What are trends in deferred income annuities?

a. Much more awareness of retirement risks which have led to a wider acceptance of income annuities by consumers, advisors, academics, and even government regulators

b. Because of the current interest rate environment, some companies are sitting on the sidelines waiting for that to change.

c. We will continue to see new products with the trend toward flexibility and meeting a number of objectives within one product offering.

**LO 10-3-3: Choosing appropriate uses of deferred variable annuities with GLWB riders**

1. What product characteristics are important when choosing a deferred variable annuity? (Video: How are Deferred Variable Annuities with Guaranteed Benefit Riders Used in Retirement Income Planning? Littell, Cloke)

a. Consider fees

(1) Note that current fees may be lower than maximum fee allowed to be charged.

(2) This means that fees could increase in the future.

b. Identify the available investment alternatives and asset allocation options.

(1) Some products give a wide range of alternatives.

(2) Others have much more limited options, making it difficult to create an appropriate asset allocation for the specific client’s needs.

c. Consider surrender charges and surrender periods as they affect liquidity.

d. Pay attention to how income rider fees are charged.
Sources of Retirement Income

(1) Some contracts charge fees against the actual account balance.
(2) Some contracts also count the fee against the phantom income base, which reduces the guaranteed income benefit provided.

2. What are the different types of riders that are available?
   a. Withdrawal benefit riders
      (1) Referred to using a number of names
         (a) Guaranteed level withdrawal benefit rider (GLWB)
         (b) Guaranteed level income benefit rider
         (c) Guaranteed withdrawal benefit (may provide for increasing benefits through a cost of living increase)
      (2) Generally, withdrawal benefit riders provide for withdrawals against the assets until the assets are depleted—after that as long as the terms of the contract have been followed (including not withdrawing more than allowed), the income guarantee provided by the contract becomes effective.
      (3) Benefit guarantees are under most contracts payable for the life of the annuitant.
   b. Guaranteed minimum income benefit (GMIB)
      (1) Income riders were the first generation of living benefit riders available. Today, most contracts are withdrawal benefit riders.
      (2) An income rider promises an annuitized benefit based on factors in the contract.
      (3) The income rider may allow for some withdrawals during an accumulation period.
      (4) An income rider may be used along with a guaranteed minimum death benefit rider.
      (5) Planning Point: This is different than GLWB contracts, which generally cannot be matched with a death benefit rider.
   c. Guaranteed minimum accumulation benefit rider (GMAB)
      (1) GMAB promises a minimum accumulation value on a specified date.
      (2) Amount can be cashed out as a single sum
      (3) Used more on the accumulation side than on the income side
      (4) Accumulation riders allow an advisor to target a minimum accumulation amount as of a specified retirement date.
      (5) These riders are not widely available today.

3. Can you provide a more detailed description of the GLWB rider?
   a. Some contracts will have a bonus that is added to the initial phantom income account or account balance.
   b. Roll-up rate
(1) Increases the phantom income account by a specified amount each year
(2) The roll-up rate may have a limit on how many years of roll up (specified years or up to a specified age, for example).
(3) A rider can also have a high water mark provision which resets the phantom income base when the actual account balance exceeds the phantom account value based solely on the roll-up rate.

c. Withdrawal benefit
   (1) The guaranteed withdrawal rate will be tied to when benefits begin (for example, 4.5 percent if withdrawals begin between age 65 and 70 and 5 percent if withdrawals begin later than that).
   (2) The guaranteed benefit is tied to the phantom account balance.
   (3) Rate will usually be tied to age—for example, 4.5 percent

4. Is the roll-up rate the same as the internal rate of return?
   a. No, roll-up rates sound like rates of return but they are not.
   b. Similar to Fahrenheit and Celsius—both sound the same but are quite different

5. How do you calculate the implied yield on different annuity products?
   a. Use a tool like The Annuity Bulldozer™
   b. Need to make assumptions, which is why this is an implied yield and not an internal rate of return
   c. Need to insert data about the product
   d. Include assumptions about:
      (1) Expected gross rate of return
      (2) How long the product will accumulate
      (3) Life expectancy
   e. Note that The Annuity Bulldozer™ does not capture high water mark increases that would occur in years of strong investment performance.
   f. The outputs include:
      (1) Total income based on the guarantees
      (2) Guaranteed withdrawal benefit
      (3) The implied yield
      (4) Number of years until the account balance is zero (remember that with these riders the withdrawals are taken against the account balance until the account is depleted—then the guarantee kicks in)
      (5) The implied yield when the account balance is zero

6. Example
Sources of Retirement Income

a.

b.

GLWB Example

- Purchase Age: 65
- Total Fees: 3.5%
- Assumed Gross Return: 7%
- Benefit Base Roll-up: 7%
- Income Start Date: 10 years
- GLWB Withdrawal Rate: 6%
- Age 85 Real Value = $0 (20 yrs.)
- IRR w/Death @ 85 = 3.8%
7. What are common myths concerning variable annuities with GLWB riders?
   a. Myth 1: The account is fully liquid.
      (1) Take withdrawals during the accumulation period and income benefits are reduced
      (2) Tax withdrawals that exceed guarantees during the distribution period and reduce income
      (3) If the objective is to have the floor benefit, then the deferred annuity is not liquid.
   b. Myth 2: This approach does not reduce assets under management.
      (1) The income benefit first comes from the account balance.
      (2) Rely on the guaranteed income benefit and assets will be used up over time.

8. Compare the GLWB to a deferred income annuity
   a. 

   ![Sample DIA Quote Image]
b.

![DIA Example](image)

**DIA Example**

<table>
<thead>
<tr>
<th>Purchase Age</th>
<th>55</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth Asset Fees</td>
<td>1%</td>
</tr>
<tr>
<td>Assumed Gross Return on Growth Assets</td>
<td>7%</td>
</tr>
<tr>
<td>DIA Roll-up Equivalent</td>
<td>9.93%</td>
</tr>
<tr>
<td>Income Start Date</td>
<td>10 years</td>
</tr>
<tr>
<td>DIA Withdrawal Rate</td>
<td>5%</td>
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<tr>
<td>Age 85 Real Value</td>
<td>$679K (20 yrs.)</td>
</tr>
<tr>
<td><strong>DIA IRR w/Death @ 85</strong></td>
<td>5.2%</td>
</tr>
</tbody>
</table>

9. Does the GLWB rider approach ever provide the most cost efficient method of creating an income floor?
   a. In some cases this is true—and a tool like the Bulldozer can help identify.
   b. More likely to happen with a younger client projecting a long life expectancy
   c. Also likely to occur if there is a long period of deferral and the withdrawal benefit begins at a later age
   d. A long deferral period also provides time to build other roll-up benefits such as a guaranteed death benefit or long-term care double benefit.

10. What are some other reasons for using a variable annuity with a GLWB other than flooring?
   a. Use to provide downside protection for the growth portion of the portfolio
b. Long-term care rider
c. The annuity wrapper allows the investor to change investments or asset allocation without tax consequences.

**LO 10-3-4: Choosing appropriate uses of deferred fixed and indexed annuities**

1. How do you use deferred fixed annuities for older clients? (Video: [How are Deferred Fixed and Indexed Annuities Used in Retirement Income Planning?](#) Littell, Cloke)
   a. Many senior clients (typically those in their 70s, 80s, and 90s) commonly invest in 3–7 year CDs.
   b. Multiyear fixed term deferred annuities can provide an alternative.
      (1) Guarantee periods are typically available for periods between 3–10 years.
      (2) These compete with CDs primarily based on available rates of return.
   c. These products vary with regard to what happens at maturity.
      (1) Existing contracts may have floor interest rates that are quite significant—and some contracts do not require the election of a new term at maturity.
      (2) Others roll into a new term unless an election is made (the interest rate will be the higher of the new renewal rates or the default guaranteed rate).

2. How do you use fixed indexed annuities in a retirement income plan?
   a. These products provide for some participation in the growth of market returns with downside protection—and at the same time guarantee no loss of principal.
   b. Clients may be able to choose from a number of available indexes.
   c. There is a range of crediting methods that vary from product to product.
   d. The annuity owner's money is not directly at risk. The insurance company meets its obligations through the purchase of options.
   e. Products generally have a cap on growth. For example, if the cap is 4 percent and the index increases by 10 percent, only 4 percent is credited to the client’s account.

3. Do fixed deferred annuities offer guaranteed level withdrawal benefit (GLWB) riders?
   a. Fixed deferred annuities offer these riders, but in today's interest rate environment, these are not competitive.
   b. Indexed annuities also offer GLWB benefits and in some cases the implied yield is higher than other options—making indexed annuities with GLWB riders a viable option to consider for creating an income floor.

4. Do existing deferred fixed annuity contracts have annuitization rates that are more favorable than current rates?
Sources of Retirement Income

a. For many years you would often find better annuitization rates in new contracts—meaning that a 1035 exchange would be made to a new product at the time of annuitization.

b. Today, current contract rates may be quite favorable.
   (1) Floor interest rates in existing contracts may be higher than currently available rates in new contracts.
   (2) Older contracts may convert at more favorable mortality tables than current policies.

c. The limitation with older existing contracts is that the annuitization options may be significantly more limited than existing contracts.

d. Planning Point: Advisors need to be careful to check the annuitization rates in an existing deferred annuity before exchanging them.

LO 10-3-5: Understanding fixed indexed annuity contract terms

1. What is a fixed indexed annuity contract? (Video: Understanding Fixed Indexed Annuity Contract Terms: Littell, Klein)
   a. A fixed annuity that provides a minimum guaranteed interest rate
   b. Opportunity for increased returns based on the performance of an identified stock index

2. What are the benefits of investing in a fixed indexed annuity?
   a. Fixed interest rate for a specified period of time
   b. Higher rates than similarly situated CDs
   c. Tax deferral on growth
   d. Opportunity to annuitize
   e. Favorable tax treatment when annuitized (exclusion ratio)
   f. Opportunity for 1035 exchange to another annuity
   g. Additional contractual guarantees (e.g., death benefits)
   h. No fees (unless income rider)
   i. Avoidance of probate

3. What are some additional benefits attributed to the indexed feature of a fixed indexed annuity?
   a. Upside potential on returns
   b. Downside protection against stock market losses
      (1) Bob Klein refers to this as the power of zero—the value of having no negative returns
      (2) Consider the issue: “Is the pain of losing bigger than the pleasure of winning?”
   c. Minimum guarantees
   d. Premium bonus in some contracts
e. Guarantee of lifetime income with an income rider  
f. Simplified investment management

4. What are the disadvantages of a fixed indexed annuity?  
   a. Long-term commitment required (5–15 years)  
   b. Lifetime commitment if an income rider is included  
   c. Premature distribution penalties prior to age 59½  
   d. Gains on the upside are limited (based on contract terms).  
   e. Withdrawals may be taxed on an earnings-taxed-first basis (this is the case if withdrawals are taken when the annuity is in deferred status—which would be the case if the owner was taking withdrawals under an income rider).  
   f. Income rider will have an associated fee

5. What stock indexes are typically used to measure gains?  
   a. Client chooses from among available options under the contract  
   b. Contracts may offer four or more options, which commonly include:  
      (1) Standard and Poor’s 500 Index (most commonly offered and chosen option)  
      (2) Dow Jones Industrial Index  
      (3) NASDAQ 100  
      (4) Euro 50  
      (5) A blended index (allocation among the different indexes)  
   c. Planning Point: Choosing a blended index provides diversification.

6. What are the indexing methods used for crediting interest?  
   a. Common features of indexing methods  
      (1) Reliance on a stock market index  
      (2) Measurement of the percentage change  
      (3) Use of a cap rate  
   b. Annual point-to-point return  
      (1) First, calculate the interest rate.  
         (a) The index is determined on the contract date and compared to the index one year later.  
         (b) If the index value is down over the period, the interest rate credited is zero. If the index increases, the percentage increase is the interest amount.  
      (2) Apply a cap rate—if that rate is lower than the crediting rate, the cap applies.
Example: On September 16, 2010, the Standard and Poor’s 500 I was 1,125. One year later, it was 1,209. This is an increase of 84 points or 7.5 percent. If the cap is 4 percent, then the interest credited is 4 percent.

Example: The point-to-point method in a down market

(a) The tables below show a comparison of a $100,000 investment in the Dow Jones Industrial Index for a three-year period in which the market was down compared to an investment in a FIA (fixed indexed annuity) with the annual point-to-point crediting method with a 5 percent cap.

(b) The FIA performs quite well in the down market as compared to the Dow Jones investment as illustrated by the ending value of the $100,000 investment of $110,250 for the FIA as compared to the $77,705 investment for the Dow Jones investment.

(c)

| Investment in DJIA vs Investment in a Fixed Index Annuity in a Down Market |
|---------------------------------|---|---|---|
| **Investment in the DOW Jones** | **Date** | **DJIA Index** | **Percentage Change** | **Value** |
| October 9, 2007 | 14,164.53 | N/A | $100,000 |
| October 9, 2008 | 8,759.19 | -38.2% | $61,839 |
| October 9, 2009 | 9,864.94 | 12.6% | $69,645 |
| October 9, 2010 | 11,006.48 | 11.6% | $77,705 |

Example: The point-to-point method in an up market

(a) The tables below show a comparison of a $100,000 investment in the Dow Jones Industrial Index for a three-year period in which the market was up compared to an investment in a FIA (fixed indexed annuity) with the annual point-to-point crediting method with a 5 percent cap.

(b) The FIA substantially underperforms the market investment in an up market as the ending value of the $100,000 investment of $115,763 for the FIA as compared to the $178,298 investment for the Dow Jones investment.
### Investment in DJIA vs Investment in a Fixed Index Annuity in a Rising Market

<table>
<thead>
<tr>
<th>Date</th>
<th>DJIA Index</th>
<th>Percentage Change</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1996</td>
<td>6,448.27</td>
<td>N/A</td>
<td>$100,000</td>
</tr>
<tr>
<td>December 31, 1997</td>
<td>7,908.25</td>
<td>22.6%</td>
<td>$122,641</td>
</tr>
<tr>
<td>December 31, 1998</td>
<td>9,181.43</td>
<td>16.1%</td>
<td>$142,386</td>
</tr>
<tr>
<td>December 31, 1999</td>
<td>11,497.12</td>
<td>25.2%</td>
<td>$178,298</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Date</th>
<th>S&amp;P 500 Index</th>
<th>Percentage Change</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1996</td>
<td>740.74</td>
<td>N/A</td>
<td>$100,000</td>
</tr>
<tr>
<td>December 31, 1997</td>
<td>970.43</td>
<td>31.0%</td>
<td>$105,000</td>
</tr>
<tr>
<td>December 31, 1998</td>
<td>1,229.23</td>
<td>26.7%</td>
<td>$110,250</td>
</tr>
<tr>
<td>December 31, 1999</td>
<td>1,469.25</td>
<td>19.5%</td>
<td>$115,763</td>
</tr>
</tbody>
</table>

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(6) **Planning Point:** These examples illustrate that it is difficult to predict results and whether the investment is appropriate depends in part of the role of that investment in the portfolio. Also, if the FIA is purchased with an income rider, the product’s primary objective may be turning on the income rider—in which case the accumulated account balance is not the most critical part of the contract.

c. **Monthly point-to-point return**

(1) With this method the percent increase or decrease in the index is determined each month. Increases are capped but decreases are not. Results are added up at the end of the year.

(2) Here’s an example with a monthly cap of 1.8 percent. When the results for the 12 months are added together, the result is negative, so zero percent is credited.
### Monthly Point-to-Point Cap Method

<table>
<thead>
<tr>
<th>Date</th>
<th>S&amp;P 500 Price</th>
<th>Dollar Change</th>
<th>Percentage Change</th>
<th>Monthly Capped Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>9/16/10</td>
<td>1,124.66</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>10/16/10</td>
<td>1,176.19</td>
<td>51.53</td>
<td>4.6%</td>
<td>1.8%</td>
</tr>
<tr>
<td>11/16/10</td>
<td>1,178.34</td>
<td>2.15</td>
<td>0.2%</td>
<td>0.2%</td>
</tr>
<tr>
<td>12/16/10</td>
<td>1,242.87</td>
<td>64.53</td>
<td>5.5%</td>
<td>1.8%</td>
</tr>
<tr>
<td>1/16/11</td>
<td>1,293.24</td>
<td>50.37</td>
<td>4.1%</td>
<td>1.8%</td>
</tr>
<tr>
<td>2/16/11</td>
<td>1,336.32</td>
<td>43.08</td>
<td>3.3%</td>
<td>1.8%</td>
</tr>
<tr>
<td>3/16/11</td>
<td>1,256.88</td>
<td>-79.44</td>
<td>-5.9%</td>
<td>-5.9%</td>
</tr>
<tr>
<td>4/16/11</td>
<td>1,319.68</td>
<td>62.80</td>
<td>5.0%</td>
<td>1.8%</td>
</tr>
<tr>
<td>5/16/11</td>
<td>1,329.47</td>
<td>9.79</td>
<td>0.7%</td>
<td>0.7%</td>
</tr>
<tr>
<td>6/16/11</td>
<td>1,267.64</td>
<td>-61.83</td>
<td>-4.7%</td>
<td>-4.7%</td>
</tr>
<tr>
<td>7/16/11</td>
<td>1,316.14</td>
<td>48.50</td>
<td>3.8%</td>
<td>1.8%</td>
</tr>
<tr>
<td>8/16/11</td>
<td>1,192.76</td>
<td>-123.38</td>
<td>-9.4%</td>
<td>-9.4%</td>
</tr>
<tr>
<td>9/16/11</td>
<td>1,216.01</td>
<td>23.25</td>
<td>1.9%</td>
<td>1.8%</td>
</tr>
<tr>
<td></td>
<td>Total Monthly Capped Changes</td>
<td>-6.4%</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest Credited</td>
<td>0.0%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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d. **Planning Point:** It is very difficult to predict which method will perform better from year to year. Within a contract, you can choose multiple measuring methods. With multiple contracts, you have different contract dates as well.

e. **Planning Point:** Being able to communicate the details of the product with clients is a challenge. If for example, the contract is being purchased primarily for the income rider, then it makes sense to start with this feature of contract. A discussion of choosing indexes and indexing methods becomes one of the details that have to be decided when filling out the application.

f. **Alternatives to the cap rate**

   (1) The most common approach to limiting participation in index increases is the cap rate. But there are several other options.

   (2) **Participation rate**

      (a) An alternative to a cap rate is a participation rate. The contract cap's increases in the chosen index will be a percentage of the increase.

      (b) **Example:** Participation rate is 75 percent and index increases by 8 percent. Interest is limited to 6 percent in this case.

   (3) **Expense reduction**
(a) Another alternative to a cap rate is an expense reduction in which the index percent increase is reduced by an expense spread.

(b) Example: Index increase is 9 percent and expense spread is 3 percent. The interest credited is 7 percent.

g. What are the guaranteed minimum interest rates?

(1) All contracts have a minimum guaranteed interest rate in the case of cash out or if a death benefit is paid.

(2) Planning Point: Good place to start a discussion of the product with a client as it identifies the minimum contract value in the worst case scenario.

(3) The minimum is calculated based on two elements:

(a) The percent of premium

(b) Credited interest rate

(4) Two common methods as illustrated in the table. A one percent interest rate credited on 100 percent of the premium. The other alternative is a 2 percent interest rate but only on 87.5 percent of the account value. As can be seen in the table, the higher interest rate on the lower percentage eventually overtakes the lower interest rate on the higher percentage.
h. What else is important about crediting interest?
   (1) Contracts also offer the opportunity to select a fixed account.
      (a) Guaranteed return
      (b) A predetermined rate of return
      (c) Planning Point: Can be used to offset fees for an income rider to ensure that the account does not suffer a loss due to the income rider fee.

7. Surrender charges
   a. Typically have a surrender period of 5–15 years
   b. Generally can withdraw up to 10 percent of the contract without surrender charge
   c. Surrender charges typically decline over time
   d. Generally, the longer the surrender period, the greater the likelihood for higher accumulation value through incentives like bonus interest rates or a more favorable income rider

8. Death benefits
   a. Additions to the accumulation value (investment in contract) include:

---

<table>
<thead>
<tr>
<th>Contract</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of Premium</td>
<td>87.5%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Interest Rate</td>
<td>2.0%</td>
<td>1.0%</td>
</tr>
<tr>
<td>1</td>
<td>89,250</td>
<td>101,000</td>
</tr>
<tr>
<td>2</td>
<td>91,035</td>
<td>102,010</td>
</tr>
<tr>
<td>3</td>
<td>92,856</td>
<td>103,030</td>
</tr>
<tr>
<td>4</td>
<td>94,713</td>
<td>104,060</td>
</tr>
<tr>
<td>5</td>
<td>96,607</td>
<td>105,101</td>
</tr>
<tr>
<td>6</td>
<td>98,539</td>
<td>106,152</td>
</tr>
<tr>
<td>7</td>
<td>100,510</td>
<td>107,214</td>
</tr>
<tr>
<td>8</td>
<td>102,520</td>
<td>108,286</td>
</tr>
<tr>
<td>9</td>
<td>104,571</td>
<td>109,369</td>
</tr>
<tr>
<td>10</td>
<td>106,662</td>
<td>110,462</td>
</tr>
<tr>
<td>11</td>
<td>108,795</td>
<td>111,567</td>
</tr>
<tr>
<td>12</td>
<td>110,971</td>
<td>112,683</td>
</tr>
<tr>
<td>13</td>
<td>113,191</td>
<td>113,809</td>
</tr>
<tr>
<td>14</td>
<td>115,454</td>
<td>114,947</td>
</tr>
<tr>
<td>15</td>
<td>117,763</td>
<td>116,097</td>
</tr>
</tbody>
</table>
(1) Initial investment
(2) Additional investments (unless a single premium contract)
(3) Interest credits

b. Reductions in the accumulation value include:
   (1) Income withdrawals
   (2) Surrender charges
   (3) Surrender charges triggering interest adjustments
   (4) Income rider charges

c. The death benefit is the higher of the accumulation value or the minimum contract value based on minimum guaranteed rates

9. Premium bonus
   a. A bonus paid on the amount of the premium at the beginning of the contract
   b. Example: Invest $100,000 in a contract with a 5 percent premium bonus and immediately the contract value is $105,000.
   c. The limitation is that there will be a recapture of the bonus if withdrawals are taken within a limited period of time.
   d. Premium bonuses lock in long-term commitment of the investor and make the products more competitive.
   e. Approximately 50 percent of the products offer bonuses.
   f. Planning Point: Higher premium bonuses may be offered by companies with lower ratings, or come with longer recapture periods.

