UNIT 16

Types of Clients

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- › LO 16.a **Recognize** the different types of clients securities professionals serve, the different ownership categories, and the legal documentation required to open these accounts.
- › LO 16.b **Distinguish** between the different kinds of business entities capable of opening accounts.
- › LO 16.c **Identify** the different types of business taxation.
- › LO 16.d **Classify** the special requirements for fiduciary accounts, including trust and estate accounts.
- › LO 16.e **Describe** the fundamentals of insurance and trust taxation.
- › LO 16.f **Identify** estate-planning options.
- › LO 16.g **Recognize** the difference between taxation of estates and taxation of gifts.

Your exam will include approximately six questions from the topics covered in Unit 16.

INTRODUCTION

When an individual account is opened, it is registered in the name(s) of one or more individuals; they are the account owners and the only individuals allowed access to and control of the investments in the account. Generally, any competent person of majority age can open an account, and anyone declared legally incompetent cannot. Fiduciary or custodial accounts may be opened for minors or legally incompetent individuals.

In addition to individuals, accounts may be opened for anyone else meeting the definition of a person. That would include business and government entities. Some of these would be considered institutional accounts as defined in Unit 9.

Please note that some of the learning objectives (LOs) involve taxation. For the most part, the numbers used were those in effect in 2021. As pointed out several times, you will never be tested on the exact numbers (because they change every year) but you will need to know the concepts.

LESSON 16.1: WHO ARE CLIENTS?

LO 16.a Recognize the different types of clients securities professionals serve, the different ownership categories, and the legal documentation required to open these accounts.

Securities professionals can serve a wide variety of clients. They range from the individual client to sovereign governments and everything in between. In this unit we'll cover accounts for natural persons, such as the various types of joint accounts. Accounts can be opened for all kinds of philanthropic endeavors, including charities and foundations. We'll also spend time describing the various types of business accounts. Even though any type of government unit from municipalities to states to countries can employ the services of broker-dealers and investment advisers, the exam does not deal with those relationships other than when a broker-dealer acts as an underwriter for, or an investment adviser gives advice to, a political issuer.

Types of Accounts

Individual Accounts

An **individual account** may be for a natural person, a trust, or a deceased person through an estate account. There is one beneficial owner. When referring to investment advisers, normally an individual client is a natural person whose investments are managed by an adviser for a fee. When a business is organized as a sole proprietorship, that business account is also considered an individual account. The adviser should establish, in consultation with the client, a written statement of objectives and investment strategy before making recommendations to the client. This document is frequently referred to as an Investment Policy Statement (IPS). In the next unit we will examine the client profile and see the information necessary to prepare the IPS. In Unit 18, we will discuss the use of the IPS by those with fiduciary responsibility over qualified retirement plans.

The adviser must periodically review the client's investment profile to determine whether any changes in circumstances could alter the client's objectives.

Unless certain legal documents are procured, the account holder is the only person who can:

- control the investments within the account; or
- request distributions of cash or securities from the account.

Suitability for Individual Accounts

Both federal and state regulations require that any investment recommendation be suitable based upon the client's needs, objectives, and financial considerations. In the next unit, we will look at a number of those issues.

Joint Accounts

A **joint account** is owned by two or more persons, and each is allowed control over the account. Generally, suitability information is required on all of the tenants in the account. For exam purposes, there are only two common types of joint accounts offered by securities firms and a third for real estate that we'll cover after those two.

On the new account form, the account must be designated as either **tenants in common (TIC)** or **joint tenants with right of survivorship (JTWROS)**. Account forms for joint accounts require the signatures of all owners. Trading activity (buying or selling) may be initiated at the request of any one of the parties. If a security is purchased, and a certificate is issued, it must be in the name of all of the tenants. Furthermore, when that security is sold, all of the tenants must sign that certificate (or a stock or bond power). The check for the proceeds must be made payable to all of the tenants, and it will be sent to the address designated in the account documents.

Joint Tenants with Right of Survivorship (JTWROS)

JTWROS ownership stipulates that a deceased tenant's interest in the account passes to the surviving tenant(s). Regardless of contributions, each JTWROS account owner has an equal and undivided interest in the cash and securities in the account. Upon the death or declaration of incompetency of any of the account owners, account ownership passes to the survivor(s); a right of succession occurs, and the other party or parties become sole owner(s) of the account.

