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## **Small Business: Dealing with Retirement**

Small business, whether a single employee or a hundred, whether annual revenues are \$300,000 or \$30,000,000, share many of the same concerns. One of the biggest is how to create and manage a reasonable retirement program. Doing so requires flexibility, stability, and performance in the desired solution.

Oftentimes, the owners of small business believe that their retirement income is their business -- that retirement income will come from the business, creating a living income for retirement. Unfortunately, this often is not realistic or possible.

There are alternatives to consider, using current cash flow to plan for future income::

- 401K programs
- IRAs
- Annuities
- Life Insurance
- SEP/Simple plans

Some of these instruments can also accomplish many of the needs associated with sustainability of the business.

### **401(k) >> Adapted from the Wall Street Journal Retirement Guide::**

A 401(k) is a retirement savings plan sponsored by an employer. It allows workers to save and invest a portion of their pay pre-tax. Taxes aren't paid until the money is withdrawn from the account. Required withdrawals/distributions must begin in the year following the account holder's attainment of 70.5 years of age.

401(k) plans, named after a section of the tax code, arose during the 1980s as a supplement to pensions. Pension funds were managed by

the employer and they paid out a steady income over the course of the retirement.

With a 401(k), you control how your money is invested, to the extent of the options provided within the plan in which you are participating. Most plans offer an array of investment options and risks. A participant needs to remember that the options available for investment of 401(k) contributions may involve risk of loss of principal.

In addition, some 401(k)s are structured to allow an employer to supply a match for contributions made by the employee. The manner in which these matches are made, and vested are stipulated by the employer in the 401(k) plan rules.

### **IRAs >> Adapted from Investopia.com and IRS.gov::**

The Individual Retirement Accounts/Arrangements are an investing tool used by individuals to earn and earmark funds for retirement savings. There are several types of IRAs: Traditional, Roth, Simple and SEP.

Features in common with the 401(k) include tax-deferred accumulation, contribution caps, penalties on withdrawals prior to age 50.5, and required minimum distribution after age 70.5.

Traditional and Roth IRAs are established by individual taxpayers, who are allowed to contribute 100% of compensation (self-employment income for sole proprietors and partners) up to a set maximum dollar amount. (\$5000 in 2012, plus a \$1000 catch-up amount for taxpayers over 50).

Contributions to the Traditional IRA may be tax deductible depending on the taxpayer's income, tax filing status and coverage by an employer-sponsored retirement plan.

Roth IRA contributions are not tax-deductible, and therefore the principal and accumulation are not taxable at withdrawal. Moreover, contributions are restricted by the amount of taxable income.

SEPs and Simple IRAs are retirement plans established by small business employers and are available to employees. The contribution caps on these accounts vary.

With the exception of Roth IRAs, where eligible distributions are tax-free, eventual withdrawal from an IRA is taxed as income; including the capital gains.

Participants in an IRA program need to remember that contributions to fund investment options may involve the risk of loss of principal.

## **Annuities**

An annuity is a financial instrument issued by a life insurance company, the primary purpose of which is to create an income stream. Beyond this, an annuity has the ability to service multiple purposes, including a guaranteed lifetime income.

Creation of an annuity requires a minimum deposit, and generally can accept additional premium pay-ins. The owner of the annuity is not subject to underwriting. An annuity can be started with either qualified or non-qualified funds, and the earnings grow tax-deferred. If an annuity is funded with non-qualified funds, only the accumulation is taxable at withdrawal.

Fixed index annuities (FIAs) use selected indices to track market performance, and can increase value when the market gains, but by contract, will **not lose** value when the market declines. In addition, some annuity contracts offer an upfront bonus to enhance the cash value account, upon which all gains in value are calculated. FIAs also permit the account holder to alter the fractions of the premium that track market gains versus guaranteed returns on an annual basis.

An annuity can be used as a retirement instrument in the following way:: many current annuity designs allow for the addition of a Guaranteed Lifetime Income Rider (although this has unique names among various annuity products). In short, this rider allows the annuity owner to gain a life long income stream, and control the point in time at which this income is "turned on."

Annuities, with the guaranteed life time income rider, will permit a larger payout the longer the annuity is held without the income rider being exercised, and is therefore a useful tool for creating a retirement income stream. In addition, should the annuity owner die prior to exhaustion of account value, the proceeds will accrue to a named beneficiary.

By contract, the premium (or principal) of a fixed index annuity is not subject to loss of value.

## Life Insurance

Small business can make use of life insurance in multiple ways:: funding a buy-sell agreement, providing for key man protection, offering several forms of employee and executive compensation, insuring succession and business sustainability.

In addition, a life insurance plan in the form of permanent insurance, can provide business owners and executives a retirement income stream, and if structured correctly, this income can be free of taxes.

The primary purpose of life insurance is to provide a death benefit to the beneficiaries of the policy's insured. Due to the structure of a permanent (cash value) life insurance policy, a policy owner/insured can also enjoy several living benefits.

A cash value policy (ie universal life) charges a premium that not only covers the cost of insurance and administration, but permits the accumulation of cash value, an account that is available for distribution in the form of withdrawals or loans. A loan from the cash value of a life insurance policy carries an imputed interest charge, which when offset by the earnings of the policy, results in a no-cost distribution. Such a distribution can comprise an income stream. In this way, a life policy, if properly structured, provides a retirement income stream as well as a death benefit.

As an example (using a policy type available in late 2012):::

Insured is 45 years old  
Non-tobacco user  
Good health  
Premium \$1000/month paid through age 70  
Loan/distribution is not subject to taxation

- The initial death benefit is \$665,200
- Annual loan/distribution is \$35,200 through age 100
- Modest illustrated annual gain on policy value

In addition, to illustrate, slightly overpaying the premium by \$100/mo for the first 11 years, results in an additional \$1400 per year of income.

The cash value accumulation in a life insurance policy, such as a fixed index universal life contract, is not subject to loss if value due to changes in market conditions.

**In summary**, what is the best for you? Nobody has a crystal ball, and even the most experienced investment advisors have slumps. The options described above each offer the ability to grow significant accounts for the benefit of retirement. Each has relative advantages and disadvantages. The circumstances and choices desired by the individual help define the best solution. Sometimes that solution may involve a combination of instruments. In addition, periodic and disciplined reviews allow you to stay informed and be flexible to achieve your goals.