10. Guaranteed living benefit riders (Video: Understanding GLWB Riders in Fixed Indexed Annuities: Littell, Klein)
   a. Are GLWB riders as important to the fixed indexed annuity market as the variable market?
      (1) Absolutely—about 75 percent of contracts include GLWB riders
      (2) Provide guaranteed income for life
      (3) Allow for flexibility in the start date of income
      (4) An income rider combined with a death benefit based on the accumulation value is a powerful combination
      (5) 2012 LIMRA data about indexed annuities
          (a) Indexed annuities reached $34 billion in sales—up 5 percent from 2011
          (b) 73 percent of owners elected income riders when they were available
          (c) 87 percent of fixed indexed contracts offer income riders

10.32
Sources of Retirement Income

b. How does the rider work?

(1) The contract specifies an income account value that is used to determine the income that will be received. During the accumulation period, the income account value will increase based on the factors described below. Once the client decides to begin income under the rider, the income amount is a stated percentage of the income account value.

(2) The income account value depends upon six factors:
   (a) The amount of the initial investment plus any additional investments
   (b) Any premium bonuses that are added on under the terms of the contract
   (c) The interest rate stated in the contract
   (d) The interest crediting method used in the contract
   (e) The interest period (how long interest is credited under the contract)
   (f) The optional interest period (if one is specified under the contract)

(3) Interest rate contract terms
   (a) The interest rate is also referred to as a roll-up rate.
   (b) Not a rate of return but a rate used to determine the income value (also called a benefit base), which affects the income that will be paid out under the contract

(4) Interest rate crediting methods
   (a) Can be specified as simple interest or compounded interest
   (b) Planning Point: A lower rate that is compounded (6 percent) may create a better result over time than a higher rate (8 percent) with simple interest.

(5) Period for which interest is credited to the income account—there are three ways to measure the interest measuring period and these approaches can be combined
   (a) Until income is started
   (b) For a specified number of years
   (c) Until a specified age
   (d) An example of a contract that considered all three factors might be written as “interest is credited until the earliest date one of the following occurs: 10 years, income begins, or the contract owner attains age 90.”

(6) In some contracts an optional interest period may be elected.
   (a) The policy may allow the crediting of interest to be extended for a number of additional years.
   (b) This may result in an additional charge for the income rider at the time the extended period is elected.
   (c) Example: Contract allows the crediting of interest for 10 years with an optional period. After 10 years, the client is not ready to take income and elects the optional interest period.
(7) Payout percentages

(a) Each contract contains a table of payout rates based on the age of the client when income begins.

(b) Typically, contracts provide percentages beginning with payouts at age 50 in five-year bands, with a payout percentage for a single life payout and payout rate for a joint lifetime payout.

(c) The payout percentage for a couple under a joint lifetime payment is based on the age of the younger spouse.

(d) Example:

- Couple age 55 and 52 invest $100,000. The rider has a 7 percent compound interest credit for the first 10 contract years. Assume that income will begin when the older spouse is 70 and younger spouse is 67.

- Table below shows the accumulation value

<table>
<thead>
<tr>
<th>Younger Spouse's Age</th>
<th>Income Account Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>52</td>
<td>100,000</td>
</tr>
<tr>
<td>53</td>
<td>107,000</td>
</tr>
<tr>
<td>54</td>
<td>114,490</td>
</tr>
<tr>
<td>55</td>
<td>122,504</td>
</tr>
<tr>
<td>56</td>
<td>131,080</td>
</tr>
<tr>
<td>57</td>
<td>140,255</td>
</tr>
<tr>
<td>58</td>
<td>150,073</td>
</tr>
<tr>
<td>59</td>
<td>160,578</td>
</tr>
<tr>
<td>60</td>
<td>171,819</td>
</tr>
<tr>
<td>61</td>
<td>183,846</td>
</tr>
<tr>
<td>62</td>
<td>196,715</td>
</tr>
<tr>
<td>63</td>
<td>196,715</td>
</tr>
<tr>
<td>64</td>
<td>196,715</td>
</tr>
<tr>
<td>65</td>
<td>196,715</td>
</tr>
<tr>
<td>66</td>
<td>196,715</td>
</tr>
<tr>
<td>67</td>
<td>196,715</td>
</tr>
</tbody>
</table>
Sources of Retirement Income

- Table below shows the payout rate for a 67-year-old—the age of the younger spouse

<table>
<thead>
<tr>
<th>Attained Age on First Day of Income Period</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>50 - 54</td>
<td>3.00%</td>
</tr>
<tr>
<td>55 - 59</td>
<td>3.50%</td>
</tr>
<tr>
<td>60 - 64</td>
<td>4.00%</td>
</tr>
<tr>
<td>65 - 69</td>
<td>4.50%</td>
</tr>
<tr>
<td>70 - 74</td>
<td>4.75%</td>
</tr>
<tr>
<td>75 - 79</td>
<td>5.00%</td>
</tr>
<tr>
<td>80 - 84</td>
<td>5.50%</td>
</tr>
<tr>
<td>85 - 90</td>
<td>5.75%</td>
</tr>
<tr>
<td>90+</td>
<td>6.00%</td>
</tr>
</tbody>
</table>

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(8) What if the accumulation value exceeds the income account value?
   (a) Most contracts will use the accumulation value instead of the income account value, if that amount is higher.
   (b) This is not likely to occur.

c. Key considerations with income riders
   (1) Planning Point: Remember that in many cases the fixed indexed annuity is being purchased primarily for the income provided by the rider. The objective then becomes getting the required income for the least cost—or another way to look at it is getting the highest amount of income from a specified investment.
   (2) The start date for beginning income is flexible and the client chooses when to start income based on income needs.
   (3) Once income is turned on, that is the amount that is paid out for the rest of the contract term (single or joint lifetime). Contracts generally do not have inflation riders, so payouts are a fixed amount.
   (4) Planning Point: Building increasing income can be accomplished by staggering the start dates with multiple contracts.
   (5) Income is determined by the interaction of the variables involved including the interest rate, whether it is simple or compound, the length of the roll-up period, and the distribution percentage.
   (6) Example: A 5 percent payout rate may not be better than a 4.5 percent payout rate. It will depend upon the other factors as well.
   (7) To illustrate the impact of the interaction of the various factors, the table below shows three different contracts. It is interesting that which contract provides the most income depends upon when income begins. The first option provides the best results when income begins at a later age,
the second provides the best results in the early years, and the third when income begins when the husband is between 75 and 80.

(8)

<table>
<thead>
<tr>
<th>Husband's Age</th>
<th>Spouse's age</th>
<th>Fixed Index Annuity (A)</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>65</td>
<td>58</td>
<td>3,710</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>66</td>
<td>59</td>
<td>3,958</td>
<td>4,820</td>
<td>4,200</td>
</tr>
<tr>
<td>67</td>
<td>60</td>
<td>4,827</td>
<td>5,481</td>
<td>4,961</td>
</tr>
<tr>
<td>68</td>
<td>61</td>
<td>5,150</td>
<td>5,859</td>
<td>5,209</td>
</tr>
<tr>
<td>69</td>
<td>62</td>
<td>5,495</td>
<td>6,237</td>
<td>5,476</td>
</tr>
<tr>
<td>70</td>
<td>63</td>
<td>5,863</td>
<td>6,615</td>
<td>6,414</td>
</tr>
<tr>
<td>71</td>
<td>64</td>
<td>6,256</td>
<td>6,993</td>
<td>6,734</td>
</tr>
<tr>
<td>72</td>
<td>65</td>
<td>7,510</td>
<td>7,781</td>
<td>7,778</td>
</tr>
<tr>
<td>73</td>
<td>66</td>
<td>8,013</td>
<td>8,180</td>
<td>8,167</td>
</tr>
<tr>
<td>74</td>
<td>67</td>
<td>8,550</td>
<td>8,579</td>
<td>8,575</td>
</tr>
<tr>
<td>75</td>
<td>68</td>
<td>9,123</td>
<td>8,978</td>
<td>9,823</td>
</tr>
<tr>
<td>76</td>
<td>69</td>
<td>9,734</td>
<td>8,978</td>
<td>10,314</td>
</tr>
<tr>
<td>77</td>
<td>70</td>
<td>10,964</td>
<td>8,978</td>
<td>11,732</td>
</tr>
<tr>
<td>78</td>
<td>71</td>
<td>11,698</td>
<td>8,978</td>
<td>12,318</td>
</tr>
<tr>
<td>79</td>
<td>72</td>
<td>12,482</td>
<td>8,978</td>
<td>12,934</td>
</tr>
<tr>
<td>80</td>
<td>73</td>
<td>13,318</td>
<td>8,978</td>
<td>13,581</td>
</tr>
<tr>
<td>81</td>
<td>74</td>
<td>14,211</td>
<td>8,978</td>
<td>13,581</td>
</tr>
<tr>
<td>82</td>
<td>75</td>
<td>15,961</td>
<td>8,978</td>
<td>14,626</td>
</tr>
<tr>
<td>83</td>
<td>76</td>
<td>17,030</td>
<td>8,978</td>
<td>14,626</td>
</tr>
<tr>
<td>84</td>
<td>77</td>
<td>18,171</td>
<td>8,978</td>
<td>14,626</td>
</tr>
<tr>
<td>85</td>
<td>78</td>
<td>19,389</td>
<td>8,978</td>
<td>14,626</td>
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</table>

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(9) Planning Point: This illustration points out the importance of having a reasonable estimate of when income is likely to begin. Having different contracts for different time horizons can also be appropriate.

d. What is the best time to begin benefits?

(1) Generally, contracts have two requirements for benefits to begin.

10.36
Sources of Retirement Income

(a) The contract holder must be at least age 50.

(b) The contract must be in force for at least one year.

(2) After those requirements have been met, income can be turned on at any time and does not have to be turned on at all.

(3) Deferring payments generally increases benefits but in an uneven manner.

(4) Example: Clients in mid-50s invest $250,000 in a contract. If income begins at 63, annual income is $20,479. If income begins at 64, income increases 6 percent to $21,708. Wait to 65 and the payout percentage increases and now the increase is 19 percent, or $25,886.

e. What is the impact of taking withdrawals prior to turning on income?

(1) If you are buying the product for the income, you do not want to take withdrawals prior to turning on the income rider because withdrawals will reduce the income account value.

(2) Withdrawals in excess of 10 percent could also trigger surrender charges.

(3) Withdrawals could also have a premium bonus recapture.

(4) Once the income rider is turned on, that is the maximum amount that can be taken out each year.

f. Can the income rider be discontinued?

(1) Technically yes, but it is unlikely that this would benefit the client.

(2) The decision that is more likely to change over time is taking the income earlier or later than originally planned.

g. What happens to the account value once withdrawals begin?

(1) Withdrawals do reduce the account value.

(2) If distributions continue over a long period, the account value can become zero but income payments continue.

(3) If the client dies only after a few years of distributions, there is likely to be a significant account value—protecting the client in the case of an early death.

h. What is the cost of the rider?

(1) Charge deducted from the accumulation value, which is a percentage of the income value.

(2) The charge is typically .6 percent to .95 percent of the income account value.

(3) The charge only reduces the account value, meaning that it does not reduce the income amount—only the account value which is the death benefit.

i. What is the difference between variable and indexed deferred annuities that include riders?

(1) Indexed annuities will have only one income rider option.

(2) Variable annuities are likely to have many more options.
SECTION 4: ANNUITY APPLICATIONS

LO 10-4-1: How to build an income floor with annuity products

1. What is the process for building a floor with annuity contracts? (Video: How Do You Build an Income Floor With Annuity Products? Littell, Kitces)
   a. Establish the appropriate flooring amount
   b. Consider annuity product solutions

2. What are the common product solutions?
   a. Build a floor with an immediate annuity
   b. Build a floor with a deferred variable annuity with a guaranteed withdrawal benefit
      (1) Example: Contract provides 5 percent withdrawals if we need $48,000 a year—need about $1 million in assets if payouts are to begin immediately
   c. Build a floor with a deferred income annuity
      (1) One option is to purchase prior to retirement with lifetime payments beginning at retirement age.
      (2) Another option is to purchase a lifetime annuity beginning at an advanced age to provide a lower-cost approach to protecting against the risk of longevity and combine with one or more fixed term annuities covering the first part of the retirement period.
         (a) Example: Purchase a 20-year term certain annuity to cover ages 65 to 85 and a deferred life annuity beginning at age 85.

3. What is the appropriate timing for building an income floor?
   a. The deferred income annuity can be purchased well before payments begin, but the limitation is that you are locked into the strategy.
   b. The deferred annuity provides the most flexibility.
      (1) Take advantage of the provisions of the policy’s income rider
      (2) Exchange for a different deferred annuity with favorable benefits
      (3) Annuitize the current contract or exchange for a better SPIA
   c. Personal considerations about strategies prior to retirement
      (1) Investment options available
      (2) Tax picture can affect choices
         (a) Some may prefer investment environment with capital gains treatment.
         (b) Wealthier clients may prefer tax deferral in an annuity.

4. What are some of the different ways that clients look at the relationship between flooring and investment performance?
 Sources of Retirement Income

a. Some clients use flooring as a fail safe strategy—maintaining flexibility and potential for upside with a diversified portfolio and only choosing to purchase a floor if asset values fall to a specified point.

b. Some respond to positive performance in their investment portfolio by taking investment gains “off the table” and either investing more conservatively or purchasing annuities to build a floor over time.

c. Others respond to positive performance in their investment portfolio—will see good investment performance as an opportunity to continue to ride the market.

LO 10-4-2: Understand the efficiencies created with nonqualified income annuities used early in retirement

1. How can deferred income annuities in early retirement improve a retirement income plan? (Video: What are Some of the Efficiencies Created With Income Annuities? Littell, Cloke)
   
a. Deferred income annuities are not often thought of as a solution.
   
b. Efficiencies of deferred income annuities
      
      (1) The cost is discounted if the annuity is purchased prior to retirement.
      
      (2) The product solution can include inflation protection.
      
      (3) Income taxes are spread over the time of the annuity payments because of the exclusion ratio.
      
      (4) The additional income can help the client optimize Social Security benefits.

2. How is the deferred income annuity more tax efficient than other options?
   
a. Investor that is living on investment earnings is paying taxes on most income (exception for municipal bonds) from both qualified and nonqualified sources.
   
b. Income taken from a deferred annuity is subject to earnings first tax treatment.
      
      (1) All income is taxed as ordinary income in the first few years of retirement (until all earnings are distributed).
      
      (2) High levels of taxable income increase the portion of Social Security benefits subject to income taxes.
      
      (3) No ability to control taxes
   
   c. Tax treatment of income annuity is subject to an exclusion ratio (FIBO® — first-in blend-out) tax treatment.
      
      (1) Lowering income taxes may allow conversions to a Roth IRA.
      
      (2) May lower Medicare Part B premium and exposure to the new 3.8 percent tax on investments

3. Example:
   
   a. Purchase a deferred income annuity six years prior to retirement that pays out for five years
b. FIBO® Benefits for Sample Client

60 Total Payments

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
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<tbody>
<tr>
<td>Yr-1</td>
<td>$1,1876</td>
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<tr>
<td>Yr-2</td>
<td>$1,9516</td>
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<tr>
<td>Yr-3</td>
<td>$2,0299</td>
</tr>
<tr>
<td>Yr-4</td>
<td>$2,1109</td>
</tr>
<tr>
<td>Yr-5</td>
<td>$2,1959</td>
</tr>
</tbody>
</table>

Principal Basis $121,908
*+4% COLA

Taxable Portion $47,928
$2,613*

Year 1 taxable income: $1,1876 - Cash Flow: $31,358
Year 2 taxable income: $1,9516 - Cash Flow: $30,616
Year 3 taxable income: $2,0299 - Cash Flow: $30,912
Year 4 taxable income: $2,1109 - Cash Flow: $30,288
Year 5 taxable income: $2,1959 - Cash Flow: $30,082

Exclusion Rate: 71.79%

FIBO® vs. LIFO Comparison for Sample Client

First Year

<table>
<thead>
<tr>
<th>Income</th>
<th>LIFO</th>
<th>FIBO*</th>
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<tbody>
<tr>
<td>Pension</td>
<td>$13,200</td>
<td>$13,200</td>
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<tr>
<td>Social Security, taxable portion</td>
<td>$9,690 (85%)</td>
<td>$50 (0.3%)</td>
</tr>
<tr>
<td>Additional taxable income</td>
<td>$35,400</td>
<td>$8,842</td>
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<tr>
<td>Total Taxable Income</td>
<td>$58,290</td>
<td>$22,242</td>
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Taxes

<table>
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<tr>
<th></th>
<th>LIFO</th>
<th>FIBO*</th>
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<tbody>
<tr>
<td>Standard deduction and exemptions</td>
<td>-$20,000</td>
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<tr>
<td>Net taxable income</td>
<td>$37,390</td>
<td>$1,142</td>
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<tr>
<td>Bracket Bump (marital rate)</td>
<td>15% to 10%</td>
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<tr>
<td>Taxes due</td>
<td>$4,769*</td>
<td>$114*</td>
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</table>

Note: Numbers vary by year
2010 Tax Rates: Married Filing Jointly

Total savings: $4,655*

* Reflects Effective Tax Rate

THRIVE
4. Summarize how a nonqualified deferred income annuity used to fund the income needs up to age 70 helps a client’s situation
   a. Derives income needs from the deferred income annuity
   b. Allows for the deferral of Social Security benefits
   c. Exclusion ratio results in low levels of taxable income allowing for Roth conversions up to age 70 at a low tax rate
   d. Conversions lower the amount in tax-deferred plans, lowering the required minimum distributions (RMDs).
   e. Lower RMDs and the Roth account provide more control over minimizing taxes during retirement.
   f. Roth allows for lump sum distributions without affecting tax rates.
   g. Roth account is a tax efficient asset to leave to heirs.
   h. **Planning Point:** This can be an especially effective strategy for the many clients that have limited non-qualified assets and most of their financial assets in tax-deferred plans. They can use their limited non-qualified funds to purchase a fixed term (e.g., five years) annuity to fund income needs in the first few years of retirement. The cost is even lower if the annuity is purchased a number of years prior to retirement. The tax treatment of the annuity allows them to afford the Roth conversions that improve the tax situation later.

LO 10-4-3: Choosing appropriate income annuity strategies that address longevity risk

1. Is the life or joint life annuity always the right approach to meet longevity risk? (Video: [What Annuity Strategies Address Longevity Risk?](#) Littell, Cloke)
   a. Not necessarily if the client is in bad health
   b. When life expectancy is short, a term certain annuity may have a lower cost.
   c. The cost savings can be used to either:
      (1) Invest the difference (between the cost of the life annuity and the term certain annuity), and if the client lives longer than expected, buy an immediate life annuity at an advanced age which will have a high payout rate.
      (2) Use the cost differential to purchase a deferred life annuity with a start date at the end of the term certain annuity—incorporating a cash refund in case the client does not live to the end of the term certain period.
   d. Another option with a client in bad health is to buy a medically underwritten life contingency policy that pays more because of the shorter life expectancy.
LO 10-4-4: Compare fixed indexed annuities (FIAs) and deferred income annuities (DIAs)

1. Features shared by DIAs and FIAs (with income riders) (Video: Comparing Fixed Indexed Annuities With GLWB Riders With Deferred Income Annuities: Littell, Klein)
   a. Guaranteed income—income payments guaranteed by the insurance company issuing the contract
   b. Lifetime income—payments are payable for a single or joint lifetime
   c. Tax-deferred income—taxes on earnings are deferred until distributions are made from the annuity

2. Features found in FIAs that are also found to a limited extent in DIAs
   a. With both products, the future income amount is known (so the cost of purchasing the income is clear)
   b. Flexibility with the income start date
      (1) With a FIA income rider, income can begin at essentially any time.
      (2) A DIA will have a specified start date when the income is purchased.
         (a) Contracts may offer some flexibility.
         (b) For example, a contract owner may be given a one-time election to reset the start date within a specified period of time (five years earlier or later).
   c. Income increases the longer the deferral period
      (1) Both provide more income when the deferral period is longer.
      (2) The deferral decision is made at the time the contract is purchased.
      (3) With a FIA, a client can choose a larger income stream by simply deferring income for an additional period of time.
   d. Both may have a death benefit.
      (1) With a DIA, if the product has a death benefit it will be payable only if the owner dies prior to the time that annuity payments begin. Also, including a death benefit reduces income payments.
      (2) With a FIA, the death benefit is the remaining account value at any point in time.

3. Features unique to FIAs
   a. Doubling of income to cover nursing home expenses (either as a contract feature or as a part of the income rider)
   b. The contract has an investment value in addition to the future income stream.
   c. Protection from loss of principle
   d. Potential for increase in the investment value
   e. Potential for premium bonus in some contracts

4. Features unique to DIAs
Sources of Retirement Income

a. Favorable income tax treatment—exclusion ratio applies to the DIA because it is an income annuity
b. Inflation rider in a DIA—these products allow for the purchase of an increasing stream of income (not currently available in FIAs)
c. A DIA can be purchased for a fixed term (not tied to life). This allows the DIA to be used to meet income needs for a limited period of time (for example, to fill an income gap prior to claiming Social Security).

5. Are both products freely available in the market?
   a. Only a number of carriers offering DIAs
   b. More robust market for FIAs

6. In which situations would you lean toward the FIA (assuming the cost of providing the income is comparable)?
   a. If flexibility of the income start date is an important feature
   b. If income streams have the same cost with each product, the FIA has the advantage of the built-in death benefit.
   c. With a FIA, you have a deferred annuity contract which can be exchanged under 1035 for another contract.

7. In which situations would you lean toward the DIA?
   a. If the income need is for a fixed term
   b. If there is a need for inflation protection
   c. In a nonqualified environment the tax advantage of using an exclusion ratio (vs. paying taxes on earnings first) may give the advantage to the DIA.

LO 10-4-5: Case study: Building a retirement income plan with a floor of income annuities

1. The case study presented in this learning objective illustrates the uses of annuities in a retirement income plan. It is not tested on the exam. If you want to follow along as you watch the presentation, click here for the powerpoint slides. (Video: Case study Cloke)

RESOURCES FOR COMPETENCY 10: CHOOSING APPROPRIATE ANNUITIES FOR THE RETIREMENT INCOME PLAN

Section 3: Product Options for Retirement Income Planning

- To visit the Annuity Bulldozer website, please go to http://www.incomeannuitytoolbox.com/
- If you are interested in learning more about the Annuity Bulldozer and other tools, please visit http://www.curtiscloke.com/
Competency 11

Evaluating Other Sources of Retirement Income
SECTION 1: EXECUTIVE BENEFITS

LO 11-1-1: Understand the role of nonqualified deferred compensation in retirement planning for executives

1. Why are executive benefits so important to retirement planning? (Video: How do Nonqualified Executive Benefits Impact Retirement Planning? (Part 1): Littell, Schiff)
   a. As income increases, Social Security benefits replace a smaller percentage of pay.
      (1) Social Security was always conceived of as a safety net.
      (2) For an individual earning $50,000, Social Security replaces approximately 50 percent of earnings. For an individual earning $250,000, the replacement rate is approximately 14 percent. With higher earnings, the replacement rate drops even more.
   b. Qualified retirement plan benefits also replace a smaller percentage of earnings for the highly compensated due to the contribution and benefit limits and the compensation cap that applies to qualified plans.