TEST TOPIC ALERT

Whenever the test uses the term *joint tenants*, it means JTWROS (not tenants in common).

Tenants in Common (TIC)

TIC ownership (or JTIC) provides that a deceased tenant's fractional interest in the account is retained by that tenant's estate and is not passed to the surviving tenant(s). Ownership of a TIC account may be divided unequally. At the death of an account owner, that person's proportionate share of the cash and securities in the account is distributed according to the instructions in the decedent's will. If one account owner dies or is declared incompetent, all pending transactions and outstanding orders must be canceled immediately.

EXAMPLE

If a TIC agreement provides for 60% ownership interest by one owner and 40% ownership interest by the other, that fraction of the account would pass into the deceased owner's estate upon death. The TIC agreement may be used by more than two individuals.

Tenancy by the Entirety (TBE)

This is a third type of concurrent ownership, or ownership by multiple persons. As with the other two we've described, each cotenant has an undivided interest in the account. Unlike the other two we've discussed, a tenancy by the entirety can be created only by married persons. The most important difference between a tenancy by the entirety and a JTWROS or TIC is that in this form of ownership, the consent of the other tenant is required before the other tenant can sell or give away her interest in the property. As with JTWROS, upon the death of one of the spouses, the deceased spouse's interest passes to the surviving spouse. Because this form of ownership is restricted to spouses, it is considered similar to the community property laws found in some states. Tenancy by the entirety is most commonly used for ownership of real property (real estate) and almost never for an account at a securities firm.

Definition: undivided interest. In a joint account, all owners have an undivided interest in the account. What does that mean, especially when we see that a TIC can have unequal shares? Simply stated, an undivided interest means that no tenant has a designated interest in any specific asset in the account. Even when the shares are unequal, one tenant doesn't get stock A and the other stock B. Using our 60/40 example with the TIC account, one owner would have 60% of each of the holdings and the other 40% of each—the assets themselves are not divided between the owners.

TEST TOPIC ALERT

- Tenants in common can own unequal interests in the account, unlike joint tenants with right of survivorship, who always share equally.
- Tenants by the entirety are considered a single owner—no separate shares.
- TIC does not avoid probate.
- Checks or distributions must be made payable in the account name and endorsed by all parties.

PRACTICE QUESTION

A new account is opened for joint tenants with right of survivorship. All of the following statements are true **except**

A. orders may be given by either party.
B. mail can be sent to either party with the permission of the other party.
C. checks can be drawn in the name of either party.
D. in the event of death, the decedent's interest in the account goes to the other party.

Answer: C. Although either party may enter an order, any money or securities delivered out of the account must be in the names of both owners. Right of survivorship means that the surviving owner (or owners) receives the deceased's interest in the account.

Suitability for Joint Accounts

The suitability requirements for a joint account follow the same basic rules as all accounts—you must have a reasonable basis to believe all recommendations presented are suitable based on the information gathered. Because a joint account is really nothing other than a collection of individuals, suitability information must be obtained on all of the account owners, and any recommendations must be appropriate based upon that information. An example you might see on the exam has two brothers with a TIC account. One brother is an accredited investor under Rule 501 of the Securities Act, while the other is far from it. In this case, suitability is usually based on the "lowest common denominator" (the nonaccredited brother).

PRACTICE QUESTIONS

1. Several investors open an account in joint tenancy. For suitability purposes, financial information is required on which of the following investors?
   A. The majority of the investors
   B. The largest investor only
   C. Only the one authorized to trade the account
   D. All of the investors

   Answer: D. When a joint account is opened, in order to be able to make suitable recommendations, financial information should be obtained on all of the account owners.

2. Which of the following individuals may not open a joint account?
   A. Two spouses
   B. Three sisters
   C. Two friends
   D. A parent and a minor child

   Answer: D. A joint account may be opened by two or more individuals who have legal standing. A minor may not be a party in a joint account because minors are not legally considered a person (think back to Unit 9). A parent (or any other adult) can be custodian for a minor, but that is a single account, not a joint account.

