Keir Digest

with

Assessment Questions

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Chapter 1

Pension and Retirement Planning Overview

Learning Objectives

1. Retirement plans may be qualified or nonqualified. Qualified plans are tax-advantaged and include defined-benefit pension plans, cash-balance plans, money-purchase pension plans, target-benefit plans, profit-sharing plans, 401(k) plans, stock bonus plans, and ESOPs. Keogh plans are qualified plans for self-employed persons, sole proprietors, and partners.

Other retirement plans have some tax advantages, but not as many advantages as qualified plans. Plans that are not considered qualified are simplified employee pensions (SEPs), savings incentive match plans for employees (SIMPLEs), and tax-sheltered annuities, or 403(b) plans, which are only available to employees of 501(c)(3) organizations and employees of public schools.

Qualified plans are tax-advantaged in that they enable the sponsoring employer to take a deduction from gross income for the amount the employer contributes to the plan. The employee is in receipt of taxable income only when the employer's contribution is paid to the employee. In addition, investment income earned on the employer's contribution avoids taxation until such dollars are paid out. For qualified plans, as well as 403(b) plans, SEPs, and SIMPLEs, the benefits are not taxed until distributed, and distributions generally can be rolled over to defer taxation longer.

Qualified plans also differ from the other tax-advantaged plans in some aspects of the tax treatment of distributions.

Although nonqualified retirement plans provide tax-deferred benefits to employees, such plans are not classified as "tax-advantaged" plans. A nonqualified deferred-compensation plan is a retirement plan established by an employer for a few carefully selected employees. The plan is "nonqualified" because it fails to meet one or more of the federal government's requirements. The major differences between a nonqualified plan and a tax-advantaged plan are: (1) the employer does not get a deduction at the time contributions are made, but must instead take the deduction at the

time benefits are paid and taxable to employees; (2) earnings on assets in the plan are currently taxable to the employer; and (3) the assets in the plan are unsecured, i.e., subject to claims of the company's creditors.

Individual retirement accounts (IRAs) and Roth IRAs are personal savings plans to which a working person who has earned income may make annual contributions. In general, contributions to an IRA are either deductible or nondeductible (depending on adjusted gross income) and grow on a tax-deferred basis. Contributions to a Roth IRA are nondeductible and grow on a tax-free basis. While IRAs and Roth IRAs have tax advantages, they are not considered qualified plans. Upon termination or retirement, employees who participate in qualified plans generally have the option of rolling benefits from the qualified plan into an IRA.

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Chapter 1

Pension and Retirement Planning Overview

Multiple Choice Questions

1. All the following opportunities are available to the financial services professional who wants to serve the retirement services market, EXCEPT:

(HL 1.2-1.3)

(A) Setting up nonqualified plans for executives
(B) Advising on investment strategies
(C) Supplementing retirement programs with 401(k) plans
(D) Installing qualified plans for local governments

2. All the following are qualified retirement plans, EXCEPT:

(HL 1.4)

(A) Cash-balance and target-benefit plans
(B) Defined-benefit and profit-sharing plans
(C) 401(k) and SEP plans
(D) Money-purchase and ESOP plans

3. Which of the following statements is true regarding employer contributions to a qualified plan?

(HL 1.5)

(A) The employer receives a tax deduction only when the employee reports income.
(B) The contributions are tax-deductible to the employer and to the employee.
(C) The contributions are deductible to the employer and taxable to the employee.
(D) The contributions are deductible to the employer, but the employee is not taxed until benefits are distributed.

4. Which of the following statements describe(s) tax advantages of a qualified plan?

(HL 1.6)

I Benefits are not subject to taxation when distributed to participants.

II Benefits can be rolled into tax-deferred vehicles when participants become eligible for the benefits.

(A) I only (C) Both I and II
(B) II only (D) Neither I nor II

5. When death benefits are paid by a qualified plan from the proceeds of a life insurance contract, which of the following statements concerning the income tax treatment of the benefits is correct?

(HL 1.7)

(A) The amounts paid are entirely excluded from income.
(B) The amounts paid are excluded from income, to the extent that the face amount exceeds the cash value.
(C) The amounts paid are entirely included in income.
(D) The amounts are excluded from income, to the extent of premiums paid.

6. Which of the following statements concerning nonqualified plans is correct?

(HL 1.7-1.8)

(A) The employer receives no tax deduction for contributions until the employee receives benefits.
(B) The employer receives a current tax deduction for contributions, and the employee defers income taxes until benefits are paid.
(C) The employer receives no tax deduction for contributions, and the employee pays no income taxes on the benefits.
(D) The employer receives no current tax deduction for contributions, and benefits are currently taxable income to the employee.

Chapter 1

Pension and Retirement Planning Overview

Answers and Rationales

1. D is the answer. Qualified plans can be installed for non-profit organizations, but not for local, state, and federal governments.

2. C is the answer. A 401(k) is a qualified plan, but a SEP is not. A SEP is basically an IRA plan, and IRAs are not qualified plans, although they obviously have some tax advantages for the participants. The plans included in A, B, and D are all qualified plans.

3. D is the answer. The contributions to a qualified plan can be deducted by the employer, but the employee is not taxed until the benefits are paid. With a nonqualified plan, the employer receives a tax deduction only when the employee reports income.

4. B is the answer. Benefits are not taxed until distributions are made, but distributions are taxable income. Benefits can be rolled into tax-deferred vehicles when participants become eligible for the benefits.

5. B is the answer. The amounts paid are excluded from income, to the extent that the face amount exceeds the cash value.

6. A is the answer. The employer receives no tax deduction for contributions until the employee receives benefits.