2. How are executives compensated?
   a. Cash payments include:
      (1) Base salary
      (2) Short-term bonus
      (3) Long-term bonus (usually based on performance over 3–5 years)
   b. Benefit arrangements
      (1) Broad-based benefits
         (a) Health care benefits
         (b) Life insurance
         (c) Short-term disability
         (d) Qualified retirement plans
      (2) Supplemental plans only for executives may include:
         (a) Employer-paid benefits using a defined-contribution approach
         (b) Nonqualified salary deferral arrangements (allow for salary deferral contributions in excess of those allowed in a 401(k) plan)
         (c) Employer paid supplemental defined-benefit plans promising a specified benefit replacing a percentage of preretirement pay
   c. Equity arrangements
      (1) Stock options
Sources of Retirement Income

(2) Stock grants
(3) Performance share programs
(4) Phantom stocks

3. Designing an executive compensation program focusing on replacing preretirement income
   a. Tools for identifying sources of income replacement
      (1) Rei-Source Management System™ identifies company-provided benefits that create replacement income in retirement.
      (2) Identifies all sources of income in a pie chart showing Social Security, qualified plans, nonqualified deferred compensation, etc.
   b. Process for evaluating the company’s program
      (1) Identify a target replacement rate
      (2) Determine if the plan meets the objective by adding up all available programs offered by the company
      (3) Example: Employer creates programs that will allow the executive to have a 60 percent income replacement if all employer-sponsored programs are fully utilized by the employee.
      (4) In this calculation, employers typically do not count the full value of stock options as part of the retirement program. A percentage of the value may be treated simply as the executive’s own personal investment.
   c. A comprehensive tool showing benefits as a replacement rate
      (1) Helps the company evaluate plan design
      (2) Helps executives plan their retirement
      (3) Helps executives appreciate their benefits
      (4) Tool can also allow for “what if” scenarios including tax rate changes, changes in inflation rates, and plan contributions.

4. What are the factors in deciding to make salary deferral contributions to a nonqualified plan?
   a. Before 2008, executives were generally very comfortable making salary deferral contributions as a way to save for retirement.
   b. General plan characteristics
      (1) Properly designed nonqualified plans offer tax deferral to the executive.
      (2) Plans have to be restricted to highly compensated and management personnel.
   c. Benefit security is clearly a consideration.
      (1) Unlike qualified plans, assets set aside to pay benefits remain available to pay the claims of a company’s creditors.
(2) Plan participants are unsecured creditors of the company.

(3) Since 2008, executives are much more concerned about the possibility that their employer could have financial difficulty.

d. Implications of the possibility of rising tax rates

(1) Concern over the possibility of rising tax rates gives rise to a belief that it is better to pay taxes now at a lower rate.

(2) Predicting future tax rates is impossible but an individual’s expectations will influence the decision whether or not to defer taxes.

(3) It is possible to evaluate the impact of rising tax rates on the benefit accumulation. It requires a comparison of current tax rates, expected future rates, and the rate of return on investments.

(4) The impact of tax deferral is powerful and overwhelms the impact of rising taxes to a certain extent.

(5) *Example:* An individual with a 35 percent current tax rate saves in a nonqualified plan for 20 years. If the account grows at 6 percent a year, tax rates can go all the way up to 48 percent and the individual is still better off saving with the tax-deferred approach. With an 8 percent return, the tax-deferred approach is effective at an increased tax rate of 52 percent.

e. An employer matching contribution to a nonqualified plan is an important factor.

(1) Nonqualified plans that are designed to mirror the 401(k) plan often contain a matching contribution.

(2) It is important to encourage participants to contribute enough to qualify for the maximum matching contribution.

f. Access to the plan funds is another significant consideration.

(1) Code Sec. 409(A) that governs nonqualified plans allows for in-service withdrawals at a specified future date. The law also allows for an additional deferral period as long as that election is made more than 12 months prior to the time the distribution was scheduled to occur.

(2) *Example:* Executive elects to defer compensation for five years. Before the end of the fourth year, the executive decides that she does not need the funds and the company is still solvent and decides to defer the compensation for an additional five years. If the executive makes the same election every year, funds become available for withdrawal on a regular basis.

(3) Many executives are not aware of this opportunity to have control over the timing of the withdrawals.

g. Impact of investment alternatives

(1) Nonqualified plans that mirror the 401(k) plan will generally offer the same investment alternatives.

(2) The plan may even offer more options assuming that the executive is a more sophisticated investor.

5. What are recent trends in employer paid supplemental retirement plans? (Video: *How do Nonqualified Executive Benefits Impact Retirement Planning? (Part 2)*: Littell, Schiff)
a. Many companies are layering plans, providing additional benefits for the more highly compensated.

b. Many qualified defined-benefit plans have been terminated because of the liability to the company, but defined-benefit income replacement plans are becoming more popular for high-level executives.
   (1) Most CEOs have some salary continuation plan (the executive is entitled to a percentage of final income for a specified number of years). Executives like this because it gives them a steady paycheck that comes in when they retire.
   (2) For “rank and file” employees, Social Security provides a significant amount of ongoing income, but for highly compensated individuals, Social Security will be inadequate.

c. Supplemental executive retirement plan (SERP) design
   (1) In most cases, benefits are fully funded by the employer.
   (2) Designed to create “golden handcuffs”
      (a) Make it financially advantageous for the employee to stay
      (b) Make it disadvantageous to leave
   (3) Vesting and benefit provisions
      (a) Do not want to undermine the golden handcuffs provision by allowing a short vesting period
      (b) The law imposes no maximum years of service and vesting provisions can be different for each executive.
      (c) Vesting can consider not only years of service but also meeting certain performance goals.
      (d) The benefit provision should also be designed to encourage continued employment.
      (e) Example: The participant is entitled to a salary continuation benefit of 3 percent of final average total compensation multiplied by years of service.
      (f) Using total compensation in the benefit formula gives the executive more incentive to meet the requirements for the bonus.
      (g) Payments can be for a specified period of time or for life with a period certain. The plans may also offer alternative forms of payment.

d. What are the trends in SERP defined-contribution plan design?
   (1) Many employers offering excess 401(k) salary deferral plans will provide a matching contribution. The match can have a golden handcuff provision such as a traditional vesting schedule or contingency upon meeting performance measures.
   (2) Some defined-contribution designs are fully funded by the employer—looking more like the money purchase pension plan with a required employer contribution each year.
   (3) As with defined-benefit plans, remember that in all nonqualified plans the employee is an unsecured creditor.
   (4) Planning Point: Executives need to understand the risks involved in a deferred compensation plan.
6. How does the type of business structure affect the plan design of nonqualified plans?
   a. The types of benefits that we have been discussing apply to employees of C corporations, either public or privately held corporations.
   b. With pass-through entities, such as S-Corporations
      (1) Employees (nonshareholders) can receive the same type of benefits.
      (2) Once an individual is an equity partner of an S Corporation, many of the nonqualified benefits cannot be provided as deferring salary increases retained earnings which are passed through and taxed to the shareholder.
      (3) The same concept applies to other pass-through entities such as partnerships, limited liability companies, and limited liability partnerships.
   c. Nonprofit organizations
      (1) Tax rules are very different for nonprofits.
      (2) 501(c)(3) organizations can sponsor 403(b) plans (similar to the structure of 401(k) plans).
      (3) Nonqualified deferred compensation is subject to the limits of Code Sec. 457.
         (a) Code Sec. 457(b) plans are subject to clear limits as to how much can be deferred each year.
         (b) Code Sec. 457(f) can apply to supplemental plans that exceed the salary deferral limits but the tax treatment is the “worst of all worlds.”
            • Salary deferral contributions become taxable as soon the participant has a nonforfeitable interest in the benefit (i.e., vested in the benefit) even though the executive may not have access to the funds.
            • Even if the participant is not vested until retirement, if a stream of payments is the form of payment, taxes are still due on the total amount.
            • Planning Point: Executives for nonprofits are unaware of this tax trap and do not find out about it until they get a big tax bill.
      (c) Planning Point: Many board members of nonprofit organizations come from the for-profit world and encourage the organization to establish similar compensation arrangements without being aware of the tax difference.

7. How can executives protect themselves as unsecured creditors in nonqualified plans?
   a. Assets set aside to pay benefits are sometimes set aside in a grantor trust referred to as a “Rabbi Trust.”
   b. The IRS has a model form to ensure compliance.
   c. The trust is taxed as a grantor trust, meaning any trust earnings are taxed to the corporation.
   d. Trust provisions
      (1) Assets can be made irrevocable to the extent that they can only be used to pay promised benefits or can only revert in specific circumstances.
Sources of Retirement Income

(2) The trust assets do have to be available to the claims of the company’s creditors to avoid tax problems.

(3) The Rabbi Trust can protect against a corporate change in control or a “change of heart.” The trust does not protect the participants if the company has financial problems—the participants are still unsecured creditors.

e. Arbitration clause

(1) An arbitration clause may protect an executive if the employer decides not to pay benefits. Going to arbitration is less expensive than going to court. Companies often prefer arbitration clauses as well.

f. Access to benefits if the employer has financial difficulty

(1) Payouts cannot be made upon a change in the financial condition of the company.

(2) If the participant elects in-service withdrawals, they have some control to take benefits as they become due instead of continuing to defer benefits if they are concerned about the company’s financial situation.

g. Planning Point: Nonqualified plans that allow for tax deferral always involve some risk. It is imperative that clients understand the risks involved.

8. The employer has three basic options for funding nonqualified deferred compensation plans.

a. Pay as you go—companies typically do not like to do this. It is the “kick the can down the road” type of scenario.

b. Set up a side fund to pay obligations either owned directly by the employer or in a grantor trust. Assets are not eligible for any special tax treatment—earnings are taxable income to the corporation.

c. Create an insurance arrangement—company owned life insurance (COLI)

(1) Because of past abuses, there are limits on COLI.

(a) The employer can only insure the top 35 percent of the payroll.

(b) The employer needs to get a written acknowledgment from the employee that

• the employee knows that they are being insured,

• the employee knows the maximum amount of insurance that can be placed on their life,

• the employee has no interest in the insurance, and

• the employee consents to the arrangement.

(2) Participants have no reason not to sign the consent because the life insurance is being used to fund the executive benefit plan.
LO 11-1-2: Identify the types of executive welfare benefits that are commonly offered today

1. Generally, what types of welfare benefits are being provided to employees? (Video: What Common Welfare Benefits are Provided to Executives Today? Littell, Schiff)
   a. Comprehensive health insurance coverage
   b. Group life insurance
   c. Disability benefits
   d. Long-term care insurance

2. Life insurance
   a. Group term life insurance is only efficient up to the first $50,000 because the first $50,000 is not taxable to the employee. Anything over $50,000 has an imputed income to the employee.
   b. Usually, the group term policy only provides a benefit if you die as an active employee. The actuarial chance of that happening is somewhere around 2 percent—98 percent of people will pay tax on the benefit and never collect on the benefit.
   c. Because of the tax consequences, employers may limit the benefit to $50,000.
   d. Also, limiting the benefit to $50,000 helps keep the premiums lower. These plans are experience rated and if benefits are larger for executives, a single large payout could result in big increases to the premiums. If benefits are limited to $50,000, the costs should remain low—even if there is a payout.
   e. What are options for providing life insurance?
      (1) At one time, split dollar was very popular. But today, most are not because of the tax consequences.
      (2) A Sec. 162 plan may be one option for providing additional coverage (discussed in a separate video).
      (3) A survivor benefit plan that continues paying income to the survivor for a specific period of time for the executive that dies while still employed is another option.
         (a) This benefit is a welfare benefit that has no tax consequences to the employees—meaning no imputed income to those not receiving any benefits.
         (b) Use COLI to fund the survivor benefit
         (c) Again, one needs to get the executive's consent to purchase COLI.

3. Employer-provided long-term care insurance
   a. If the employer pays the premium, the employer receives a deduction, the employee incurs no income tax, and benefits are not taxable.
   b. There are no nondiscrimination rules that require coverage of rank and file employees.
   c. Planning Point: Advise executives to ask for this benefit and consider trading coverage for compensation because of the tax benefits.
4. Medical insurance
   a. Receive the same comprehensive health care program available to all employees
   b. Additional benefits such as a comprehensive annual physical may be a supplemental benefit.
5. Disability benefits
   a. Receive the basic disability program available to other employees
   b. Common to provide supplemental disability benefits for executives
6. Retiree medical benefits
   a. Trend is to reduce or eliminate this benefit to the “rank and file” employee
   b. Same trend for executives to reduce employer-paid benefits. Cost-sharing arrangements are a common trend.

LO 11-1-3: Understand how Sec. 162 bonus life insurance programs can benefit an executive

1. What is driving the resurgence of the Sec. 162 bonus life insurance plan? (Video: How Can a Sec. 162 Bonus Life Insurance Plan Benefit an Executive? Littell, Schiff)
   a. Tax treatment
      (1) The Roth IRA has brought awareness of the value of tax-free growth on assets.
      (2) Executives often exceed the eligibility requirements to make new contributions to Roth IRAs, so they may not have access to this type of tax treatment.
   b. Benefit security
      (1) With Sec. 162 plans, the participants own the policies, eliminating the problem of benefit security.
      (2) In contrast, benefit security is always an issue with nonqualified deferred compensation, and that concern was exacerbated recently with large companies going out of business. In the past, people did not worry as much about large companies going out of business.
   c. Possibility in increasing tax rates
      (1) Whether tax rates will go up is uncertain.
   d. With this uncertainty, paying taxes now at a 35 percent rate may seem to some as a better option than waiting.
2. What are the tax ramifications of other types of tax-advantaged plans?
   a. There are three tax issues when saving:
      (1) Contribution stage—When am I paying taxes on my contribution; are these taxes deferred?
      (2) Growth stage—Does investment grow tax-free or do I have to pay investment gains?
      (3) Withdrawal stage—What happens when I take the money out?
b. With qualified plans and nonqualified deferred compensation, contributions are tax-deferred, earnings on the growth are deferred, but taxes are paid on the entire value of the withdrawal.

c. With a Roth IRA, contributions are after-tax (no deduction), but earnings grow tax-free so there is no tax on the withdrawal.

3. Is there a tax vehicle that can emulate the tax benefits of a Roth IRA without the statutory limitations on who can use the structure?

   a. Life insurance under Code Sec. 7702
      (1) Satisfy the qualifications for an insurance arrangement
      (2) All of the internal growth is fully tax-deferred and the death benefit is tax-free.
      (3) In addition, you can withdraw up to your basis in the policy tax-free (as long as the policy is not a MEC).
      (4) You can also borrow money against it on a tax-free basis (as long as the policy is not a MEC). Loans do not have to be paid back during lifetime; the outstanding balance can be paid back from the death benefit proceeds.

   b. This emulates the tax benefits of the Roth IRA without the restrictions placed on Roth IRAs.

   c. However, this type of plan is a lot more complicated than a Roth IRA. This plan has to be carefully managed.

   d. One problem that could occur is that if policy loans are taken and the policy lapses, it could create a huge tax bill. These policies should be held to maturity.

4. Can a Sec. 162 insurance arrangement be used to save for retirement?

   a. Life insurance policies are typically not designed to be very cost effective savings vehicles because of the cost of the death benefit.

   b. Policies can provide for smaller death benefits, maximizing the investment potential. The design can ensure that the net amount at risk is sufficient to meet requirements each year.

5. Benefit security

   a. The executive owns the policy, eliminating the risk that if the employer has financial difficulties that benefits will not be paid.

   b. Participants have full access to the funds—unlike a deferred compensation plan.

   c. Most states provide creditor protection.
      (1) Full protection against death proceeds
      (2) Most states give some protections against cash surrender values.

6. How do Sec. 162 plans work?

   a. Policies are purchased on each executive's life.

   b. Premiums paid by employer are fully deductible under IRC Sec. 162 as employee compensation.
Sources of Retirement Income

c. Benefit programs that are paid for by the employer may be eligible for simplified issue or guaranteed issue policies.

d. In the example of a company designed policy, the company would set up a policy for each individual employee. Premiums for the insurance contract can be paid by either the employer or employee or a combination of the two.

e. The program can also be voluntary and initiated by the employee.

f. Once the policy is set up, it is the employee's policy and he or she gets everything that comes along with a regular insurance policy.

g. If the employer is paying the premium, that premium becomes taxable income.

h. The plan may allow for additional employee investments and executives may want to reposition assets by contributing to the policy.
   (1) May provide some asset protection
   (2) Benefit from the tax advantages of these plans

i. There is no specific limit on how much can be put into this plan subject to the person's insurability.
   (1) However, one must make sure that no matter how much goes into this account, it continues to meet the life insurance arrangement requirements under IRS Code Sec. 7702.

j. Also, if lifetime withdrawals are expected, the rules regarding modified endowment contracts (MECs) must also be followed to get favored tax treatment.

LO 11-1-4: Understand the types of equity-based compensation offered to executives today

1. What are the trends in equity-based compensation in public companies today? (Video: What Types of Equity-Based Programs are Offered to Executives Today? Littell, Schiff)
   a. Equity-based compensation continues to be an important part of the compensation package.
   b. Stock options at one time were quite popular.
      (1) Number of options granted based on length of employment, position in the company, performance of the stock
      (2) The accounting rules have changed, making stock options less attractive today.
   c. In some cases, stock options have been replaced by performance shares, restricted stock, and outright stock grants.
   d. There continues to be an interest in tying the executives to the performance of the company and executives want an ownership interest as well.
   e. Performance shares are stock grants based on meeting certain performance criteria.
f. Restricted stock has restrictions on when the stock can be sold—could be forfeited if performance goals are not met.

2. What are the trends in equity-based compensation for privately held companies?
   a. There can be problems giving executives small outright ownership interests.
      (1) They do not have much say in the company.
      (2) May not have a market for selling the stock
      (3) Could cause problems for the company if the executive terminated with the ownership interest
   b. Phantom shares can be used to tie the executive’s interest to the performance of the company.
      (1) Shares can be granted based on meeting performance goals.
      (2) The value of the shares can be determined based on parameters established in the plan.
      (3) The account grows and may not be available for withdrawal for a period of time.

SECTION 2: LIFE INSURANCE

LO 11-2-1: Understand the role of life insurance death benefits in retirement planning

1. Life insurance is an important tool for retirement planning because it can help protect wealth and replace income in the event of an early death. (Video: What is the Role of Life Insurance Death Benefits in Retirement Planning? Littell, Lemoine, Graves)
   a. If an adequate amount of life insurance is purchased, life insurance can provide income replacement.
   b. Planning Point: When determining an adequate amount of life insurance, an advisor should take into account payments made to the spouse and children through Social Security, the ability of the spouse to go back to work if needed, and the income that the surviving spouse is likely to earn. Conservative planning might be best in these situations in the event that the surviving spouse cannot go back into the workforce. The amount of adequate life insurance coverage varies by person and situation.
   c. Planning Point: Coverage should be obtained for a nonworking spouse as there will be additional expenditures if that person were to have an early death—for example, child care expenses.
   d. Another decision point will be the length of time that income replacement is required. One approach is to plan on replacing income up until retirement age—but another is to consider income replacement needs through retirement as well. For a younger person, taking into consideration the longer time horizon will not require that much additional life insurance coverage because the present value cost for an event happening well into the future (30–40 years) is not that significant.

2. Life insurance policies offer a range of settlement options.
Sources of Retirement Income

1. Many elect a single sum option and do not consider the range of settlement options available in the policy.
2. The lump sum can be used to purchase an annuity, but it is prudent to compare the outside annuity to the settlement options available under the life insurance contract. In some circumstances, an older policy with higher guaranteed interest rates may provide a more cost-effective solution.
3. A settlement option other than a lump sum may make sense when there are concerns about the beneficiary squandering the policy proceeds. A company may allow the contract holder to control the settlement option through the beneficiary election, or the life insurance policy could be held within a trust with the trustees making the payout decisions.

3. Insurance product options for income replacement for younger clients
   a. Term insurance may be the right option for younger clients with small budgets, as they may not be able to afford the amount of insurance needed with a permanent product. If term insurance is used, the limitation is insurability, and choosing the appropriate length of term coverage becomes an important consideration.
   b. A permanent policy may be more appropriate for wealthier clients that prefer a product that can provide a dual purpose—create income replacement and retirement income.

4. Income replacement needs continue into the retirement period.
   a. In retirement, couples planning for income needs have to address the loss of Social Security and pension benefits that will occur at the first death—requiring additional income replacement.
   b. Life insurance may be an appropriate way to replace income in this case. Insurability and price are two major concerns when purchasing life insurance policies at an older age.
   c. Not enough people plan for the early death of a spouse in retirement, which is quite problematic for widows, who are most at risk for financial difficulties in retirement.
   d. Many workers have life insurance coverage at work, which ceases at retirement. If the policy is portable, very few continue coverage or purchase replacement coverage.
   e. Income replacement planning can be even more critical for couples with large age discrepancies.
   f. In addition to life insurance, company-sponsored retirement plan distribution options become another way to address income replacement after death.
   g. Dependents can be cared for with the selection of a joint and survivor annuity that continues payments into retirement.
   h. Household cash flow needs generally do not drop significantly after the first death, which should be considered when determining how much income is needed after the first death.

5. Insurance product options for replacing income needs well into retirement
   a. Permanent life insurance products are generally more cost effective if coverage needs continue into retirement.
   b. Purchasing permanent policies at an older age involves several issues.
(1) Cost increases the older the client is when the policy begins—this factor weighs in favor of purchasing at an early age.

(2) Insurability may be more problematic at an older age—also weighing in favor of purchasing at an earlier age.

(3) Life insurance needs may not be clear until a later age—requiring purchase as the need arises.

**LO 11-2-2: Understand the role of life insurance cash value benefits in retirement planning**

1. Life insurance is a product that can be very flexible and meet multiple objectives. (Video: What is the Role of Life Insurance Cash Value Benefits in Retirement Planning? Littell, Lemoine, Graves)
   a. Used to provide death benefits
   b. Used to accumulate assets for retirement needs

2. If withdrawals are expected during lifetime, the tax treatment of withdrawals depends upon whether the policy is a modified endowment contracts (MEC).
   a. For policies that are MECs, withdrawals and loans are treated first as distributions of taxable earnings.
   b. Non-MEC policies are eligible for FIFO (first-in-first-out) tax treatment. This means that the first distributions are treated as a return of cost basis, and only after all basis is recovered are distributions taxable. You can also borrow against a non-MEC policy without any tax consequences.