Legal Requirements for Opening Accounts

Opening an account for an individual requires the completion of the new account agreement. This is basically a contract between the broker-dealer or investment adviser and the customer explaining the rights and obligations of both and the charges for the services that will be rendered. Information that must be obtained from the client includes items such as:

- legal capacity (that is, is the client of full legal age in the state or jurisdiction or residence, and does she have the capacity to enter into the agreement?);
- employment information; and
- the Customer Identification Program (CIP) notice. In order to help the government fight the funding of terrorism and money laundering activities, broker-dealers and investment advisers are required by federal law (the USA PATRIOT Act of 2001) to obtain, verify, and record information that identifies each person who opens an account. Customer identification requirements apply to all customers opening a new account as those terms are defined in the Bank Secrecy Act (BSA). That information includes:
  - full name,
  - date of birth,
  - permanent physical address (no mail receiving or incorporation services), and
  - identification number (if a U.S. citizen, this is typically the Social Security number);
- citizenship or visa details; and
- financial information about the client.

In the case of joint accounts, the information is the same except that details on all of the joint owners must be furnished. One of the joint owners is designated as the primary contact to receive statements and other communications.

We have not heard anything about the exam requiring you to know the account opening details for business accounts, although there is plenty about those accounts tested that will be covered shortly.

In Unit 4, we dealt with derivatives, especially options. There are some unique requirements to open those accounts. NASAA does not have a specific rule dealing with the opening of options accounts. Therefore, we will refer to the FINRA rules that are used as the guidelines for most states.

Because trading options (puts and calls) generally involves a higher degree of risk than stocks, bonds, or mutual funds, a designated supervisory person with knowledge about options must approve the account opening. In addition, there is a special options disclosure document (ODD) that must be provided to any prospective options customer.

In approving a customer's account for options trading, a broker-dealer or agent associated with the broker-dealer must exercise due diligence to ascertain the essential facts relative to the customer, his financial situation, and his investment objectives. One question asked on a new options account form that is not required on a normal brokerage account opening is investment experience and knowledge (e.g., number of years, size, frequency, and type of transactions) for options, stocks and bonds, commodities, and other financial instruments. Based upon such information, the designated supervisory person shall specifically approve or disapprove in writing the customer's account for options trading.

The account approval will indicate the:

- date the options disclosure document (ODD) is furnished to the customer;
- nature and types of transactions for which the account is approved (e.g., buying, covered writing, uncovered writing, spreading, discretionary transactions);
- name of the agent assigned to the account;
- name of the supervisor approving the account;
- date of approval; and
- dates of verification of currency of account information.

Within 15 days after a customer's account has been approved for options trading, the broker-dealer must obtain from the customer a written agreement that the customer is aware of and agrees to be bound by FINRA rules applicable to the trading of option contracts and that the customer has received a copy of the current ODD. Part of the agreement states that the customer is also aware of and agrees to be bound by the rules of the Options Clearing Corporation.

Finally, there are specific requirements for opening a margin account, and those will be covered in Unit 23.

PRACTICE QUESTION

When an agent with a broker-dealer opens a new options account for a client, in which order must the following actions take place?

I. Obtain approval from a qualified supervisor.
II. Obtain essential facts from the customer.
III. Obtain a signed options agreement.
IV. Enter the initial order.

A. I, II, III, IV
B. I, II, IV, III
C. II, I, IV, III
D. II, I, III, IV

Answer: C. The steps in opening an options account occur in the following order: obtain essential facts about the customer; give the customer an options disclosure document; have the manager approve the account; enter the initial order; and have the customer sign and return the options agreement within 15 days.

KNOWLEDGE CHECK 16.1

1. If three individuals have a tenants in common account with a firm and one individual dies, then
   A. the account must be liquidated and the proceeds split evenly among the two survivors and the decedent's estate.
   B. the two survivors continue as co-tenants with the decedent's estate.
   C. trading is discontinued until the executor names a replacement for the deceased.
   D. the account is converted to joint with right of survivorship.
2. The Bank Secrecy Act requires that financial institutions, such as broker-dealers, make reasonable efforts to determine the true identity of those who wish to open an account. The primary vehicle for this is the customer identification program (CIP). Information *not* required as part of the CIP would be the customer's
   A. full name.
   B. complete date of birth.
   C. physical address of birth location.
   D. identification number.