3. A life insurance policy that is not a MEC can operate somewhat like a Roth IRA. Premiums are paid with after-tax dollars and significant withdrawals can be made without tax consequences. A wealthier individual may use a life insurance policy as a way to save on a tax-preferential basis.

4. Other wealthy clients purchase policies exclusively for meeting legacy goals.

5. The cash value benefits of a life insurance policy can provide a great deal of flexibility.
   a. Cash value can be tapped to meet college funding needs without affecting FAFSA financial aid.
   b. It can provide benefits for retirement.
   c. Some of the cash value can be withdrawn and still maintain the policy for the death benefits.

6. What are some important considerations when using a life insurance policy with cash value benefits as part of a retirement plan?
   a. Be conservative when estimating what cash value may be available in retirement. Look at illustrations using a range of assumptions.
   b. Identify the objectives for purchasing the policy.

7. Policy options
   a. Variable universal life
      (1) Offers control over investment direction and contributions
11.15

(2) Negative performance may result in the need to make large contributions to avoid MEC status.

b. Permanent policies have fewer concerns under the MEC rules and can be considered as a conservative portion of the retirement portfolio.

c. **Planning Point**: Consider the impact under the policy of cash value withdrawals on death benefits—in some cases benefits will decrease.

8. Creditor protection

a. **Planning Point**: Life insurance policies may have state asset protection which varies state by state. Typically, a state will offer protection from creditors up to a set amount for life insurance policies (can vary between $500,000 to $2 million).

b. Professionals such as lawyers and doctors who are at risk of malpractice suits often will plan to protect assets from creditors—and life insurance is one option for doing this.

**LO 11-2-3: Identify specific strategies for using life insurance in a retirement income plan**

1. Specific uses of life insurance in retirement planning (Video: *Uses of Life Insurance in Retirement*: Littell, Graves, Hegna)

   a. Guarantee the children’s legacy with life insurance freeing up retirees to spend their retirement assets
   
   b. Leverage a modest gift to the grandchildren by purchasing life insurance
   
   c. Leave more to your favorite charity by leveraging the gift through purchasing life insurance
   
   d. Replace the loss of Social Security benefits when the first spouse dies—first to die life insurance is a product that could be used for this purpose
   
   e. Pension maximization—if the spouse is unlikely to outlive the pensioner, choosing a single life annuity and purchasing life insurance ensures that a death benefit is paid to the spouse or other heir if the spouse dies first
   
   f. Covering final expenses—leveraging existing assets to build a larger fund to meet final expenses

2. Life insurance on the first spouse to die for replacing income (Video: *Using Life Insurance in a Retirement Income Plan*: Littell, Cloke)

   a. Life insurance on the first spouse to die can provide additional income for the surviving spouse.
   
   b. It can also provide income to pay taxes for a Roth conversion.
   
   c. It can replace lost income due to a reduction in Social Security or pension benefits.

3. Build life insurance cash value to provide a supplemental source of retirement income

   a. Maximum fund the policy ensuring not to overfund to the extent that the plan becomes a modified endowment contract
   
   b. Withdrawals can be tax-free
(1) First withdrawals are a return of premiums (cost basis) and are not taxed.

(2) After premiums have been withdrawn, additional amounts can be taken out as non-taxable loans.

(3) It is important to ensure that loans do not result in a default in the policy (which would have negative tax consequences).

4. Policy design considerations
   a. Typically use different policies for different objectives—one policy for meeting death benefit objectives and another that focuses primarily on cash value build up
   b. When the primary focus is the death benefit, the objective is to purchase the death benefit at the lowest cost and the cash value is not as important.
   c. When the primary focus is building a source of retirement income, the focus is on return earned on the policy and minimizing the cost of insurance.
   d. May consider second to die policies when the goal is building cash value because of the lower cost for the death benefit
   e. Concerns about illustrating projected results for the types of products being used today for building cash value for retirement income
      (1) Participating whole life insurance
         (a) Many advisors use current dividend rates for illustration purposes.
         (b) Even though we are at the bottom of the interest rate cycle, it may be more appropriate to use a rate that is 75 percent of today's rate.
      (2) Indexed universal life
         (a) Perception that interest rate crediting will remain at historical returns for equities
         (b) Rates can certainly go down and any change will affect the illustration.
         (c) Loan interest rates also matter if you are assuming that some of the cash value will be borrowed during retirement.
         (d) Other projected rates may change over time, which will effect an illustration.
            • Assuming the cost of insurance (COI) is below the maximum, the cost could increase.
            • Assuming that fees are not at the maximum, they may rise as well.
            • Interest crediting rates can be lowered to the minimum rate.
SECTION 3: FEDERAL CIVILIAN AND MILITARY BENEFITS

LO 11-3-1: Understand the types of retirement benefits available to federal civilian and military employees

1. What retirement benefits are available to federal civilian employees? (Video: What Retirement Benefits are Available to Federal Civilian and Military Employees? Littell, Cermak)
   a. Eligible for a pension whose design and features are dependent on when they became federal employees
   b. Two systems that are based on number of years of service and average pay over the highest 3 years of salary
      (1) Civil Service Retirement System (CSRS)
         (a) People who came into federal service before 1984
         (b) The employee contribution to CSRS is 7 percent of pay.
         (c) Employees do not pay Social Security taxes, and work for the federal government does not count toward determining Social Security benefits.
      (2) Federal Employee Retirement System (FERS)
         (a) People who came into federal service after 1983
         (b) The employee contribution to FERS is .8 percent of pay.
         (c) These employees do pay Social Security and are eligible for Social Security benefits.

2. What other benefits are available that impact retirement security?
   a. Federal Employee Health Benefits Program can be continued in retirement.
      (1) It is a significant benefit, better than most other retiree health programs—especially important for those who retire before Medicare eligibility.
      (2) Both CSRS and FERS retirees are eligible for the program.
      (3) The program is quite comprehensive and even includes dental and vision care.
      (4) Planning Point: The coverage is priced competitively and the overwhelming majority of retirees elect to continue coverage. The key planning issue is that a retiree will not be eligible to continue benefits unless they retire with an immediate annuity. If they defer retirement benefits, they lose the option.
   b. Group life insurance benefits can continue into retirement.
      (1) A portion of the available benefit can be purchased at a very competitive rate.
      (2) Additional benefits may also be available—but will not be cost effective except for those that are otherwise uninsurable.
c. Long-term care insurance
   (1) Policies are not subsidized during employment and there is no price change at retirement, so this product can be compared easily to other commercially available options.
   (2) Policies can be purchased even after retirement.

3. Are the benefits different for postal workers?
   a. The benefit structure is exactly the same.
   b. The only difference is that the pay scale is different than for other federal civilian employees.
   c. This is relevant to the extent that retirement benefits are tied to salary.
   d. Planning Point: An advisor who is familiar with the civilian employee pay structure may not be aware of the significant differences for postal workers.

4. What retirement benefits are available for retired Military employees?
   a. Military retired pay is completely different than either FERS or CSRS.
   b. Generally, an individual who retires with 20 or more years of service is immediately eligible for lifetime retirement pay. The benefit structure is calculated based on the average-high-three-year-salary and years of service. Retiree pay goes all the way up to 100 percent of base pay for 40 years of service.
   c. Military employees pay Social Security taxes and are eligible for benefits.

5. Who is eligible for the Thrift Savings Plan?
   a. This plan operates essentially as the federal government’s 401(k) plan. It allows for salary deferral contributions and participant investment direction.
   b. All federal civilian and military employees are eligible to make salary deferral contributions.
   c. Military and civilian employees under CSRS are not eligible for a matching contribution.
   d. FERS civilian employees are eligible for an employer match.

6. What retiree medical benefits are available for military employees?
   a. TRICARE is a totally different program than the Federal Employee Health Benefit (FEHB) program in retirement for federal employees.
   b. More cost effective than the FEHB program and has more options
   c. The plan is comprehensive, covering dental, vision, and prescription drugs.

7. What other welfare benefits are available to retired military employees?
   a. Military employees are eligible to purchase the federal long-term care insurance program with the same terms as civilian employees.
   b. The military has its own separate life insurance program.
      (1) Serviceman's Group Life Insurance (SGLI) covers those on active duty.
      (2) The maximum benefit is $400,000—the insurance amount is not tied to the individual's pay.
(3) SGLI continues for 120 days after retirement for no charge.
(4) SGLI can be converted to Veteran's Group Life Insurance (VGLI) upon retirement.
(5) VGLI is 5-year renewable term coverage that is not competitively priced.
(6) It can be purchased at termination without evidence of insurability, making it a valuable benefit for retirees with an insurance need who are not in good health.

c. Survivor Benefit Plan (SBP)
   (1) When a married person is retiring from the military, they have the option to elect SBP, which protects a portion of their retired pay for their spouse if they die first.
   (2) Can protect up to 55 percent of their pension
   (3) Cost is 6.5 percent of retirement pay no matter what age benefits begin
   (4) Spousal coverage is the most important planning consideration.
      (a) Because the cost is the same regardless of age, it is quite cost effective for providing income replacement for older spouses.
      (b) The 6.5 percent reduction may not be the right choice if it is unlikely that the spouse will outlive the retiree. For example, a young female retiree with an older husband may be better off with life insurance to ensure that a death benefit is paid.

d. VA nursing home benefit
   (1) All military are eligible for care in a VA nursing home.
   (2) However, there is limited availability and a priority list—active duty personnel who are injured in the line of combat receive top priority.
   (3) Military retirees are lower on the priority list, so a VA nursing home option is generally not going to be an option.

LO 11-3-2: Identify the pension benefits and planning opportunities under the Federal Employee Retirement System (FERS)

1. FERS benefit formula (Video: What Benefits are Provided Under the Federal Employee Retirement System (FERS) Program? Littell, Cermak)
   a. Inputs in the calculation
      (1) Average of highest three years of salary
      (2) Multiply by the number of years of employment
   b. Benefit formula
      (1) 1 percent multiplied by years of service times average salary
(2) If you retire at age 62 or later and have at least 20 years with the federal government, the multiplier is 1.1 (for example, an individual who retires at age 62 with 30 years of service earns a benefit of 33 percent of average salary).

c. Employees make a mandatory contribution of .8 percent of pay each year.

d. Three components for calculating when you can retire and with what:
   (1) 1 percent of highest three years of salary
   (2) 1.1 percent after age 62 and with 20 years of service
   (3) The minimum retirement age is based on your birthday.
      (a) Example: Born before 1948, the earliest retirement age is 55
      (b) In order to take either a deferred annuity or immediate annuity, you must retire at age 55 or later if you were born before 1948.
      (c) Example: Born after 1970, the earliest retirement age is 57
   (4) The Federal Employees Almanac lists the benefits and applicable rules.

2. Benefit statements come in two forms.
   a. Retirement calculator
      (1) Accurate estimate is available for those who ask for it
      (2) Can ask for it as often as you want
      (3) Based on current pay and number of years—if you retire at age X, your pension is scheduled to be Y.
      (4) Can also model several alternatives
   b. Thrift Savings Plan statement
      (1) Allows federal employee to get a comprehensive look at what all of their income from the federal government would look like
         (a) Shows Social Security benefits
         (b) Shows Thrift Savings Plan benefits
         (c) Provides estimate of FERS pension benefit

3. Early retirement
   a. Benefit is reduced by 5 percent for each year of retirement prior to age 62
   b. Deferring retirement benefits, however, has a negative consequence—the individual who defers cannot elect to continue health insurance benefits in retirement.

4. Distribution options
   a. Life annuity only
   b. Married participants can provide a spousal survivor benefit of 25 percent or 50 percent of the pension.
c. The cost for the 50 percent survivor option is a reduction in pension of 10 percent regardless of the age of the spouse.

d. In some circumstances, the cost of the survivor pension is cost effective as compared to purchasing commercial insurance.

e. No lump sum option is available for the FERS benefit.

5. Additional benefits for long-service employees

a. Federal employees that retire after minimum retirement age with at least 30 years of service do not incur the 5 percent reduction for each year of retirement prior to age 62.

b. They are also eligible for a supplemental benefit (that makes up for the absences of Social Security benefits) that ends at age 62.

6. Mistakes that participants and planners make about federal employee retirement benefits

a. Failing to contribute enough to the Thrift Savings Plan to receive the 5 percent matching contribution that FERS employees are eligible to receive

b. For those who have a life insurance need and are insurable, the option B Federal Employee Group Life Insurance coverage becomes quite expensive around age 55. A mistake is not replacing this coverage with a lower cost policy.

7. Planning opportunities to maximize benefits

a. Retirees are eligible to purchase a portion of the basic life insurance which is a permanent product that can be purchased at a very low cost and is guaranteed issue. Generally, $100,000 of coverage is available and the cost is $194 a month.

b. For those who follow military service with government service, additional pension benefits can be purchased adding the military service to the calculation of the pension benefit. The cost is quite low and everyone who has the opportunity to do this should take advantage of it.

**LO 11-3-3: Identify the pension benefits and planning opportunities under the Civil Service Retirement System (CSRS)**

1. Transitioning from CSRS to FERS (Video: What Benefits are Provided Under the Civil Service Retirement System (CSRS) Program? Littell, Cermak)

   a. FERS came into effect in 1987, but had a retroactive impact.

   b. Those hired after 1983 are in the FERS system.

   c. Those hired prior to the end of 1983 are in the CSRS system.

   d. CSRS offset—hybrid group

      (1) Hired under CSRS, had a break in service, and then came back after 1983

      (2) Will start paying Social Security tax when they come back, which will be calculated the same as if they are FERS
(3) CSRS offset receive total benefits that equal CSRS benefits
(4) To find out which system an individual is in, look at the employee's Thrift Savings Plan statement.

2. Benefits available under CSRS
   a. Retirement pay is calculated differently than FERS.
   b. Multipliers are significantly bigger partly because they are not paying any Social Security tax or getting any Social Security income.
   c. Participants contribute 7 percent of salary.
   d. The benefit is more lucrative than the combination of FERS and Social Security.
   e. The cost of living adjustment calculation in retirement is better because for CSRS it is tied directly to CPI. FERS cost of living adjustments are CPI minus 1 percent.
   f. The multiplier for the federal pension for people in CSRS is 1.5 percent of the first 5 years, 1.75 percent of the next 5 years, and 2 percent for additional service.
      (1) Someone in CSRS for 41 years will get the maximum pension of 80 percent of average salary.
      (2) The maximum benefit under FERS is 44 percent of pay.
   g. CSRS employees are eligible for the Thrift Savings Plan but are not entitled to a matching contribution.
   h. Planning Point: CSRS retirees have a more secure retirement benefit because of the better annual cost of living adjustment.

3. Voluntary contribution plan
   a. Only available to CSRS employees
   b. Allows employees to put up to 10 percent of their pay into another tax-deferred account that will earn interest
   c. The opportunity is that the maximum contribution is 10 percent of lifetime compensation and contributions do not have to be made by payroll deduction. The employee can write a check to the plan.
   d. The contributions are made on an after-tax basis. Earnings can be transferred into a Thrift Savings Plan at any time and the remaining after-tax contributions can be transferred into a Roth IRA with no tax consequences.

4. Retirement age
   a. Can retire at age 55 if you have at least 30 years of service
   b. Can retire at age 60 if you have at least 20 years of service
   c. Can retire at age 62 if you have at least 5 years of service
   d. No early retirement reduction in pension benefits

5. Distribution options
Sources of Retirement Income

a. Single life annuities and survivor options for married participants are exactly the same as they are for FERS.

b. No lump sum option except for voluntary contributions

LO 11-3-4: Advise clients regarding their opportunities under the Thrift Savings Plan

1. Thrift Savings Plan (TSP) overview (Video: How Does the Federal Thrift Savings Plan Work? Littell, Cermak)
   a. Tax implications and contribution limits are the same as in a 401(k) plan.
   b. As of May 2012, participants have the right to make a Roth election on their salary deferrals.
   c. Effective October 2012 for military

2. Investment options are much more limited.
   a. Only five options
   b. Expenses are very low—expense ratio of 25 percent
   c. Ability to borrow up to $50,000 or half of one’s vested account balance

3. Up to a 5 percent contribution for FERS employees, but none for Military and CSRS employees
   a. 1 percent nonelective contribution for all employees
   b. 100 percent match for the next 3 percent
   c. 50 percent match on next 2 percent contributed

4. Types of investment options
   a. C Fund – S&P 500 index
   b. S Fund – Wilshire 4500 index
   c. I Fund – EAFE international index
   d. F Fund – Bond index
   e. G Fund – Savings account
   f. Life-cycle funds are available from L income to L 2020, L 2030, etc.
      (1) Funds available for 10-year periods (mutual fund companies often have funds for 5-year periods)
      (2) Life-cycle funds are a combination of the other five investment options.
   g. Some options commonly available elsewhere are not available.
      (1) No real estate option
      (2) No actively managed funds

5. Distribution options
   a. Full range of lump sum and annuity options
b. Participants can choose to leave even a small balance in Thrift Savings Plan—there are no involuntary cash outs for small balances.

c. Benefits can be rolled into an IRA—Roth elections are rolled to a Roth IRA

d. Have the option of buying an annuity directly through the federal government program
   (1) Annuity options can be single life, joint with spouse, joint with other than spouse, increasing payments (adjusted for inflation with a cap of 3 percent), cash refund, or 10-year refund.
   (2) Planning Point: It may be possible to obtain better annuity rates outside of the plan.

LO 11-3-5: Advise long-term retiring military personnel about their retirement pay options

   a. Regular army individuals are entitled to retirement pay after 20 years of service.
   b. Military retired pay can actually begin as early as after 15 years of service in limited circumstances—but in most cases 20 years of service is required.
   c. Those that retire after 20 years are eligible immediately for lifetime retiree pay.
   d. Methods for calculating retired pay
      (1) People hired before September 1980—at 20 years, 50 percent of active duty pay on their last day of service
      (2) People hired after September 1980—50 percent of the average highest 3 years of salary
   e. Cost of living increases
      (1) Normally CPI minus 1 percent
      (2) Decided each year by Congress

2. Are benefits the same for all branches of the military?
   a. Benefits are the same for each branch of the military.
   b. Regardless of the branch of service, reservists receive a different pension formula and benefits are only available at age 60.

3. Planning issues with the survivor benefit plan
   a. Spousal survival benefits
      (1) When a married individual retires from the military, spousal consent is required to waive spousal retirement continuation benefits.
      (2) If enrolled, the benefit to a surviving spouse is 55 percent of the retiree’s pension.
      (3) The cost is 6.5 percent of the retired pay, but it is paid with pre-tax dollars (reducing the after-tax cost).
Sources of Retirement Income

(4) The cost of the spousal benefit is very competitive for those in their 40s and world beating for a retiree in their 60s.

b. Spouse and child benefit
   (1) If the surviving spouse dies and the children are under age 18, or 22 if in college, they would continue to receive the benefit until they are 22.
   (2) Costs only a few dollars more a month than the spouse only option—so everyone with minor children should consider electing this option

c. Child only
   (1) When both spouses are active duty and there is less of a need to protect the spouse than there is to protect the child
   (2) Child benefit invaluable for a disabled child, as the benefits would last for the rest of the child’s life (available at a low cost)

d. Insurable interest
   (1) Someone dependent upon you other than a spouse or child
   (2) Example: Caring for a grandchild
   (3) Cost would be determined by the age of the dependent

4. Planning considerations concerning when to retire
   a. Must have 3 years at current pay grade for the current salary to count—this means that choosing a retirement date needs to consider this issue to maximize benefits.
   b. For those that work more than 20 years, retiree pay increases 2.5 percent for each additional year of service (prorated per month).
   c. Retirement decisions should consider marketability for another job.
      (1) May want to leave at a younger age to appear more attractive to another employer
      (2) If the individual has limited marketability, remaining in the military, building additional retiree pay may be the best course of action.
      (3) Someone considering a move from military service to the federal government should consider staying on active duty as long as possible—if maximizing pension benefits is a key consideration.

LO 11-3-6: Identify when retiring military personnel are entitled to disability benefits

1. What disability benefits are available to military personnel? (Video: What Disability Benefits are U.S. Military Personnel Entitled to? Littell, Cermak)
   a. Continue to receive pay while status is being considered
   b. People who are medically retired can receive retirement pay.
c. Generally active duty military cannot purchase disability insurance (exception for some active duty physicians).

d. Upon military retirement, retirees are evaluated to determine whether they are eligible for Veteran's Administration disability income which is in addition to retiree pay.

  (1) Can be medically retired before 20 years of service and receive retiree pay and disability pay
  (2) VA disability ratings are determined based on what has happened to one's health while on active duty.
    (a) They receive a rating of 0 percent disabled to 100 percent disabled based on that review.
    (b) If less than 50 percent disabled, then some portion of retiree pay is tax-free.
    (c) If 50 percent disabled or greater, you are eligible for concurrent receipt—no deduction from military retired pay.
    (d) Disabled receive additional tax-free, inflation-adjusted payments
    (e) No survivor benefit option
  (3) A lot of people are eligible for a lot more VA disability benefits than they think they are.
    (a) Can receive 50 percent VA disability for sleep apnea
    (b) Planning Point: Everyone should file for military disability because of the potential benefits.
  (4) Consider life insurance protection for surviving spouse since these benefits are not payable to a surviving spouse.

e. One-time determination of disability—generally future status does not affect benefits (VA disability rating can be changed under some circumstances)

f. Benefits can increase if more problems arise that can be traced back to when they were on active duty.

g. Insurance applications ask about disability income from any source.
  (1) May need to provide reasons for VA disability
  (2) Supply copy of VA determination letter which will explain the reasons for the disability pay
  (3) Issues such as hearing loss will not affect the purchase of life insurance.

LO 11-3-7: Understand nonpension military benefits that can improve retirement security

1. Survivor Benefit Plan (Video: What Are Other Benefits Available to the Military That Can Affect Retirement Security? Littell, Cermak)
   a. Costs 6.5 percent of retired pay in order to buy it
   b. Provides a benefit of 55 percent of the retiree’s income for the surviving spouse
   c. Because it is not age dependent:
Sources of Retirement Income

(1) The younger you are, the less competitive it is with commercial insurance.
(2) The older you are, the more competitive it is with commercial insurance.

d. Survivor benefit is more valuable for older retirees and those that are uninsurable.

e. Complicating factors in determining whether it is always the right answer or just usually the right answer:
   (1) Scenarios would be dependent upon the overall financial needs of the family, the presence of children who need to be protected in the event of the death of both spouses, and the relative life expectancies of the two spouses.
   (2) Example: If the military retiree has a considerably longer life expectancy than the spouse, the chances are good that SBP will not pay out any benefits. With commercial insurance, someone will receive the death benefit.

f. Optional disenrollment period from SBP
   (1) Only between 24–36 months after leaving active duty
   (2) Withdrawal is an irrevocable decision.

g. If you take SBP as a retiring military member, and your spouse dies and you remarry, you have the option of enrolling your new spouse in the SBP as long as it is done within one year of the wedding date.

2. Veteran’s Group Life Insurance
   a. After retirement from the service, the Serviceman’s Group Life Insurance is free for four months (120 days) before it expires.
      (1) Military member pays $27 a month for $400,000 of coverage.
   b. During that time, there is an open enrollment period for Veteran’s Group Life Insurance.
      (1) Can be signed up for without proving insurability
      (2) Can get up to $400,000 of coverage
      (3) Cost is a 5-year renewable term that is not particularly competitive with commercial term insurance
   c. Sign up for Veteran’s Group Life Insurance as a placeholder until they get a job that has an open enrollment period

3. GI Bill transferability provisions for children
   a. Anyone on active duty after 9/11 with children born before they retire from service has the option to transfer their GI Bill benefits to a spouse or children.
      (1) Four years of education for the price that is equal to the average cost of a public school
      (2) Equals out to be somewhere in the range of $80,000 of tax-free money
   b. Example: A military retiree has a 5-year-old son and plans on putting him in a public college. The GI Bill will cover just about all of that.
SECTION 4: PLANNING FOR BUSINESS OWNERS

LO 11-4-1: Determine ways to maximize the value of a business and identify other retirement planning strategies for small business owners

1. Small business owners have trouble planning for retirement. (Video: How Does the Sale of the Business Factor into the Retirement Planning of the Small Business Owner? Littell, Kurlowicz)
   a. Concentrating solely on building the business—plowing both financial capital and human capital into the business
   b. Not thinking about transitioning into retirement
      (1) Have difficulty envisioning life different today
      (2) Have had no time to build other interests, hobbies, or other ways to spend time in retirement
   c. Also, they do not have the mindset of reaping rewards through the sale of the business or other transition.

2. Building a succession plan
   a. Planning for the dissolution or exit strategy should be considered as you are choosing the legal entity, business partners, and building the business structure.
   b. Having a succession plan in place is critical.
      (1) Do you have the right people to take over?
      (2) Are they ready to take over?
      (3) Is there a funding mechanism?
      (4) Planning early is critical, but it is uncommon.
      (5) Early planning requires having the right advisors. However, there is a limited number of succession planning experts.

3. Valuing the business
   a. Begin with an appraisal of the business
      (1) Owners resist because of the cost.
      (2) The transfer process cannot begin without an appraisal.
      (3) Owners sometimes underestimate the value of the business—an appraisal helps the advisor.
   b. Buy-sell agreements
      (1) Specify how the value will be determined
      (2) What events trigger the sale (retirement, death, disability, divorce)?

4. Protection of assets and income
Sources of Retirement Income

a. Work with a risk management expert to identify risks and identify gaps in protection, and consider transferring the risk

b. The type of entity can (in some cases) protect the owner.
   (1) The type of legal entity does not protect the professional against personal malpractice suits.
   (2) Must be concerned about protection even many years after practice stops

c. Asset protection
   (1) Homestead protection in some states creates asset protection for the family home.
   (2) Titling assets—asset protection trust
   (3) Qualified plan assets have the best protection.

d. Business insurance
   (1) Protect property (fire, theft)
   (2) Personal liability

5. Qualified plans
   a. There is a cost for covering other employees.
   b. Profit-sharing plans
      (1) Offer the flexibility to make discretionary contributions
      (2) The lack of a contribution requirement may be a disincentive to be prudent and contribute to the plan.
   c. It is important to take advantage of tax deductions.
   d. Asset protection is a key benefit for the small business owner.
   e. Work with a qualified specialist to get the proper plan design.
      (1) Helps to ensure compliance
      (2) Some plan designs can limit the cost for rank and file employees.
   f. Only a small percentage of small businesses establish plans.

6. Ways to generate income from the business
   a. Installment sale through a self-cancelling note
   b. ESOPs can be used for buyouts.
   c. Corporations may be able to provide nonqualified deferred compensation.
   d. Payments for consulting after the sale or agreeing not to compete
   e. Planning Point: Installment sales and other deferred payment strategies require that the subsequent owners are successful in the business.

7. Conclusion
HS 354 Outline

LO 11-4-2: Choosing a tax-advantaged retirement plan for a small business

1. Reasons that a business owner may establish a retirement plan
   a. Employees complicate the retirement plan landscape a great deal. Plans have to meet coverage requirements, provide information to participants, and the plans are subject to ERISA and its rules regarding fiduciary responsibility. Before discussing these complications, let’s first talk about why small businesses need tax-advantaged plans.
   b. Owners of small businesses typically are self-made high achievers who may feel psychologically compelled to reinvest money in the business. However, putting everything in the business is like owning one stock. It is more prudent to set aside a separate fund to meet retirement needs as many things can happen to the value of the business.
   c. Business owners, like others, will want to take advantage of saving on a tax-deferred or tax-exempt basis.
   d. The higher an individual’s income, the lower the replacement rate provided by Social Security and more private savings required.
   e. Creditor protection
      (1) The Bankruptcy Abuse Protection and Consumer Protection Act of 2005 provided sweeping bankruptcy creditor protection for all types of tax-advantaged plans.
      (2) Outside of federal bankruptcy—for example, under an enforcement proceeding—creditor protection is broad but not quite as fool proof.
      (3) If asset protection is a key consideration, it is important to discuss the issue with an attorney so that the client fully understands the nuances and some of the state-specific rules involved.

2. Reasons for a competitive employee retirement plan
   a. Attract and retain good employees
   b. Compete for quality employees
   c. Compensation package that motivates employees
   d. A plan for turning over the work force

3. Business owners' concerns about establishing tax-advantaged retirement plans
Sources of Retirement Income

a. Maximum contribution for owner
   (1) Defined-contribution plan—lesser of $50,000 (2012) or 100 percent of compensation
   (2) Defined-benefit plan—the amount needed to fund a $200,000 (2012) life annuity beginning at age 65 in a defined-benefit plan

b. Cost of covering employees
   (1) All tax-advantaged retirement plans have coverage requirements.
   (2) To cover, the owner must cover at least some of the rank and file employees.
   (3) Example: Based on the plan design selected, half of the contribution benefits the owner and the rest benefits the other employees.
      (a) One owner may look at this as a cost of doing business and the plan as a valuable part of the employee compensation package that helps attract and retain good employees.
      (b) Another owner may see this as an additional cost of saving for him or herself. For this individual, saving on an after-tax basis, even at a 35 percent tax rate, may look like the cheaper option.

c. Contribution flexibility

d. Administrative complexity
   (1) The per-employee cost will be higher for small plans as the complex IRS and DOL rules apply to small and large companies alike.
   (2) Small businesses have limited resources and time spent by the owner dealing with administrative headaches may take time away from building the business.
   (3) Retirement plans are complex and if responsibilities are not clearly identified and addressed, IRS deadlines can be missed, employees can become annoyed, and in the worst case create added stress, penalty taxes, and even employee lawsuits.

e. Fiduciary responsibility
   (1) The owner or owners may act as trustees and/or as the plan administrator and can be personally liable for failing to meet fiduciary responsibility.
   (2) Owners are not trained to meet these roles and need advisors who can help them navigate the landscape.

4. Cost of covering employees
   a. Appreciate value of covering employees
   b. Limiting coverage as allowed by law
   c. Vesting provisions can reduce costs as some participants will not be fully vested.
      (1) 401(k) salary deferrals for the owner have no direct cost to the owner (however, a plan has to satisfy nondiscrimination rules).
(2) SIMPLE salary deferrals for the owner have no direct cost (SIMPLEs are not subject to nondiscrimination rules).

(3) Cross-tested profit-sharing plan allows for larger contributions for older, more highly compensated employees than for younger employees.

(4) Defined-benefit plans also allow larger contributions for older employees.

5. Contribution flexibility
   a. Profit-sharing plan—the company has almost complete discretion in how much to contribute each year as long as the amount does not exceed the maximum deductible contribution limit.
   b. SEP—has the same flexibility and maximum contributions as a profit-sharing plan
   c. 401(k) plan
      (1) Nonelective contributions—profit-sharing contributions subject to the same flexibility
      (2) Matching contributions—even these can be made on a discretionary basis
   d. Defined-benefit plans have some funding flexibility
      (1) Contributions must satisfy the minimum required contribution.
      (2) Contributions cannot exceed the maximum deductible contribution limit.

6. Administrative complexity
   a. IRA funded plans (SEP and SIMPLE)—plans funded with IRAs, which include the SEP and the SIMPLE, are much easier to administer as there is no annual reporting requirement, fewer requirements when participants are paid out, and no ongoing trust fund management or liquidation when plan termination occurs.
   b. Profit-sharing plans are relatively simple to administer.
   c. A 401(k) plan is more complex because of the accounting requirements, additional nondiscrimination testing, and quarterly benefit statements.
   d. Defined-benefit plans are often considered the most complex as they require the services of an actuary who must determine whether the funding requirements are being satisfied.
   e. Third party support
      (1) What also affects administrative complexity from the employer’s perspective is whether they have the proper help.
      (2) For a fee, most if not all responsibility can be delegated to third parties—but still there is a wide range in the quality of administrative services provided.
      (3) It is key to have a quarterback in the administrative process that makes sure that roles and responsibilities are clearly identified. Successful administration can be bundled or unbundled as long as someone is taking that quarterback role.

7. Fiduciary responsibility
a. Managing fiduciary responsibility begins by understanding which employees will be considered fiduciaries. Generally, the small business owner will be one because he or she is both the trustee of the plan and acts as the administrator. Other employees may have these roles as well.

b. As with administration, third parties can be hired to help. In some cases, the owners retain the fiduciary roles while the financial advisor helps them understand and navigate their responsibilities. In other cases, third parties take on the fiduciary roles, which include plan administrator, trustee, or making investment decisions about part or all of the plan's assets.

c. In 401(k) plans, it is common to give participants investment direction. If certain requirements are satisfied, under ERISA Section 404(c), the participants and not the fiduciaries are responsible for the investment decisions. It is important to understand that navigating the exception is not that easy and that ERISA 404(c) does not completely relieve the fiduciary from all responsibility.

d. The small business owner can also purchase insurance to provide coverage for negligent acts that may result in fiduciary liability. As we mentioned, fiduciaries are personally liable and insurance coverage is prudent.

8. Choosing a plan

a. What is the objective?
   (1) Maximize contribution for business owner and minimize cost for covering other employees
   (2) Employee benefit plan

b. What is the budget?

c. What is the makeup of the employee census?

d. Are there any related employers?

9. SEP

a. Advantages
   (1) The SEP is flexible because contributions are discretionary and the employer can choose how much to contribute each year.
   (2) A SEP is much easier to set up and administer than a qualified plan.
   (3) The maximum contribution for the business owner cannot exceed Code Sec. 415(c) limit which is the lesser of 100 percent of compensation or $50,000 (2012). Total contributions for all employees cannot exceed 25 percent of covered payroll. If the entity is unincorporated, the maximum contribution for the owner is somewhat less—20 percent of net adjusted self-employment income.

b. Disadvantages
   (1) Contributions must be fully vested at all times so there can be no savings for early terminations.
   (2) The plan's allocation formula must either be allocated to participants as a level percentage of compensation or be a formula integrated with Social Security. For example, with a level allocation, if the
owner wants to contribute 15 percent on his or her own behalf, 15 percent has to be contributed for all other eligible employees as well.

(a) Example: If the employer wants to contribute $50,000 for the owner and the owner earns $250,000 or more, with a level percentage formula, the employer would have to contribute 20 percent of compensation.

(3) The plan must cover even part-time employees who have earned a minimal amount ($550) a year for three out of the previous five years and have attained age 21. All eligible employees must be covered. No one who is eligible can be excluded.

10. Profit-sharing

a. Advantages

(1) Same contribution flexibility and maximum contribution rules as a SEP

(2) A plan's allocation formula is more flexible than a SEP. Contributions can be allocated on a cross-tested basis so as to limit the cost of providing benefits for the rank and file employees.

(a) Example: With the cross-tested allocation formula and the right employee census, it may be possible to make a $50,000 contribution (as indexed for 2012) for the business owner while limiting the contribution for other covered employees to 5 percent of compensation.

(b) Coverage requirements do allow for the exclusion of some employees.

(c) Deferred vesting schedules reduce cost somewhat.

b. Disadvantage—more administrative complexity than a SEP, resulting in more cost and time. A plan that uses the cross-tested approach does require more expertise by the advisor and usually adds some additional expense.

11. Qualified plan coverage

a. Employees who can always be excluded from the plan include:

(1) Employees with less than one year of service

(2) Employees who have not yet attained age 21

(3) Employees working less than 1,000 hours a year

b. Annually, a plan has to satisfy one of three coverage tests:

(1) Ratio test

(2) Percentage test

(3) Average benefits test

12. Ratio test

a. The ratio test is the most flexible as the plan must cover a minimum percentage of nonhighly compensated employees that equals 70 percent of the percentage of highly compensated employees covered under the plan.
b. *Example:* The law firm of Sherman and Douglas covers four of the eight (50 percent) of its highly compensated employees. To qualify under the ratio test, the plan must cover 35 percent of its nonhighly compensated employees, that is, 70 percent multiplied by 50 percent.

13. **Coverage options**

a. It is common for a plan to exclude the employees that do not have to be counted. These are employees under age 21, those with less than a year of service, and part-time employees working fewer than 1,000 hours a year.

b. The employer trying to reduce the cost of covering employees may very well want to exclude additional employees. Under the ratio test, we know that we could exclude an additional 30 percent of the nonhighly compensated employees or more if some of the highly compensated employees are not covered. In practice, when doing this, you would identify a job classification to exclude. For example, hourly employees or associates in a law firm.

c. The coverage rules do not protect highly compensated employees and any number of the highly compensated can also be excluded, which lowers the percentage of the nonhighly compensated employees that have to be covered. Take a small medical practice with two doctors. The younger one wants more cash and is willing to be excluded from the plan. This means that only 35 percent of the nonhighly compensated have to be covered.

14. **401(k)**

a. The owner can contribute a salary deferral contribution of $17,000 (as indexed for 2012) without having to make contributions for the other participants.

b. If the owner has attained age 50, an additional catch-up contribution of $5,500 is also allowed.

c. The plan can give participants the option to contribute salary deferrals on a pretax basis or make a Roth election.

d. Salary deferral contributions are not entirely free of cost because in order for the owner or other highly compensated employees to make maximum salary deferrals, the plan must satisfy the ADP nondiscrimination test. This will typically require that a matching contribution be made to encourage the nonhighly compensated employees to make salary deferral contributions. As an alternative, the employer can elect to make a safe-harbor contribution, which eliminates the need to perform the ADP test.

e. Plans can also allow for nonelective profit-sharing contributions for all employees.

15. **401(k) example**

a. Ryan and Susan are physical therapists who each earn $100,000 per year.

b. They run a practice with six other young employees who are not that concerned about pension benefits.

c. Ryan and Susan establish a 401(k) profit-sharing plan. Each makes salary deferral contributions of $17,000 (the maximum salary deferral for 2012).

d. In order to avoid problems with the ADP test, they decide to make a matching safe-harbor contribution which requires a 100 percent match on the first 3 percent of salary deferred and a 50 percent match.
on the next 2 percent of salary deferred. This requires a 4 percent of compensation contribution for everyone who makes the minimum salary deferral. In this case, Ryan and Susan each get an additional 4 percent of compensation ($4,000) for a total allocation of $21,000.

e. The only cost is the matching contribution for the one other employee who makes a salary deferral contribution.

f. If Ryan and Susan want to make additional contributions, this is accomplished as a profit-sharing contribution and an allocation formula is chosen.

16. SIMPLE

a. The employer with a small benefit budget that wants to allow employee salary deferrals may want to establish a SIMPLE IRA instead of the 401(k) plan. Establishing and maintaining a SIMPLE is considerably less complicated than a 401(k) plan. The SIMPLE is also preferable if the employer expects to have difficulty satisfying the ADP nondiscrimination test.

b. The 401(k) plan is better for maximizing contributions and directing employer contributions to a targeted group of employees, which are typically two common goals of small plan sponsors. In addition, a 401(k) plan is much more flexible than a SIMPLE. The 401(k) plan can be limited to part of the workforce as long as the minimum coverage requirements are met and matching and profit-sharing contributions can be designed to meet a variety of goals. Finally, employer contributions can increase or decrease over time.

c. The SIMPLE is still a great plan for the vast number of small employers who have not previously sponsored a retirement plan. The barriers to entry are much lower, the administrative expense and burden is minimal, and the employer contribution amount by law is modest.

d. Example: Ryan and Susan in the example above may decide to establish a SIMPLE IRA. Remember they earn $100,000 each and their other six young employees are not that concerned about pension benefits. Assuming that Ryan and Susan do not have that much to put away, they can establish a SIMPLE and each can make salary deferral contributions of up to $11,500 (in 2012). They can also make the 3 percent matching contribution for themselves and anyone else that chooses to participate. If they later want the flexibility of the 401(k) plan, they can simply stop making contributions to the SIMPLE and set up a 401(k) plan.

17. Defined-benefit

a. Small businesses do not typically choose defined-benefit plans because of the administrative expense and complexity. However, there is definitely a niche for the defined-benefit plan in the small plan market.

b. When a business owner wants to contribute more than the maximum $50,000 defined-contribution limit to a plan (as indexed for 2012), the only option is the defined-benefit plan. How much can be contributed is based on the participant's age, the benefit formula, and the actuarial assumptions used. The small business owner who is in his or her 40s or 50s, who has not accumulated enough pension assets, who currently has the ability to make large contributions, and who is looking for a significant tax deduction may be a candidate for a defined-benefit plan.
c.  *Planning Point:* If you know someone in this situation, the best strategy will be to involve a consulting actuary to provide a study on the costs and benefits of establishing a defined-benefit plan as compared with other approaches.

d.  Small business owners can set up a plan with the traditional defined-benefit structure or may also choose the benefit structure of a cash-balance arrangement.

**SECTION 5: OTHER APPROACHES**

LO 11-5-1: How can an advisor evaluate nontraditional approaches to retirement planning

1.  Many people have incorporated nontraditional elements into their retirement plans. (Video: *What are Some Out-of-the-Box Methods That People Choose to Prepare for Retirement and How Can Those Strategies be Incorporated into a Retirement Plan?* Littell, Lemoine, Okumura)
   a.  Vacation home, house at the lake, ranch
   b.  Collectibles such as coin collections

2.  Motivation may be tied to the multiple uses of the asset (e.g., vacation home brings pleasure today and housing in retirement).

3.  Fact-finding
   a.  Understanding the nonfinancial reasons for the asset or strategy
   b.  Understanding how the asset fits into the retirement plan (e.g., planning to sell the principal residence and moving into the vacation home in retirement)
   c.  Identifying the costs of maintaining the investment (e.g., vacation condo has property taxes, association fees, etc.)

4.  What are the issues involved in evaluating the financial impact (rate of return) of these nontraditional strategies?
   a.  Identifying an appropriate way for valuing the property
   b.  Probability of whether the asset is actually going to be used to fund retirement
      (1)  *Example:* A coin collection may be seen as an investment—but will the client actually be willing to sell it?
      (2)  *Example:* The family may have two homes—selling one makes financial sense but the home has emotional attachment for at least one family member.
      (3)  *Planning Point:* A good question to ask a client about whether an asset is likely to be sold is “Who has veto power over the sale of the property?”
   c.  Evaluating the projected rate of return on the property
(1) Be sure to factor any costs associated in maintaining the property.
(2) What are reasonable expectations about property appreciation?

5. Other financial considerations
   a. Diversification
      (1) Between asset classes
      (2) Within asset class
   b. Consider liquidity—will there be a ready market for the property?
   c. What is the value of the nonfinancial reasons for maintaining the investment?

6. Other planning considerations
   a. A strategy may not be evaluated because of a lack of expertise by the advisor.
   b. A strategy may not be evaluated because the client does not come to the financial advisor.

7. Review of the process for evaluating nontraditional approaches
   a. Fact-finding
      (1) Nonfinancial reasons for the approach
         (a) Example: Vacation home provides recreation and a place to spend time with adult children and grandchildren.
      (2) Identifying the cost or current value of the asset
      (3) How it fits into the retirement plan
         (a) Example: The client’s plan is to sell the antique car collection at age 65 when the family is retiring to Florida.
      (4) Identifying the costs of maintaining the investment
         (a) Example: With real property, identify property taxes and other expenses of ownership.
   b. Return on investment
      (1) What is the current and future value?
         (a) It may be difficult to find a qualified person to perform an appraisal.
         (b) It may be difficult to determine the likelihood of appreciation.
         (c) There is always the issue of whether there will be a market for the asset when it is time to sell it.
      (2) What is the probability that the asset is actually going to be used to fund retirement needs?
      (3) What is the cost of the investment?
      (4) Can the property be sold quickly?
      (5) What are the tax implications of a sale?
   c. Other financial considerations
Sources of Retirement Income

(1) Diversification
   (a) What is the percentage of total wealth that is held in the investment class?
   (b) How much diversification within the investment class?
   (c) Example: With a vacation home, there is the question about how much of total wealth is now in real estate and the fact that the real estate investment is tied up in one or two investments.

(2) Value of the nonfinancial reasons
   (a) Nonfinancial reasons may outweigh modest return on investment.
   (b) Investment could also result in a type of forced savings—like paying off a mortgage or investing in additional coins over time.

d. Comprehensive planning
   (1) The more you know about the client’s situation, the better the planning.
      (a) One of the main reasons for this learning objective is to help advisors to think as broadly about retirement planning as their clients do so the client’s entire financial picture can be brought into the planning process.
      (b) Note that the client might have strategies that affect expenses too—for example, planning to relocate or move in with family members.
   (2) A strategy may not be evaluated because of a lack of expertise by the advisor.
      (a) Planning Point: Be sure to have a good network of related professionals.
      (b) Be sure to ask enough questions—the client may not think about talking about the issue with the advisor.