LESSON 16.2: NONNATURAL PERSON ACCOUNTS

LO 16.b Distinguish between the different kinds of business entities capable of opening accounts.

Sole Proprietorship

This is the simplest form of business organization and is treated like an individual account. Therefore, the same issues of suitability that apply to individual accounts apply to the management of sole proprietorship accounts. In a sole proprietorship, all income (or loss) is that of the individual. In fact, one of the risks of operating in this fashion is that all of the owner's assets are liable for the debts of the business—you can lose everything. Obviously, this is one of the major considerations when opening an account for this form of business.

Partnership Accounts

General Partnership

A general partnership is an unincorporated association consisting of two or more individuals. In a general partnership, the partners manage and are responsible for the operation and debts of the business. Partnerships are easy to form and easy to dissolve, but they are generally not suited for raising large sums of capital. Partnerships allow the business's profits and losses to flow directly through to the investors for tax purposes, thus avoiding double taxation of profits at the business and individual levels. As is the case with a sole proprietorship, the partners are personally liable for debts of the business.

Because the income and losses flow through to the individual partners, an investment policy for a general partnership would have to consider the combined/collective objectives of all of the partners.

Limited Partnership

In the case of an enterprise organized as a limited partnership, the management (and liability) is assigned to the general partner(s) while the limited partner(s) are passive and have liability limited to their investment. This is the typical case with the Direct Participation Programs (DPPs) discussed in Unit 5. Suitability decisions are similar to a general partnership except that the limited partners do not have the full liability of the general partner(s).

Corporate Accounts

S Corporation

An **S corporation**, although taxed like a partnership, offers investors the limited liability associated with corporations in general. The profits and losses are passed through directly to the shareholders in proportion to their ownership in the S corporation. One of the limitations placed on an S corporation is that it may not have more than 100 shareholders, none of whom may be a nonresident alien, or more than one class of stock (presumably common).

Losses on S corporation stock may be claimed only to the extent of an investor's basis in the shares. The basis includes money contributed or lent to the corporation.

TAKE NOTE

Geraldine invested $25,000 in an S corporation, along with nine other investors who invested the same amount. Within a year, the corporation needed additional equipment, so Geraldine lent $10,000 to the business from her own funds. Her basis is now $35,000. If the corporation experiences a $400,000 loss, Geraldine's portion is $40,000. However, she may deduct only $35,000 of the loss because that is the amount of her basis.

C Corporation

A **C corporation** is a business structure that distinguishes the company as a separate entity from its owners. If a business expects to need significant capital, this form is almost always the preferred choice. Unlike the management of a partnership (the general partner[s]), in most cases, the corporation's officers and directors are shielded from personal liability for the corporation's debts and losses. Shareholders are also shielded from corporate creditors. That is the limited liability benefit of owning stock. Corporate income tax applies to the corporation as an entity rather than being passed through to the shareholder. If your client is a C corporation, you will only look at the corporation's financial needs and objectives when determining suitability.

TAKE NOTE

C corporation earnings are subject to double taxation. Before distribution, the earnings are taxable to the corporation and then are taxed again to the shareholder when paid out as a dividend. Distributions from LLCs and S corporations are taxed only once because there is no taxation at the business entity level. On the other hand, as we will learn in later in this unit, C corporations are entitled to exclude 50% of dividend income received from domestic corporations.

Limited Liability Company (LLC)

Not really a corporation nor a partnership, a **limited liability company** (**LLC**) is a business structure that combines benefits of incorporation (limited liability) with the tax advantages of a partnership (flow-through of taxable earnings or losses). The LLC owners are **members** (not shareholders) and are not personally liable for the debts of the LLC. Don't be surprised if the exam uses the term *limited liability membership company*. That is just another way of saying LLC. Unlike the S corporation with its limit of 100 shareholders, there is no upper limit on the number of members in an LLC.

TEST TOPIC ALERT

If a sole proprietorship operates under a DBA (Doing Business As) name that might seem to imply it is a corporation, it does not remove the full liability from the individual owner.

TEST TOPIC ALERT

Any business organization client where the entity itself has no liability and is not subject to tax, such as a partnership, an LLC, or an S corporation, requires the adviser to look through the entity to the owners in order to properly meet the suitability standards.

Choosing the Right Business Structure

Here are some testable points to consider when a person is considering the most appropriate business form to use:

- The easiest business to set up, especially if you don't expect much liability, is the sole proprietorship. However, because the business and the owner are inseparable, there is unlimited liability and no limits to the amount of the loss (if any) that may be claimed on the proprietor's tax return.
- Partnerships and LLCs are generally easier to form and dissolve than a C corporation.
- Benefits of structuring a business as a general partnership, an LLC, or an S corporation would include no double taxation as is the case with a C corporation.
- However, a company that expects to be very profitable should be a C corporation instead of a partnership, an LLC, or an S corporation because in those three, all earnings pass to owners—nothing can be retained.
- Only the sole proprietorship and the C corporation are taxed on their income. The sole proprietorship's income is on the owner's personal tax return (Schedule C of Form 1040) and the corporation's is on Form 1120.

- The only logical choice where a large amount of capital is to be raised is the C corporation.
- The business entities that have limited liability for owners as well as flow-through of income or loss are the limited partnership, LLC, and S corporation. The C corporation has limited liability but no flow-through; the sole proprietorship and general partnership have flow-through but unlimited liability.
- Corporations (including LLCs) survive the death of their owners (even if there is only one shareholder in an S corporation or C corporation or one member of the LLC).
- When it comes to transferability of ownership, the corporate form, especially the C corporation, is the preferred choice (selling shares is usually pretty straightforward).

PRACTICE QUESTIONS

1. Three friends plan to start a new business. It is anticipated it will be several years before the business turns a profit. Which of the following types of business organization would be best if they wish to limit their liability while at the same time being able to receive favorable tax treatment for the expected losses?
   A. C corporation
   B. S corporation
   C. General partnership
   D. Sole proprietorship

   Answer: B. The only way to limit liability is through a corporation (or LLC or limited partnership—neither of which is offered here as a choice). The S corporation allows for the flow-through of operating losses to the shareholders while the C corporation does not.

2. Which of the following business structures is most appropriate for retaining money in the business?
   A. A C corporation
   B. A sole proprietorship
   C. An LLC
   D. An S corporation

   Answer: A. Only in the case of a C corporation is money retained not subject to tax on the personal level. In all of the other choices, any income is passed through to the owners, making it inefficient to accumulate funds in the business.

3. Felix and Kathleen are two equal partners in a successful business. With surplus funds to invest, they contact a financial planner registered as an investment adviser. One recommendation the adviser makes is that they restructure the business as a limited liability company (LLC). The most likely reason for that is
   A. tax savings.
   B. the ability to raise additional funds without giving up control of the business.
   C. removing the unlimited liability from the two partners.
   D. customers feel more comfortable dealing with an LLC than a partnership.

   Answer: C. One problem with the partnership form of business is that the partners have unlimited personal liability. That is not the case with an LLC; liability is limited to the invested capital. The tax treatment for an LLC and a partnership are the same, so there would be no tax savings. Raising additional funds means bringing in more members with the possibility of losing control.

LO 16.c Identify the different types of business taxation.

Sole Proprietorships

Sole proprietorships are the simplest business form but offer no liability protection to the owner. In fact, this is the only form of business where the potential loss is unlimited because the personal assets of the owner are at risk in addition to any assets owned by the business. The owner computes the earnings of the business on Schedule C of her Form 1040, so anything made (or lost) by the business is reflected directly on her tax return—there is no separate tax return for the business entity.

Partnerships

Partnerships are relatively easy to form and dissolve and come in two types. Both offer flow-through of income and losses, the difference being in the degree of liability. General partnerships provide no liability protection to the partners. In other words, if the business goes under, they, collectively and separately, are liable for any losses. In a limited partnership, as the name implies, something is limited. In this case, it is the liability. A limited partner's maximum loss is what has already been invested plus any funds committed for but not yet contributed. That is why so many DPPs are organized as LPs.