RESOURCES FOR COMPETENCY 11: EVALUATING OTHER SOURCES OF RETIREMENT INCOME

For more information on these topics, please visit:

- The IRS has an internet tool to help employers choose and design a retirement plan. It also provides information about staying in compliance with the rules. Check it out here.
- Here is an IRS archived webinar on easy, low cost ways to start a small business retirement plan.
Competency 12

Building a Retirement Portfolio
SECTION 1: PORTFOLIO BUILDING BLOCKS

LO 12-1-1: Understand how risk tolerance affects the planner’s options to allocate assets

1. Definition of portfolio risk
   a. Volatility of the returns generated by a portfolio of assets over time
   b. Measured by standard deviation
   c. Risk tolerance is determined by:
      (1) Ability to take risk
      (2) Willingness to take risk

2. Factors affecting one's ability to take risk
   a. Importance of attaining a desired level of retirement income
      (1) Example: Ryan and Tom
         (a) Ryan desires to use investments to only meet basic living expenses.
         (b) Tom desires to use investments to not only meet basic living expenses, but also to provide for luxury spending. Tom enjoys taking a week-long ski trip every year.
         (c) Ryan is not able to tolerate as much risk as Tom because the dissatisfaction he will endure from a given shortfall in retirement income is less than that which Tom will endure.
         (d) If the retirement income stream for both investors ends up being $10 per month less than expected, Ryan may not be able to eat dinner one day a month while Tom will only have to sacrifice one day a year on the ski slope.
      b. This relationship between spending levels and satisfaction is illustrated with the concept of a utility function. (Video: SmartBoard Presentation: Nanigian)
         (1) Utility curves illustrate that utility (satisfaction) increases with additional spending but at a decreasing rate.
         (2) This can be illustrated with the Tom and Ryan example above. Tom's consumption level is much higher on the utility curve than Ryan's. You can see that if there is a loss of consumption, the amount of disutility (loss of satisfaction) is less for Tom than for Ryan.
   c. Length of time horizon
      (1) Another determinant of a client's ability to take risk is the length of his or her time horizon.
      (2) All else held constant, the greater the number of years until retirement, the greater a client's ability to take risk.
      (3) This is mainly because younger clients will not have to suffer as great a reduction in their consumption (or increase in their allocation of time to work) during their working years as older clients will in
order to sustain a desired level of consumption during retirement if they incur a major decrease in the value of their portfolio.

(4) This can be illustrated in the table showing how much of a reduction in consumption (additional amount that would be needed to saved) if an individual has a $100,000 retirement need shortfall, a 5 percent return on assets, and is to retire at age 65. As you can see on the table, if you were aware of the shortfall at an early age (unexpected loss to the portfolio, for example) the additional amount needed to save each year (reduction in consumption) to make up for this event would be quite modest. However, if the shortfall occurs quite close to retirement, the additional amount needed to be saved spikes considerably.

3. Factors affecting one’s willingness to take risk
   a. Often estimated through the use of questionnaires
   b. Observations of the client’s prior financial decisions are also used
      (1) Investment experience
         (a) Example: Clients with significant experience investing in risky assets, who do not change their portfolio allocations much over time and who are not emotionally disturbed by fluctuations in the value of their portfolio, tend to be more risk tolerant.
      (2) Insurance coverage
         (a) Example: Clients who want to insure against any possible loss and those who hold insurance policies with high levels of coverage tend to be less risk tolerant.

LO 12-1-2: Understand how to minimize portfolio risk

1. Market risk
   a. Affects the entire market
HS 354 Outline

b. Cannot be eliminated through diversifying one's portfolio

2. Diversifiable risk
   a. Affects the risk of an individual security
   b. As implied by its name, it can be eliminated through the process of diversification.
   c. Comprised of:
      (1) Industry risk
      (2) Company-specific risks
         (a) Legal risk
         (b) Actuarial risk
         (c) Corporate strategy risk

3. Risk is typically measured by the standard deviation of an asset's time series of returns.
   a. Standard deviation measures the average deviation from the mean.

4. Benefits of diversifying away company-specific risks
   a. The portfolio generally decreases with the number of stocks in the portfolio.
   b. Portfolio risk can be further reduced through diversifying across industries.
   c. Just as risk decreases with the number of companies in an industry portfolio, risk also decreases with the number of industries in a total risky asset portfolio.

LO 12-1-3: Analyze the implications of modern portfolio theory (MPT) on retirement investing

1. The benefit of MPT optimization
   a. The importance of diversification was discussed in the previous learning objective.
   b. In the example, each asset was equally weighted.
   c. Diversifying by allocating capital equally to each of the assets under consideration ignores how the returns on assets move together over time.
   d. Modern Portfolio Theory (MPT), developed by Nobel laureate Harry Markowitz¹, provides a superior method of constructing an investment portfolio through accounting for the correlation structure of asset returns.
   e. The correlation structure quantifies the comovement between each asset in a portfolio.
   f. There are often high correlations between stocks within an industry and lower correlations between stocks of different industries.

(1) *Example:* The correlation between two life insurance company stocks is likely to be high.

(2) *Example:* The correlation between a life insurance company stock and a funeral home stock is likely to be low.

2. MPT optimization
   a. Inputs in MPT optimization
      (1) Expected average return on each risky asset considered for inclusion
      (2) Expected standard deviation of each of the associated return series
      (3) Expected correlation between each asset’s return series
   b. Since predicting future values of these characteristics is extremely difficult (if not impossible), historical values are often used instead by practitioners.

3. The general process of MPT optimization
   a. An algorithm is then run on a computer which, through an iterative process, constructs portfolios of various asset mixes.
   b. The ultimate objective of MPT optimization is to find the one portfolio that offers the highest rate of return per unit of risk.
      (1) This, of course, is also the portfolio that offers the lowest level of risk per unit of return.
      (2) Also referred to as the optimal risky portfolio
   c. This concept is illustrated in the graph titled “mean-variance space.” With the average (mean) return on the Y axis and the standard deviation on the X axis, clearly the optimal risky portfolio dominates the portfolio with equal levels of exposure to each industry.

4. Derive utility given a level of portfolio return, standard deviation, and risk aversion
   a. Because investors differ in terms of their tolerance for risk, the optimal risky portfolio is rarely the optimal household portfolio.
b. The optimal household portfolio is comprised of both a risk-free asset and the optimal risky portfolio.

c. It should be noted that a 90-day treasury bill is often used to represent the risk-free asset, although this practice is often criticized.

5. Derive optimal capital allocation between risky and risk-free assets

a. Because the utility functions of individual investors are not directly observable by the financial planner, determining one's optimal household portfolio is a challenging task.

b. However, many believe that the equation below is a reasonable approximation:

   \[ \text{Utility} = \text{Expected Return} - \left[ \frac{1}{2} \times (\text{Standard Deviation} \times \text{Standard Deviation}) \times \text{Level of Risk Aversion} \right] \]

c. The following equation should be used to determine how much capital to allocate to the optimal risky portfolio:

   \[ \text{Weight to Optimal Risky Portfolio} = \frac{\text{Expected Return on Optimal Risky Portfolio} - \text{Expected Return on Risk-Free Asset}}{\left[ \text{Standard Deviation} \times \text{Standard Deviation} \right] \times \text{Level of Risk Aversion}} \]

d. The remainder of one's capital should be allocated to the risk-free asset.

e. Note that rates of return and standard deviations should be provided in decimal form as opposed to percentages.

LO 12-1-4: What is tactical asset allocation and why is it popular

1. What is tactical asset allocation and why is it popular? (Video: What is Tactical Asset Allocation and Why is it Popular? Littell, Nanigian, Kitces)

a. Broadly defined, tactical asset allocation is a strategy where asset allocation changes over time based on future market expectations. This can include expectations about:

   (1) Changes in investment returns
   (2) Changes in investment risk
   (3) Changes in correlations between asset classes

b. Focus is on short-term expectations on macroeconomic conditions (shorter than strategic asset allocation time frame—longer than market timing).

c. Strategic asset allocation decisions are built around a longer time frame (maybe 30–40 years) and typically change more often when the client’s goals and objectives change.

2. How does tactical asset allocation fit within modern portfolio theory?

a. Under modern portfolio theory, portfolio construction occurs in two stages:

   (1) Stage 1: Figure out expectations for market returns, risks, and asset correlations.
   (2) Stage 2: Take these expectations and translate them to a concrete allocation of a portfolio.

b. MPT helps determine the appropriate asset allocation in step 2; the user develops the inputs into step 1. So either strategic asset allocation or tactical asset allocation can be relied on to develop the inputs.
(1) Strategic asset allocation focuses on long-term data.
(2) Tactical asset allocation is based on shorter-term expectations such as 1-, 3-, 5-, or 10-year time frames.

3. Why is tactical asset allocation popular today?
   a. Even though stocks have averaged approximately 10 percent over the last 100 years, markets go through extended periods of growth and extended flat periods of returns.
   b. We have seen several long-term bull markets that have lasted from 5 to 25 years. There may be volatility and occasional downturns, but the long-term direction is up.
   c. Markets also have experienced extended flat periods of returns characterized by volatility but no long-term upward movement.
      (1) *Example:* The market showed no growth from 1929 until after WWII and from 1966 to 1980.
   d. In a secular bull market, everyone is making money.
      (1) *Example:* Even those who threw darts and picked stocks performed well in the 1990s. In this market, outperforming others requires taking additional risk.
   e. Secular bear markets require different strategies.
      (1) Pick individual stocks that will thrive and survive the bear market.
      (2) Sector rotation
      (3) Rise in alternative investment classes
      (4) Rise in tactical asset allocation
         (a) Actively managed funds do better in bear markets.
         (b) Risk management techniques can provide value (additional alpha) in a bear market.

4. Why is market valuation a popular indicator for making investment decisions?
   a. Stock valuation provides some of the best information about determining long-term returns.
   b. Stock valuation indicators
      (1) Price earnings ratio—price relative to earnings
      (2) Earnings price ratio—how much does the company earn relative to its price
      (3) Price to book—price relative to book value
   c. *Example:* Stocks purchased with earnings yields below 5 with a P/E over 20 are unlikely to yield good long-term returns, while stocks with earnings yields above 10 and P/E below 10 are more likely to see strong returns.
   d. These characteristics can be overwhelmed in the short-term by bull or bear market trends.

5. What other indicators can be used?
   a. Other valuation metrics such as price to book, price to cash flow, or price to sales
b. Absolute valuation measures—look at the current average stock valuation in relation to historical averages

c. Relative valuation measures—for example, value of large cap stocks as compared to small cap stocks may provide an indication of which type will perform better

d. Macroeconomic analysis—certain sectors perform better based on expectations of where we are in the business cycle
   (1) Expectations in a down economy—certain sectors perform better (often referred to as defensive stocks)
      (a) Health care
      (b) Consumer staples
   (2) Expectations in an expanding economy—as the economy expands these sectors perform better
      (a) Financials
      (b) Discretionary consumer stocks
      (c) Technology stocks
      (d) Industrial and materials sectors

e. Technical analysis—looking at moving averages (longer time horizon than market timing)

f. A combination of valuation, macro analysis, and technical analysis can better inform and direct proper asset allocation.

6. Is tactical asset allocation important during the postretirement period?
   a. Tactical asset allocation techniques apply during both the preretirement and postretirement periods.
   b. During the withdrawal phase, we may appreciate the value of risk management techniques more than the increase in return.
   c. When withdrawals are being made from the portfolio tactical asset allocation, techniques become another factor (in addition to tax efficiency) that can help determine what assets to liquidate and sell.
      (1) Example: Information suggests that exposure to certain sectors should be reduced. Selling stocks from that sector can generate income, and reduce exposure to that sector with minimum transaction costs.
      (2) In this way, tactical planning becomes both an opportunity and an efficiency.
SECTION 2: SELECTED ISSUES IN BUILDING A RETIREMENT PORTFOLIO

LO 12-2-1: Identify how human capital affects savings decisions

   a. A client's most valuable asset is their earning potential.
   b. Human capital is the present value of wages that people earn over the course of their lifetime.
   c. How does human capital apply to a retirement plan?
      (1) For people investing in an education, they are said to be “investing in human capital.”
      (2) The returns to investment in human capital can be high.
      (3) Human capital, over time, has to be converted into financial capital.
      (4) At retirement, there is very little human capital remaining.
      (5) As you approach retirement, you must make sure that the financial capital that you are creating is invested properly to create an appropriate income stream.
   d. Investment categories
      (1) Human capital is analogous to an asset class.
      (2) Human capital is like a bond if one's future earnings are stable, predictable, and are not that impacted by stock market conditions.
         (a) Example: Professors with tenure
      (3) Human capital is like a stock if one will have greater risk of unemployment or lower earnings if the stock market performs poorly.
         (a) Example: Commission-based jobs
   e. One step in determining an appropriate asset allocation is to determine an individual's risk tolerance.
   f. Once risk tolerance has been determined and the appropriate asset allocation has been decided, be sure to consider both financial assets and human capital when applying the asset allocation model.
      (1) Example: After determining that based on risk tolerance and other factors that a 70 percent stock and 30 percent bond asset allocation is appropriate, a professor with a job that is secure and more like a bond may decide to invest 100 percent of financial assets in stocks.
   g. There may be other factors that influence asset allocation.
      (1) As you age, you have less human capital left, so more bonds are needed.
      (2) Risk tolerance may change with age.
      (3) Pensions and annuities should be considered as retirement income sources.
h. Even though these factors are relevant, the main point is that time horizon and risk tolerance are not the only factors. It is also critical to focus on the composition of the job as an asset class.

i. Another example of incorporating the entire personal balance sheet when making investment decisions is with life insurance.
   (1) Human capital = human life value = insurance need
   (2) Take the concept of human life value, and the economist's view of human capital and portfolio theory and bring it all together so that you can talk about life insurance in the same conversation when you talk about diversification.
   (3) Right now the life insurance and investment conversations are separate—they really should be part of one conversation.
   (4) You cannot treat your job as a bond until you have insured it, and you cannot determine your stock/bond allocation until you figure out the value of your human capital.
   (5) The returns from life insurance are perfectly negatively correlated with human capital.
   (6) Other insurance that protects human capital like disability insurance also fits into the picture.

j. Impact of pensions on asset allocation
   (1) Clients with a defined-benefit plan can afford to take more risk in their 401(k) plan, 403(b) plan, or IRA.
   (2) Clients with no defined-benefit plan need to be safer with their investments.

k. How does working during retirement affect human capital?
   (1) Clients will not need to save as much.
   (2) Clients can value their human capital more highly.
   (3) Caveat: The client may not have the ability to capitalize on their human capital in retirement.

2. Problems with employer stock
   a. Shlomo Benartzi, in the Journal of Finance, found that employees allocate about one-third of their defined-contribution plan assets to their employer's stock.
   b. This is a problem because if the company an employee works for fails, the employee will lose both his or her retirement savings as well as his or her job.
   c. Because the returns to human capital are strongly correlated with those on employer stock, it makes sense for employees to seek to minimize their allocation to employer stock.
   d. Employees should also seek to minimize their allocation to stocks of other companies in the same industry as their employer for the same reason.
   e. Benartzi suggests that employees' excessive allocations to employer stock are attributable to familiarity about the company and excessive extrapolation of past stock performance.
f. Planning Point: The financial advisor can enlighten clients about investing in assets that are less highly correlated with human capital.

LO 12-2-2: Understand paying off a mortgage as part of the retirement portfolio

1. Introduction
   a. We will focus here on whether or not to prepay principal on a mortgage before retirement.
   b. We will consider risk, rate of return of various investments, effect of taxes, as well as different types of mortgages.

2. Academic perspective
   a. Modern portfolio theory states that an investor’s portfolio consists of two portions: risky assets and risk-free assets.
   b. The optimal portfolio depends on risk tolerance.
   c. Prepayments of principal are a type of investment.
      1. The payments of principal are the same as investing that money in an investment that pays the same interest rate as the mortgage.
      2. If a homeowner has a fixed rate 6 percent mortgage, then all principal payments have the same effect on the homeowner’s wealth as if this money were used to purchase an investment that paid a fixed rate of 6 percent.
   d. Payments of principal on a fixed rate mortgage are essentially a risk-free rate of return.
      1. There is no default risk associated with this investment and no interest rate risk.
      2. The risk-free, fixed return portion of the portfolio increases and the overall level of risk is reduced.
   e. Payments of principal on an adjustable rate mortgage do have some risk associated with them, as the future interest savings are now somewhat uncertain.
      1. Prepayments on adjustable mortgages still have no default risk.
      2. This is similar to fixed income investments, yet here it is not risk-free.

3. Returns among risk-free investments
   a. One asset commonly identified as a risk-free asset is the 90-day Treasury bill.
   b. As of July 14, 2014, the 90-day Treasury bill rate was at 0.07 percent while the average 30-year fixed rate mortgage rate was at 4.24 percent. Thus it seems that prepayments of principal are a better investment than the 90-day T-bill.
   c. The fixed rate mortgage rate is also higher than those on low risk investments such as savings accounts and CDs, which are around 1 percent.
d. This is essentially the argument for why risk averse individuals should prepay their mortgage: it provides a greater return than other investments that are essentially risk-free.

4. Younger clients
   a. It makes sense for them to take on more risk and thus minimize the portion of their portfolio in risk-free assets.
      1. Most of their wealth is human capital, so the risk of losing their investments has a minimal impact on their overall wealth.
      2. They have the opportunity to rebuild the portfolio should they suffer any financial setbacks.
   b. Younger clients would not usually prepay their mortgage as it will change their allocation towards the risk-free asset.

5. Older clients
   a. They do not always have the luxury of compensating for portfolio losses before they hit retirement.
   b. They cannot afford to take on the same levels of risk as younger clients who have a long period of income accumulation ahead of them.
   c. It usually makes sense for older clients to prepay their mortgage so that they have a larger portion of their portfolio in the risk-free asset.

6. Tax considerations
   a. While there are tax benefits associated with paying off a mortgage during retirement, retirees may be in a low marginal tax bracket since they usually have less taxable income.
   b. There is less need for tax sheltering through itemized deductions.
   c. Additionally, mortgage payments are amortized over time and the payments near the end consist primarily of principal and little interest.
   d. These interest payments may be too small for retirees to make an itemized deduction, especially if they do not have other deductions to make their itemized deductions exceed their standard deductions.
   e. Getting cash to make mortgage payments may require either sale of assets or withdrawals from retirement accounts in order to generate cash.
   f. Sale of assets and withdrawals lead to more taxable income.
   g. This will increase income taxes, increasing the need to generate even more taxable income!

7. Two strategies for prepaying
   a. Prepay by adding principal to your mortgage payments regularly.
   b. Invest what would have been prepayments to earn a greater expected rate of return.
      1. If the average annual rate of return is greater than the mortgage rate, then this strategy has a higher expected value than the first, at least in the absence of any other taxes.
2. In this strategy, the investment fund is accumulated until the point at which the value of these investments is equal to the value of the resulting mortgage. Then, the homeowner can liquidate the investments and pay off the mortgage a lot sooner than simply adding prepayments in regular intervals.

3. This strategy carries considerably more risk than the first.

8. When not to prepay
   a. If the client has a considerable amount of high interest debt, such as consumer debt, it is important to pay off this debt first before worrying about prepaying their mortgage.
   b. Prepaying their mortgage would be a bad idea if the client lacked an emergency fund for retirement. If money is tied up in a mortgage, it is harder to liquidate for emergency expenses than if it is in investment funds.
   c. Prepaying a mortgage is not rational if they are giving up on capturing a company matching contribution on retirement savings. In this case, it is more important to increase their 401(k) in order to capture the matching contribution.

9. When it is more complicated
   a. If the client can earn a better rate on their investments than the mortgage rate, it may be more reasonable for them to hold on to their mortgage and maintain their investments.
      1. There are a number of advisor-focused articles that advocate against prepaying for this reason.
      2. Yet, what is often missed in this conversation is that alternative investments create significant investment risk.
      3. Clients need to decide whether the extra expected return is worth the additional risk.
   b. Even if the investment rate is lower than the mortgage rate, if the client can save on a tax-advantaged basis, they might be better off.
      1. It is important for the client to weigh the rate of return, risk, and tax advantage of both options.
      2. This is discussed in a paper from 2007, which argues that many households could save by keeping money in retirement accounts instead of paying off their mortgage early.

10. Psychological implications
   a. Many people value owning their home free and clear, and have been taught to value this for generations.
   b. It can be stressful to have monthly mortgage payments in retirement.
   c. Paying off a mortgage early provides security and reduces risks, debt, and expenses.
   d. Debt aversion intensifies when clients approach retirement.
   e. Being mortgage free gives clients more freedom of where to spend their money in retirement.

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2 Amromin, Gene “The Tradeoff between Mortgage Prepayments and Tax-Deferred Retirement Savings” March 2007
LO 12-2-3: Choosing a portfolio rebalancing discipline

1. Portfolio rebalancing
   a. Example: Joe has no prior investment experience and wants to start contributing $1,000 per month to a 401(k). After meeting with his stock broker, it was determined that Joe should allocate half of his assets to an index fund tracking the Wilshire 5000 and the other half to a fund tracking the Barclays Capital Aggregate Bond Index. Joe begins putting $500 a month into the stock fund and $500 a month into the bond fund.
   b. The stock allocations have become excessive over time because stocks are expected to generate higher returns than bonds over long time periods.

2. Rebalancing is the ongoing process of adjusting the allocation of one’s portfolio such that it is closely aligned with what is desired.
   a. The benefit of rebalancing is that it keeps the portfolio risk at an appropriate level.
   b. The costs of rebalancing
      (1) Transaction costs
      (2) Tax costs

3. Frequently employed rebalancing disciplines
   a. Calendar rebalancing
      (1) Simplest and most popular discipline
      (2) Planner will examine the asset class exposures in the portfolio at a specific frequency, and upon examination buy and sell securities such that the desired asset class exposures are attained
   b. Percentage-of-portfolio rebalancing
      (1) On each trading day, the financial planner will examine the client’s portfolio and adjust his or her asset class exposures when a specified threshold corridor of exposure is exceeded.
      (2) More costly than calendar rebalancing, but it results in more desirable asset class exposures

SECTION 3: TRANSITIONING INTO RETIREMENT

LO 12-3-1: Characterizing the change in the risk/return paradigm that occurs at retirement

1. What is the risk/return paradigm for retirement income planning? (Video: What is the Risk/Return Paradigm for Retirement Income Planning? Littell, Woerheide)
   a. Classic accumulation portfolio risk/return paradigm
      (1) Single period model: Portfolio is set up and investments are made
Sources of Retirement Income

(a) Return = the rate of the return on the portfolio for that one period
(b) Risk = variability (standard deviation)

(2) Second way to look at it
(a) Return = expected return calculation
(b) Risk = volatility (beta coefficient)

(3) Beta coefficient is a measurement of the volatility of a specific asset or portfolio as compared to the volatility of the whole market.

b. Retirement income planning portfolio risk/return paradigm
(1) Focus is not on a single period but now changes to a multi-period framework
(2) Return = the amount withdrawn from the account
(3) Risk = will the portfolio be exhausted before the end of life?
(4) The more cash withdrawn, the higher the risk of portfolio exhaustion.
   (a) The problem is that everyone wants more return and less risk.
   (b) In theory, each person has an optimal trade-off between return and risk.
(5) Planning Point: Risk tolerance is a key factor in identifying an appropriate withdrawal rate. Must make clients comfortable with the risk they are taking on so they are not overly concerned their portfolio will be exhausted before they die.

c. A legacy goal complicates the analysis as it adds an additional variable—this can be seen in what the research has shown about asset allocation in the retirement income portfolio.
   (1) It is a myth that bonds will be the best and most conservative way to protect a legacy goal.
   (2) Having a retirement income portfolio with too high an allocation to bonds means increasing the risk of depleting the portfolio (and having no remaining legacy).
   (3) Adding equity (up to a point) lowers inflation risk and helps protect against portfolio exhaustion (50 to 75 percent equities).
   (4) Research also shows higher equity allocations (75 to 100 percent) will increase both:
      (a) the average remaining balance (legacy)
      (b) the risk of portfolio failure

2. Is there a role for modern portfolio theory (MPT) in the retirement income planning?
   a. MPT seeks to identify combinations of assets that allow lower variability without compromising return.
   b. This is done by increasing diversification.
   c. Current research focuses on two asset portfolios: a stock index and a bond index; increasing asset classes should reduce variability (standard deviation).
d. Reducing variability will allow for higher sustainable withdrawal rates—in part because it reduces the sequence of return risk by reducing the magnitude of negative results.

e. Future research should look at the impact of adding additional assets to the decumulation portfolio.

3. What is the impact of individual risk tolerance in the decumulation phase?
   a. Risk aversion addresses the amount of additional return required to take on risk.
   b. With retirement income portfolio, return is the amount withdrawn from the portfolio, and as the withdrawal rate increases, the risk of portfolio ruin increases.
   c. Different people have different utility functions—that is how much they value the additional spending in relation to the increasing risk of failure.
   d. Because of the different possible answers to that question, there is no universal optimal withdrawal rate.
   e. A 4 percent withdrawal rate may be too low for the risk tolerant and too high for the risk averse.
   f. **Planning Point:** Real decisions have to be made involving risk tolerance as clients choose withdrawal rates and asset allocations.
   g. Risk capacity varies by individuals as well.
      (1) **Example:** A client having $80,000 a year in guaranteed income that withdraws $20,000 annually from a portfolio to meet additional discretionary needs can take more risk (higher spending) because even if the portfolio fails the client still has $80,000 of guaranteed income.

**LO 12-3-2: Understanding the interface between preretirement saving and postretirement spending**

1. How can tying together the pre- and postretirement periods improve retirement readiness? (Video: [How Can Tying Together the Pre- and Post-Retirement Period Improve Retirement Readiness?](https://www.youtube.com/watch?v=Littell_Nangian_Pfau))
   a. Using the current literature, you may think that the appropriate savings target should be tied to the safe withdrawal rate.
   b. **Example:** Assuming a 4 percent withdrawal rate, a client needs to save $1 million at retirement to generate $40,000 of annual income during retirement.
   c. This may be a simple and appropriate way to think about the issue when the client is young (20–30 years away from retirement).
   d. This is not a good approach for those approaching retirement, as the safe withdrawal rate can range from 4–10 percent for a 30-year retirement period, depending on what year the client retires.
   e. The safe withdrawal rate literature does not answer what is a sustainable withdrawal rate specific to the individual's year of retirement. The literature starts at retirement date and does not take into consideration the preretirement period.
   f. The safe withdrawal paradox illustrates this concern.
Sources of Retirement Income

(1) Example: Two individuals each have $1 million at the beginning of 2008. Person A retires and with a 4 percent withdrawal has $40,000 of annual income. Person B retires at the beginning of 2009. Both suffer a 40 percent loss in 2008 (portfolio value is now $600,000). Person B withdraws 4 percent and now only has $24,000 of annual income.

2. A different approach is to take into consideration both the pre- and postretirement periods.
   a. Instead of a safe withdrawal rate, identify a safe savings rate, which is the amount that is needed to be saved each year to support retirement spending requirements.
   b. If the client has followed the safe savings rate at retirement, the targeted amount can be withdrawn regardless of the wealth accumulation at retirement or the withdrawal rate.
   c. This approach would solve the safe withdrawal rate paradox described above.

3. What is the impact of market conditions on the safe withdrawal rate?
   a. The safe withdrawal rate is based on historical market conditions in the U.S. and identifies the withdrawal rate based on the worst-case scenario.
   b. A bull market prior to retirement means that the accumulation swells but the withdrawal rate will need to be low to reflect the likelihood of lower returns later.
   c. A bear market prior to retirement means a smaller accumulation but the ability to take a higher withdrawal rate as market conditions are likely to improve (in some cases as high at 10 percent).
   d. Research has shown a relationship between return on portfolio and change in withdrawal rate.
      (1) When portfolio returns are positive and the portfolio grows in a year, the following year results in lower sustainable withdrawal rates for new retirees.
      (2) When portfolio returns for the year are negative, a retiree the next year can have a much larger sustainable withdrawal rate.
   e. This research finding has real implications for clients—those who are nearing retirement in a bull market may be overly optimistic and stop saving while those in a bear market may be overly pessimistic.
      (1) One practical concern for those retiring in a bear market is that advisors and clients may have difficulty drastically increasing the withdrawal rate.
      (2) Example: Those who retired in 1921 would need a withdrawal rate of 9–10 percent.
      (3) Similarly, those who retired in 2000 may require a withdrawal rate lower than 4 percent because market valuations were much higher than any time before. Note that we do not have historical data validating the 4 percent safe withdrawal rate after the early 1980s simply because we do not have 30 years of data.
      (4) Under the safe savings rate study, those retiring in 2000 could meet their spending goals (50 percent of their preretirement salary for 30 years) with a 2.6 percent withdrawal rate.
   f. What is the required safe savings rate?
      (1) Very similar to safe withdrawal rate methodology using rolling historical period analysis
(2) As with the safe withdrawal rate, the safe savings result assumes the savings rate in the worst-case scenario.

(3) With the baseline case, what is the safe savings rate required safe enough to replace 50 percent of inflation-adjusted preretirement salary assuming saving for retirement for 30 years and a 30-year retirement period (60-year life cycle)?

(4) For the baseline case and a 60/40 equity allocation, the safe savings rate is 16.6 percent.
   (a) The worst-case scenario was for the retiree retiring in 1918.
   (b) The required savings rate would be lower for any other retirement date.

(5) What is the impact of shortening or lengthening the savings period?
   (a) With a 20-year savings period, the safe savings rate balloons to 36 percent.
   (b) With a 40-year savings period, the savings rate is only 9 percent.

(6) What is the impact of changing the length of the retirement period?
   (a) Change to a 40-year retirement period and the savings rate becomes 18.6 percent (2 percent more).
   (b) Change to a 20-year retirement period and the rate drops to 13.9 percent.
   (c) Note that changing the savings period has more of an impact on the savings rate than changing the retirement period.

4. Getting on track for the mid-career client
   a. How difficult is it to predict meeting a wealth accumulation target?
      (1) The target is often referred to as “the number.”
      (2) We often assume that the portfolio will meet our expectations of the average rate of return—assume a 7 percent rate of return; we assume the portfolio will double in 10 years—and our planning to meet the wealth accumulation target becomes dependent on meeting these goals.
      (3) The reality is that it is extremely difficult to predict if you will hit the wealth accumulation goal (the number).
         (a) The relationship between wealth accumulation 5 years before retirement and at retirement is very weak.
         (b) Example: A retiree in 1921 and another in 2000 saving 10 percent a year had similar accumulations 5 years prior to retirement but the 1921 retiree accumulated less than 4 times earnings at retirement while the 2000 retiree accumulated 12 times earnings.

   b. Why focus on mid-career clients?
      (1) Continuation of the safe savings rate study which only focused on those beginning to save for retirement
Sources of Retirement Income

(2) This study addressed those currently nearing retirement and helps consider what they need to save to meet their retirement spending goals.

c. What are the options for a 55-year-old who currently has accumulated 4 times their earnings to save for retirement?

(1) Assume the spending goal is replacing 50 percent of their inflation-adjusted preretirement earnings and that retirement lasts to age 100 (so that different retirement ages can be studied).

(2) With 65 as the retirement age, they need to save 52 percent of salary each year for 10 years.

(3) If they can only save 15 percent, then they can still be prepared if they work until age 71.

5. Can we predict the sustainable withdrawal rate for a new retiree?

a. Instead of using historic returns, this study looked at what happens if you use current market conditions to predict future returns.

b. Current stock valuations being quite high and interest rates and bond yields are quite low

(1) 4 percent cannot be considered as a safe withdrawal rate for today’s retirees.

LO 12-3-3: Choosing the appropriate portfolio adjustments for an aging client

1. Should equity asset allocation be reduced as the client ages? (Video: Should Equity Asset Allocation be Reduced as the Client Ages? Littell, Kitces)

a. Research has clearly shown that reducing equity exposure over time results in lower sustainable withdrawal rates.

b. Maintaining a steady asset allocation appears to be a superior approach, which runs counter to conventional thinking.

c. The declining equity position over time is problematic during sustained flat periods of investment returns.

(1) Example: Take a retiree with 60 percent equity position who sells 2 percent of equities during each year of retirement. After 15 years, the equity position is only 30 percent, making the equity position too small to benefit when the market rebounds.

d. Reducing equity strategies

(1) Based on the research simply reducing equity, exposure based only on client’s age can reduce returns and increase portfolio failure rates.

(2) However, reducing equity exposure to lock in gains can be an appropriate strategy—allows a client who has met goals to be more conservative.

e. Does the retirement income strategy affect asset allocation?

(1) With systematic withdrawal strategies, few asset allocation changes are typically warranted.
(2) With flooring strategies there can be some issues.
   (a) Exchanging bonds for an immediate annuity results in a portfolio heavily weighted in equities.
   (b) It is more typical to purchase the annuities with a combination of bonds and equity investments to retain the same or similar asset mix after the purchase.
   (c) Planning Point: This is an interesting concern. Annuities are often considered having characteristics similar to bonds so substituting annuities for bonds makes sense at one level. However, advisors, clients, and regulators tend to look at the investment portfolio separate from the annuity income so the asset allocation may look too aggressively weighted toward equities which may look less appropriate for an older client.

SECTION 4: RETIREMENT INCOME RESEARCH

LO 12-4-1: Understanding research methodology and its role in evaluating retirement income research

1. What is the historical approach to retirement income research? (Video: What Methodologies are Used for Retirement Income Research? Littell, Woerheide)
   a. The historical analysis testing overlapping time periods
      (1) Identify historical data as far back as is available or reasonable (the CRISP database goes back to the end of 1925).
      (2) Starting with the first year of data available, choose a testing time period (commonly 30 years) and test that period.
         (a) Example: Test 1926–1956
      (3) With overlapping periods, move forward one year and test that period.
         (a) Example: Test 1927–1957
   b. Reasons for this approach
      (1) It provides a lot of sample periods.
      (2) The future is unpredictable, but it may be similar to some historical period.
      (3) Historical data provides actual correlation data between stock and bond returns for a specific year.
      (4) Provides comfort to know that these results actually occur
      (5) Example: Bengen’s safe withdrawal rate research using overlapping periods demonstrated that a 4 percent withdrawal rate was successful for all 30-year periods.
      (6) This may provide clients with the comfort level to make the decision that they need to—like holding equities in the retirement portfolio.

2. What is Monte Carlo analysis?
Sources of Retirement Income

a. There are a number of different models and different software programs.

b. A simple example involves a client with a portfolio of $100,000 who wants to withdraw a simple annuity (not adjusted for inflation) of $5,000 a year. To perform Monte Carlo analysis, assumptions need to be made about:

(1) The average rate of return (for example, 8 percent)
(2) The standard deviation (10 percent)
(3) An assumption about the distribution of returns—most are built assuming a normal distribution (bell curve)
   (a) Two-thirds of the time, returns are within one standard deviation of the expected return. In our example, two-thirds of the return will be between -2 and 18 percent (8 percent – 10 percent = -2 percent and 8 percent + 10 percent = 18 percent)
   (b) 95 percent of returns will be within 2 standard deviations (-12 and 28 percent)
(4) The next step is to select a random return, which is based on a univariate normal distribution table, and apply it to the portfolio and withdrawal rate being tested for the first year. That process is repeated for the time period being tested (for example, 30 years). You can identify success or failure (is there any money remaining) and what is the amount of the ending value of the account.
(5) With Monte Carlo analysis, the previous step constitutes one run or one data point. Now you go through this process many more times—possibly 1,000, 10,000, or even 100,000 data points.
(6) If you run an example 1,000 times, you can then determine:
   (a) A success rate (the percentage of portfolios that provided the needed income through the entire time period)
   (b) The average ending balance
   (c) The standard deviation of the ending balance

c. The more observations you have, the less likely it is to have a 100 percent success rate.

(1) Planning Point: Research using historical analysis may result in a 100 percent success rate, while Monte Carlo simulations run with software illustrations are less likely to do so.
(2) With historical analysis you may only have 50–60 observations and they are not independent of each other—only one year changes with each additional testing period.

d. Monte Carlo analysis with multiple asset classes

(1) For each asset class, you need to specify rate of return, standard deviation, and identify how asset class returns will relate to each other.
(2) How returns of different asset classes move in relation to each other is measured with either covariance or the correlation coefficient.
(3) Monte Carlo analysis is subject to the GIGO (garbage in, garbage out) problem as the results are only meaningful if the inputs are realistic.
e. Bootstrapping is a combination of historical data and Monte Carlo analysis.
   (1) Start with historical data.
   (2) Instead of sequentially testing the data, pick random years of returns in the testing process.
   (3) A benefit of using actual historical data is not having to guess at correlation of returns between stocks/bonds.
   (4) A drawback is that the selection of random returns results in a sequence of returns that may not be realistic.

3. Why would you choose one method over another?
   a. If the researcher or advisor really believes that future returns will not reflect historical experience, Monte Carlo is the superior approach.
   b. If you have no reason not to believe that the future will be different than the past, then historical overlapping period methodology or bootstrapping may be the better approach.

**LO 12-4-2: Modifying safe withdrawal rates based on recent research**

1. Length of the retirement period (Video: What are Recent Findings in the Safe Withdrawal Rate Research? Littell, Kitces)
   a. Safe withdrawal rate research was built around a 30-year period. However, there is no reason not to test other periods.
   b. The safe withdrawal rate for a 30-year time horizon is 4–4.5 percent.
   c. If the retirement period is extended 10 years to 40 years, reduce the safe withdrawal rate by .5 percent.
   d. If the retirement period is only 20 years, add 1 percent to the safe withdrawal rate.
   e. Optimal asset allocation also shifts when the retirement period changes.
      (1) For a 30-year time horizon, the optimal allocation is 40–60 percent in equities and the rest in fixed income.
      (2) For a 40-year time period, it shifts to 50–70 percent in equities.
      (3) For a 20-year time period, the allocation to equities decreases to 30–50 percent.
   f. Choosing an appropriate time horizon for a client can be a difficult task.
      (1) Some advisors start with an average life expectancy for that client and add a number of years (add 5–10 years to the average joint life expectancy for a client couple).
      (2) Some advisors choose a planning age for all clients (for example, age 95).

2. The impact of fees on the safe withdrawal rate
   a. Early research ignored investment fees and simply assumed that the indexed returns were earned on the portfolio.
b. Newer research considering fees shows that investment fees result in a reduction in the withdrawal rate of about one-third of the investment fee.

c. *Example:* With a baseline assumption of a 4 percent withdrawal rate and a 1 percent investment fee, it is appropriate to reduce the withdrawal rate by 1/3 percent to 3.66 percent.

3. The impact of taxes on the safe withdrawal rate

a. Traditional safe withdrawal rate research did not consider taxes at all.

b. With a taxable account, earnings are reduced by taxes (a drag on returns) so it is appropriate to reduce the withdrawal rate.

   (1) The higher the tax rate, the larger the impact on the safe withdrawal rate.
   (2) Low tax rates may reduce the withdrawal rate by .25 percent.
   (3) A 25 percent tax rate may reduce the withdrawal rate by about .5 percent.
   (4) A high tax rate (30 percent or more) reduces the withdrawal rate by about .75 percent.

c. With a tax-deferred account, the withdrawal rate is not reduced—you can take, for example, a 4 percent safe withdrawal rate, but that amount is subject to income taxes, reducing the after-tax amount available to spend.

4. Factoring in risk tolerance in the withdrawal rate

a. The first way to consider risk tolerance is based on the traditional view of risk tolerance as a factor in selecting an asset allocation.

   (1) Based on risk tolerance, choose an appropriate equity allocation in the portfolio.
   (2) Determine a withdrawal rate based on equity allocation and reasonable spending needs.

b. An additional way to consider risk tolerance is to evaluate the client's risk tolerance in relation to volatility in spending.

   (1) Is the client willing to take the risk that spending more today may result in a reduction in spending later if markets underperform?
   (2) If the safe withdrawal rate is 4 percent, a risk tolerant client willing to take on some risk of a future reduction may be able to withdraw 6–7 percent.

   (3) *Planning Point:* This trade-off requires a heart-to-heart discussion with clients of the real possibility of reducing spending in the future.
   (4) The ability to reduce spending is also tied to risk capacity—a reduction in spending of basic needs is much more difficult than a reduction in discretionary spending.
   (5) It is important to evaluate this type of risk tolerance with a question like, “How do you feel about having to tighten your spending belt?”

5. Recent research on the impact of lowering equity exposure on portfolio failure rates
12.24

a. The range of optimal asset allocations to sustain the safe withdrawal rate is quite wide—it may be 40–60 percent equities or even as wide as a 30–70 percent allocation to equities.

b. The research shows that the safe withdrawal rate for a 40 percent equity portfolio is almost identical to a 60 percent equity portfolio.

c. Clients can have different reactions to this information.
   (1) Some may react by saying, “Why take on more risk by adding equities if the sustainable withdrawal rates are virtually the same?”
   (2) Other clients may take the opposite approach—“Why wouldn't you take the higher percentage of equities as it provides more upside potential (more spending/larger legacy) with the same downside risk?”

**LO 12-4-3: Modifying safe withdrawal rates based on current market conditions**

1. Is the 4 percent safe withdrawal rate sustainable when using historical analysis in other countries? (Video: [What is the Safe Withdrawal Rate Based on Current Market Conditions?](#) Littell, Pfau)
   
   a. This research is important if you view U.S. returns in the 20th century as an anomaly.
      (1) Returns on stocks and bonds were quite high in the 20th century.
      (2) Down markets recovered relatively quickly.
      (3) The U.S. had one of the lowest inflation rates.
      (4) In this environment, a 4 percent withdrawal rate was successful 100 percent of the time using historical analysis.

   b. If it was an anomaly, maybe the future in the U.S. looks more like the experience in other countries.

   c. When tested in 19 countries over an 80-year period using a 50/50 stock/treasury bill allocation, the 4 percent rule did not fare well.
      (1) In Italy, the 4 percent rule failed 80 percent of the time.
      (2) Very low withdrawal rates during periods of high inflation
      (3) Many of the bad outcomes occurred during WWI and WWII.
      (4) The U.S. and Canada had the highest safe withdrawal rates.
Sources of Retirement Income

(5)

| Sustainable Withdrawal Rates with Perfect Foresight Assumption for Retirees, 1900–1979 |
|-----------------------------------------------|----------------|
| SAFEMAX                                       |          |
| Canada                                        | 4.42 |
| Sweden                                        | 4.23 |
| Denmark                                       | 4.08 |
| United States                                 | 4.02 |
| South Africa                                  | 3.84 |
| United Kingdom                                | 3.77 |
| Australia                                     | 3.68 |
| Switzerland                                   | 3.59 |
| The Netherlands                               | 3.36 |
| Ireland                                       | 3.28 |
| Norway                                        | 3.13 |
| Spain                                         | 2.56 |
| Italy                                         | 1.56 |
| Belgium                                       | 1.46 |
| France                                        | 1.25 |
| Germany                                       | 1.14 |
| Japan                                         | 0.47 |


2. Is the 4 percent withdrawal rate sustainable based on current expectations of future returns?
   
a. Historical average returns (adjusted for inflation)
      
   (1) Stocks averaged 8.7 percent real rate of return.
   
   (2) Volatility was approximately 20 percent.
   
   (3) Geometric return/compounded average return 6.6 percent
   
   (4) Relatively high compared to international standards

b. Historical average returns for bonds (adjusted for inflation)

   (1) Bonds averaged a 2.5 percent real rate of return.
   
   (2) Volatility was 7 percent.
   
   (3) T-bills earned approximately a .7 percent real rate of return.

c. Are these historical averages too optimistic going forward?
   
   (1) The current 5-year TIPS yield was -1.1 percent in July 2012.
   
   (2) The historical rate of return on bonds was 2.5 percent.
d. What investment assumptions did you make in your study?
   (1) At the time of the study, the 5-year TIPS rate was .3 percent, and this was chosen as the rate of return for fixed income investments.
   (2) Chose to use historical averages for volatility (7 percent for fixed income and 20 percent for equities)
   (3) For stock returns, chose a real rate of return of 5.1 percent
      (a) Based on an equity premium (earnings in excess of bond returns) of 4.8 percent, which represented the equity premium looking at a GDP weighted world equity portfolio (which is lower than the historical U.S. average)
      (b) With a .3 percent bond return and a 4.8 percent equity premium resulted in the 5.1 percent real rate of return

e. What did you find when testing the 4 percent withdrawal rate using these investment assumptions?
   (1) Used a 50 percent stock allocation and Monte Carlo simulation
   (2) Using historical rates of return in the analysis, the failure rate was 6–7 percent (an acceptable failure rate).
   (3) Using the revised investment assumptions, the failure rate climbed to 47 percent.

3. Who is this research most relevant to?
   a. Those retiring today
   b. Choosing an appropriate withdrawal rate should be determined based on current conditions.

4. A model for advisors to determine withdrawal rates based on their own assumptions
   a. Advisors may disagree with basic assumptions of safe withdrawal rate and want to add their own assumptions about rates of return, correlations, and standard deviation.
   b. Advisors may also want to add asset classes.
   c. Model allows advisors to make their own assumptions in testing a withdrawal rate

LO 12-4-4: Understanding the implications of life-cycle theory research on retirement income planning

   a. Theoretical development dated back to the 1920s (older than safe withdrawal rate research), asking the question of how to come up with a lifetime strategy for making decisions about savings and spending.
   b. Conceptually, an individual wants to be able to shift consumption from times of plenty to times of need.
   c. We see this with retirement planning—employment earnings are used to fund retirement needs.

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Sources of Retirement Income

(1) Spend less than you earn during working years
(2) Spend more than you earn during retirement years
d. The objective is consumption smoothing:
   (1) The objective is to optimize lifetime spending by finding a proper balance between spending and saving during different life states.
   (2) Example: Purchasing health insurance is an example of consumption smoothing. You lower consumption to purchase insurance for those times that you are sick.

2. What is utility theory?
   a. Underlying core concept of life-cycle finance theory
   b. Idea that as you spend more, the satisfaction you get from that additional spending increases—but at a decreasing rate
   c. Happiness (utility) gains are highest for meeting basic needs.
   d. Utility and life-cycle finance theories are the theoretical support for the flooring and upside approach to retirement income planning.
      (1) This is the strategy that first uses available assets to build an income floor to meet basic needs and then uses withdrawals from the remaining portfolio to meet discretionary needs.
      (2) Overview of how this is the optimal strategy based on life-cycle theory can be seen in the book, Retirement Portfolios, Theory, Construction and Management, by Michael Zwecher.
      (3) How much is withdrawn from the portfolio depends on a number of factors including the individual’s own view of how much additional pleasure is gained by additional spending in relation to how much discomfort will be incurred if spending is reduced in the future. This is based on what is referred to as the individual’s own utility curve.
      (4) The utility figure below illustrates the relationship between additional spending and value from the spending, which can also be called utility or happiness derived from the additional spending. The chart shows a linear relationship between spending and satisfaction. This is unrealistic, as a spending level that is lower than meeting basic needs will be more painful than the pleasure of increasing discretionary spending. The other lines represent utility curves for two different rationale individuals, but with a different trade-off between increases and possible decreases in spending.
3. Factoring in life expectancy probabilities in spending patterns
   b. Since we do not know how long we will live, when considering consumption smoothing it is appropriate to factor in life expectancy probabilities.
   c. Under a traditional withdrawal rate strategy, you spend the same at age 65 as you do at age 100.
   d. The “rationale” consumer will maximize lifetime utility by spending more at age 65 than at age 100 because the probability of being alive at 100 is quite low.
      (1) The rational plan is to decrease spending as you age because of decreasing survivability probability.
      (2) Different individuals can have different levels of risk aversions to outliving assets.
      (3) The risk averse client would prefer more level spending over the expected lifetime.
   e. An individual with more pension income can have higher spending (higher withdrawal rate) from the portfolio in the early years of retirement because the higher income floor is a protection in case the higher withdrawal rate results in a depletion of the portfolio.

4. How does risk tolerance affect withdrawal rates?
   b. The research focuses on spending flexibility, which like longevity risk aversion is addressing the client’s aversion to making cutbacks later in life.
   c. Research accounts for market returns and also attempts to incorporate the safe withdrawal rate concept into life-cycle finance theory.
Sources of Retirement Income

d. Addresses the issue of how averse an individual is to reducing spending
   (1) More flexibility means a higher withdrawal rate early in retirement.
   (2) In safe withdrawal rate terms, this means a more flexible spender is willing to accept a higher rate of portfolio failure.

e. Research addresses the question, "What is an appropriate (acceptable) failure rate?"
   (1) Appropriate failure rate depends on other guaranteed income such as Social Security and company pensions.
   (2) A client with high risk tolerance, spending flexibility, and Social Security income may have an optimal withdrawal rate of 7 percent.
   (3) This is not the same as a safe withdrawal rate—in fact, in this case there is a 57 percent chance they will run out of wealth by end of life.
   (4) The difference here is that the safe withdrawal rate only focuses on downside risk and puts no emphasis on a client’s desire to spend more. This research incorporates the desire for additional spending.

LO 12-4-5: Understanding the implications of choosing a cash-reserve (buffer-zone) strategy

1. How does a buffer-zone strategy compare to a 100 percent investment portfolio?4 (Video: How Does a Buffer Zone Strategy Compare to a 100% Investment Portfolio? Littell, Woerheide)
   a. The buffer-zone strategy is a common strategy.
      (1) Suggested by Harold Evensky in Retirement Income Redesigned (2006)
      (2) Mentioned by Steve Horan at Bankrate.com
      (3) Commonly mentioned in the trade literature
   b. What is the buffer-zone strategy?
      (1) Instead of putting 100 percent of assets into an investment portfolio, put a portion in a safe position, such as a money market mutual fund (MMF).
      (2) Place a specified number of years of expenses in a money market fund and the rest in an investment portfolio of riskier assets.
      (3) After a passage of time (usually one year), take withdrawals as follows:
         (a) If the value of investment portfolio increases, take withdrawals from the investment portfolio.
         (b) If the value of the investment portfolio decreases, take expenses from the money market fund.
         (c) In years the value of the investment portfolio increases, also replenish the cash account.

(4) The simplistic explanation is that the strategy allows the retiree to avoid selling investments when prices are down—the cash set aside can be used to meet expenses during those years.

(5) The more sophisticated or academic explanation is that the strategy:
   
   (a) Takes advantage of mean reversion in prices (if it exists)
   
   (b) The introduction of the money market account (with little variability) reduces the variability in the portfolio which should increase sustainability.

(6) Unfortunately, the money market account results in reduction in expected average return. The empirical question becomes “Does the reduced risk and variability outweigh the lowered average return?”

c. Research methodology

(1) The following combinations were tested
   
   (a) 1- to 4-year buffer zones
   
   (b) 100 percent stocks to 100 percent bonds in 25 percent increments (5 different portfolios)
   
   (c) Withdrawal rates from 3 percent to 9 percent (in 1 percent increments)
   
   (d) Time horizons from 15 years to 30 years in 5-year increments

(2) Methodology
   
   (a) Used historical analysis with overlapping periods
   
   (b) Model compared failure rates of the buffer zone portfolio to those produced by investing solely in a comparable investment portfolio with no buffer zones

(3) Why was the maximum buffer zone 4 years?
   
   (a) Examined historical data on the number of years of consecutive down turns in the stock market
      
      (a) Stock market has never been down 5 years in a row.
      
      (b) One time the market was down 4 years in a row.
      
      (c) Two times it went down exactly 3 years in a row.
      
      (d) Four times it went down exactly 2 years in a row.
      
      (e) Twelve times it went down one year between up years.
   
   (b) Examined the historical data on bonds as well
      
      (a) The market was never down 4 years in a row.
      
      (b) One time the market was down exactly 3 years.
      
      (c) Three times it was down exactly 2 years.
      
      (d) Twelve times it was down a single year between up years.
   
   (c) Planning Point: This data supports the selection of a relatively short buffer-zone period.
d. Results of the study

(1) How did the one-year buffer zone perform in comparison to the 100 percent investment portfolio?
   (a) Only one time the buffer-zone portfolio had a lower failure rate than the investment portfolio.
   (b) While 32 times the investment portfolio had a lower failure rate.
   (c) The buffer-zone strategy showed similar results when comparing a range of payout rates.

(2) How did the 4-year buffer zone perform in comparison to the 100 percent investment portfolio?
   (a) Pure investment portfolio again had a lower failure rate than buffer-zone strategy in more instances when evaluating the range of portfolio combinations.
   (b) Pure investment portfolio had a lower failure rate in more instances when evaluating a range of payout rates.
   (c) Research showed that a buffer-zone strategy is not a way to support higher withdrawal rates.

(3) Looking at 1–4 year periods, the only time the buffer zone was possibly comparable to the investment portfolio is with a 100 percent bond portfolio.

e. General conclusions

(1) Buffer zones are an inferior strategy compared to a pure investment portfolio—even with 1- and 2-year buffer zones.

(2) The reduction in returns created by setting aside cash offsets the benefits of reducing variability.

(3) However, even though it may not be the optimal strategy, if a buffer-zone strategy makes the client more comfortable holding stocks in the portfolio, having a buffer zone with a significant position in equities is superior to a portfolio of 100 percent bonds.

SECTION 5: CREATING AN INCOME FLOOR WITH INVESTMENT PRODUCTS

LO 12-5-1: Analyze how to create an income floor

1. The most common way to floor is to use a laddered bond portfolio. (Video: How Do You Build an Income Floor with Bonds? Littell, Kitces)
   a. Flooring with investment products is similar to liability driven investing techniques used by pension managers and others. Specific assets are matched to meet specific liabilities. With retirement income, the liabilities are the future cash flow needs.
   b. Flooring with a bond ladder allows the client to identify specific bonds that will mature at the right time to meet each cash flow need.

2. Zero-coupon bonds are a common option for meeting flooring needs.
a. A zero-coupon bond is a debt security that does not pay ongoing interest payments (does not pay a coupon), but is sold at a deep discount to the face value at maturity.

b. Clients do not need the ongoing interest (coupons). Clients need the principal to match their spending needs.

c. Example: A zero-coupon bond can be purchased that will payout $40,000 in year three of retirement, meeting that year’s income needs. Another one can be purchased that matures in year four providing $41,000 of income, etc.

d. The fact that there are no coupon payments in the intervening time does not matter to the client since the primary goal is a bond that matures with the appropriate amount of income.

3. STRIPs (Separate Trading of Registered Interest and Principal of Securities) can also be used to build the floor.
   a. A STRIP separates the income payment and the principal payment in a bond (“strip” out the income or principal).
   b. Clients can buy just the principal payment or just the income payment.
   c. Planning Point: For flooring purposes, purchase STRIPs of principal payments of government bonds to meet cash flow needs. This is a similar strategy to purchasing zero-coupon bonds as the only payment is the principal payment at maturity.

4. The most common way to floor benefits with federal government bonds is to eliminate default risk.

5. Some planners and clients use municipal bonds because of the special tax treatment they are accorded.
   a. Planning Point: Planners need to think in terms of the client’s overall plan to assess the importance of the tax benefit.
   b. Planning Point: Planners should focus on the after-tax yield.
   c. There are some problems with municipal bonds.
      (1) Some planners avoid municipal bonds because they have default risk.
      (2) Municipal bonds are sometimes callable, so they may not work for flooring.

6. Corporate bonds are seldom used for flooring because they have default risk.
   a. Default risk is not acceptable when flooring.
   b. Yields on corporate bonds, however, may be higher, which lowers the cost of building the income floor.

7. Planners need to be aware of the tax treatment of the bond.
   a. Corporate bonds are fully taxable.
   b. Municipal bonds are federally tax-free.
   c. Treasury bonds are exempt from state income taxes.
   d. Original issue discount bonds (including zero-coupon bonds) result in imputed income each year. The gains are amortized and taxed each year even though they are not paid until a later time period.
   e. Tax treatment also depends on whether the bond is held in a qualified plan.
f. Planning Point: The traditional strategy has been to hold ordinary income producing assets like bonds in a tax-deferred account. In today's environment, bond returns are so low there is less need to hold them in tax-deferred accounts. It might actually make more sense to hold equities that are actively traded in the tax-deferred environment.

8. Flooring with STRIPs of TIPs
   a. STRIP the interest and principal portion of TIPs (Treasury Inflation Protected Securities).
   b. TIPs automatically adjust for inflation so they are appealing for income flooring because they maintain purchasing power.
   c. Planning Point: Purchasing principal STRIPs of TIPs allows you meet a specified future inflation-adjusted cash flow need.

9. One problem with a bond strategy is that it does not account for longevity risk. Clients can outlive the planned-for time horizon.
   a. Flooring strategies with annuities take away longevity risk.
   b. Alternatively, a client can use a bond income floor along with an annuity or address longevity risk with a separate portfolio.
   c. Alternatively, a client can be conservative when setting the time horizon (establish a longer time horizon for the income floor) and use the bond strategy for flooring.

10. An important issue is the timing of when the bonds will be purchased.
    a. Practitioners tend to set up bond ladders when rates are relatively appealing. People are slower to implement a bond ladder when rates are low.
    b. The issue of when to set the floor is an investment-driven discussion.

11. Bond mutual funds are not optimal for flooring because they do not line up well after time with the client’s income needs.

SECTION 6: TAX EFFICIENT WITHDRAWAL STRATEGIES

LO 12-6-1: How to improve portfolio longevity through a tax efficient sequencing of withdrawals

1. A retiree may have assets in three different types of accounts. (Video: How Can the Sequence of Withdrawals Affect How Long the Portfolio Will Last in Retirement? Littell, Reichenstein)
   a. Tax-deferred accounts (e.g., regular 401(k))
   b. Tax-exempt accounts (e.g., Roth IRA or Roth 401(k))
   c. Taxable accounts (brokerage account)
2. One critical issue is whether the order of withdrawals makes the portfolio last longer. It turns out that tax-efficient withdrawals can increase portfolio longevity by six or more years.

3. Two guiding principles to consider when determining the order of withdrawals:
   a. First principle—taxable accounts are taxed more heavily than the tax-deferred account and tax-exempt accounts, so as a general rule take money from taxable accounts first.
      (1) *Example:* 5 percent bond; client in 28 percent tax bracket
          (a) Client gets a 3.6 percent after-tax return holding the bond in a taxable account.
          (b) Holding it in a Roth IRA, your client gets 5 percent.
      (2) Taking out taxable money first may add over 3 years to the portfolio’s longevity. Reason: The extra 1.4 percent rate of return (5 percent in a Roth or tax-deferred account versus 3.6 percent in a taxable account) will make a difference.
      (3) Note that nonqualified annuities and nondeductible IRA contributions get some tax deferral but there is still a tax-drag on the account. This would mean that the order should be taxable accounts, then nonqualified annuities, followed by withdrawals from tax-deferred and tax-exempt accounts.
   b. Second principle—partnership with the government. The government “owns” part of the principal—for every dollar withdrawn, the government receives a percentage equal to the tax rate.
      (1) If the tax rate is 25 percent, it is like the government owns 25 percent of the account.
      (2) The planner should look for opportunities throughout retirement where the client can take withdrawals from the tax-deferred account that will be taxed at less than the 25 percent that the government gets.

4. Methodology used in the research
   a. Used a simplified tax structure
   b. Use current marginal tax rates in the U.S.
   c. Assume 0 percent inflation
   d. Assume 5 percent nominal return
   e. *Note:* Using a simplified tax structure makes the research more relevant to the developed world—as every developed country currently uses a progressive tax structure.

5. Case study used in the research
   a. Female client assuming a 30-year retirement period withdrawing $79,400 each year
   b. Strategy 1: Inefficient withdrawal strategy
      (1) Withdrawals are taken first from the Roth IRA, then from the 401(k) account, and then from the taxable account.
      (2) With this inefficient approach, the sample portfolio lasted 30 years—the case study was set up so that assets would support the required withdrawals for 30 years.
c. **Strategy 2: Take advantage of principle 1**
   
   (1) Client takes withdrawals from the taxable account first until it is exhausted, then from the 401(k) (tax-deferred account), and then from the tax-exempt account (Roth IRA).

   (2) The portfolio now lasts 33.41 years—adding 3.41 years by letting the tax code work to the client’s advantage.

d. **Strategy 3: Take advantage of both principle 1 and principle 2**

   (1) Client takes withdrawals first from the 401(k) account to the top of the 15 percent tax bracket and then takes the rest out from the taxable account until it is exhausted. When the taxable account is exhausted, continue taking a portion (maximizing the 15 percent bracket) and taking the rest from the Roth account. Once all other accounts are exhausted, take all withdrawals from the 401(k), which will be subject to a higher marginal tax rate.

   (2) With this strategy, the portfolio lasts 36.2 years—6.2 years longer than the tax-inefficient approach.
6. What does it mean to take withdrawals to the top of the 15 percent bracket?
   a. The client can take out the personal exemption amount (and any deductions for dependents) for the year.
   b. The client can take out the standard deduction amount (basic standard deduction), and if over age 65, the additional standard deduction amount for the year as well.
   c. The personal exemption and standard deduction are not taxed (0 percent tax).
   d. They can also take out the amount taxed at the 10 percent rate.
   e. Finally, they can take out the additional income amount that is taxed at the 15 percent marginal rate.
   f. To illustrate this concept, the example below calculates the withdrawal using this approach and using the 2011 tax rate schedule and numbers (planners should use current schedules). The example is for an individual who is age 66. As you can see, this single taxpayer can withdraw $45,500 under this approach:

<table>
<thead>
<tr>
<th>Year</th>
<th>Roth IRA</th>
<th>401(k) tax acct</th>
<th>Roth IRA</th>
<th>401(k) tax acct</th>
<th>Roth IRA</th>
<th>401(k) tax acct</th>
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### Basic Standard Deduction Amounts

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<th>Filing Status</th>
<th>Standard Deduction Amount</th>
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<td><strong>2011</strong></td>
<td></td>
</tr>
<tr>
<td>Single</td>
<td>$5,800</td>
</tr>
<tr>
<td>Married, filing jointly</td>
<td>$11,600</td>
</tr>
<tr>
<td>Surviving spouse</td>
<td>$11,600</td>
</tr>
<tr>
<td>Head of household</td>
<td>$8,500</td>
</tr>
<tr>
<td>Married, filing separately</td>
<td>$5,800</td>
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</table>
### Sources of Retirement Income

#### Amounts of Each Additional Standard Deduction (Age 65 plus)

<table>
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<tr>
<th>Filing Status</th>
<th>2011</th>
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<tbody>
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<td>$1,450</td>
</tr>
<tr>
<td>Married, filing jointly</td>
<td>$1,150</td>
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<tr>
<td>Surviving spouse</td>
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</tr>
<tr>
<td>Head of household</td>
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</tr>
<tr>
<td>Married, filing separately</td>
<td>$1,150</td>
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</table>

(Add $1,450)

#### Personal and Dependency Exemption

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<th>2011</th>
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<tbody>
<tr>
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<td>(Add $3,750)</td>
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</tbody>
</table>

#### 2011 Tax Rate Schedules

**Single—Schedule X**

<table>
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<th>If taxable income is:</th>
<th>But not over--</th>
<th>The tax is: of the amount over--</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over--</td>
<td>$0</td>
<td>$850.00 + 15%</td>
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<tr>
<td>$0</td>
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<td>$850.00 + 15%</td>
</tr>
<tr>
<td>$8,500</td>
<td>$34,500</td>
<td>$8,500</td>
</tr>
<tr>
<td>$34,500</td>
<td>$83,600</td>
<td>$850.00 + 15%</td>
</tr>
<tr>
<td>$83,600</td>
<td>$174,400</td>
<td>$8,500</td>
</tr>
<tr>
<td>$174,400</td>
<td>$379,150</td>
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<td>...</td>
<td>$174,400</td>
</tr>
<tr>
<td>$5,800 + $1,450 + $3,750 + $34,500 = The top of the 15 percent bracket is $45,500.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

7. Implications of topping out the 15 percent bracket with tax-deferred withdrawals
   a. With this approach, any additional taxable income (in the case study, this would be earnings on the taxable account) would be taxed at higher 25 percent tax rate.
   b. An alternative strategy is to estimate the amount earned on the taxable account and subtract it from the 401(k) amount that is withdrawn so that no taxable income is taxed at the 25 percent marginal tax rate.
   c. In the case study, the first approach netted a better result, but in other fact patterns, the second approach may provide the better result.

8. Can you describe the slightly different results obtained by other researchers in an article in the January 2012 Journal of Financial Planning?\(^5\)
   a. Used slightly different methodology and came up with slightly different results
      (1) Used a highly sophisticated model
      (2) Brought in the alternative minimum tax

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b. It came to the conclusion that the best strategy was either taking money out to the top of the 0 percent tax bracket or to the top of the 10 percent. Withdrawing to the top of the 15 percent bracket gave a slightly worse result.

c. Both papers agree that you should take at least some money out of the tax-deferred account to fill up some low tax bracket (10 or 15 percent).

d. Both papers agree that you should take out money from the taxable account before the Roth.

9. Choosing additional tax-deferred withdrawals over Roth account withdrawals

a. Before taking money out of the tax-exempt Roth account, be mindful of future tax rates. The client may be better off taking out more from the tax-deferred account, and subjecting it to the 25 percent tax rate if the future tax rates are expected to increase substantially—providing incentive to retain more of the tax-free Roth account.

b. Roths can also be good to hold on to because:

   (1) They have no required minimum distributions (while the client is alive).
   
   (2) They have superior estate tax opportunities.
   
   (3) They are the best pot from which to draw emergency money (e.g., new car).

10. What are situations in which a client may be in a low tax bracket, allowing the client to take advantage of tax-deferred withdrawals at a low tax rate?

a. Early in retirement when other income is withdrawn from a taxable account

b. Deductions for large charitable contribution

c. Large deductions for other situations (e.g., high medical expenses later in retirement), which leads to the strategy of retaining some tax-deferred funds until later in retirement—which can then be withdrawn to meet the medical expenses without significant tax consequences.

11. Changes in objectives

a. In our case study, the objective was to maximize the longevity of the portfolio.

b. If the objective changes (for example, the focus becomes maximizing the estate), then the appropriate withdrawal strategies may change.

c. Example: The step up in basis rules may weigh in favor of retaining a taxable account to avoid capital gains tax.

d. Planning Point: Tax efficiency does not mean the lowest taxes for the year. The client must consider the average tax rates over many years. Taking advantage of low tax rates is a crucial consideration, even if it means paying more taxes currently.
LO 12-6-2: Identify key practical tax considerations in retirement income planning

1. As the client starts to take distributions from different taxable accounts, they distort the balance of investments they have in each of the types of taxed accounts (tax-deferred, tax-free, taxable), which impacts asset allocation. (Video: What are Key Practical Tax Considerations in Retirement Income Planning? Littell, Nanigian, Kitces)

2. Example: Assume the client put stocks in a Roth IRA and bonds in a regular IRA. If we liquidate the regular IRA first, then the asset allocation will change to be heavily weighted with stocks and ultimately only stocks. Because of the uneven liquidation, additional transactions must occur to balance the portfolio.

3. Planning Point: In some circumstances, rebalancing a portfolio might have other consequences. For example, if you are using a fixed annuity as part of a bond allocation, taking withdrawals from the annuity to rebalance could have unfavorable consequences—like triggering a surrender charge.

4. Taking distributions from many sources in retirement causes another practical issue—taxable income may vary substantially from year to year, depending upon investment returns and what accounts are drawn from. This volatility can result in volatility in after-tax income, requiring additional planning to meet after-tax income needs.

5. The goal of paying taxes when the rates are lowest is not as easy as it sounds. For example, if future rates are expected to increase, the client should consider a Roth conversion to take advantage of the lower current rates.

6. Another example is if capital gains rates are expected to increase, you may want to harvest gains (not losses). Leave the losses so they can be used in the future when rates are higher.

7. Tax planning in the distribution phase is substantially more complicated than in the accumulation phase, requiring careful year-by-year planning paying close attention to the changing circumstances.