Partnerships do not pay taxes. They file an information return, a Form 1065, and attach to that (and send a copy to each limited partner) a Schedule K-1 indicating the amount of income (or loss) to be inserted on the investor's personal Form 1040.

Limited Liability Company (LLC)

The LLC is somewhat of a hybrid between the partnership and the corporation. The federal government does not recognize an LLC as a classification for federal tax purposes. An LLC business entity must file as a corporation, partnership, or sole proprietorship. Generally, a one-member LLC will use Schedule C, just as if it were a sole proprietorship. Those with two or more members invariably file as partnerships using Form 1065 to provide the IRS with the information and Schedule K-1 for each member's share of income or loss. If filing as a corporation, they generally file as an S corporation, but it is unlikely, for test purposes, that you will have to know anything about an LLC filing as a corporation.

Corporations

As with partnerships, we have two types here as well—the C corporation and the S corporation. Of all the business entities we've discussed, the only one that actually files a tax return on which it must pay income tax is the C corporation. It files on Form 1120 and pays taxes at a rate that generally does not exceed 21%. The key fact about the C corporation is that its dividends are paid out after paying income taxes, and then that dividend is taxable to the shareholder; hence the term *double taxation*.

The S corporation (sometimes referred to by its ancient name, *Subchapter S corporation*, on the exam) is treated for tax purposes the same as a partnership except that the return filed is Form 1120S. Shareholders receive a Schedule K-1 indicating their share of income or loss. Just as with the LLC and the partnership, the business entity is not taxed; everything flows through to the owners. The TCJA (Tax Cuts and Jobs Act) of 2017 made a major change in the way that flow-through business entities are taxed, but those are unlikely to be tested.

C corporations are major investors in securities. Some **Internal Revenue Code (IRC)** provisions affecting C corporations as investors include the following:

- **Dividend exclusion rule:** Dividends paid from one corporation to another are 50% exempt from taxation. A corporation that receives dividends on stocks of other domestic (and certain qualifying foreign) corporations, therefore, pays taxes on only 50% of the dividends received.
- **Municipal securities:** Like individual taxpayers, corporations do not pay federal taxes on interest received from municipal bonds.

Filing Dates for Business Tax Returns

Sole Proprietorship

A business organized as a sole proprietorship is an extension of the individual running the business, so its year-end date is December 31, and the tax return due date is the same as the individual's—April 15 of the following year.

Single Member LLC

If the business is an LLC with only one member, it is taxed like a sole proprietorship, using Schedule C with a year-end date of December 31. The tax returns are due and taxes payable on April 15 of the following year.

Partnership and Multiple Member LLCs

The tax-filing requirements for a partnership and an LLC with more than one member are the same. An information return is filed on Form 1065, with a Schedule K-1 sent to the partners/members indicating the amount of income or loss attributable to each of them. Remember, the business entity pays no income tax—all reportable income/loss flows through to the partners/members. Form 1065 and the K-1 are due on March 15 of the following year. The year-end date for these businesses is typically December 31. Because these are flow-through entities, they don't pay taxes. Taxes are due on April 15, when the individual partners/members file their Form 1040s showing their share of the business's income or loss that was reported on Schedule K-1.

Corporations

A regular (C) corporation may choose any convenient date as their year-end date (usually a quarter-end date). C corporation tax returns are due and taxes are payable on the 15th day of the fourth month after the end of the company's fiscal (financial) year. So, a C corporation with a year-end date of December 31 must file and pay taxes by April 15; a C corporation with a year-end date of September 30 must file and pay taxes by January 15.

In the case of an S corporation, income/loss is taxed on individual income tax returns. Therefore, an S corporation must usually take a calendar year-end date (December 31) unless the corporation can establish a reasonable business purpose for a different date. The due date for filing Form 1120S is the same as for partnerships and multiple member LLCs (March 15 for a December 31 year-end date). As with the other flow-through entities, Schedule K-1 is sent to shareholders one month before their personal income tax due date and is used in the preparation of their Form 1040 returns.

TEST TOPIC ALERT

You may be asked about tax documents for each of these different forms of business organizations. Sole proprietors file their business information on Schedule C. Members of LLCs and shareholders in S corporations receive Schedule K-1, and C corporations report their income on Form 1120.

PRACTICE QUESTION

Most new businesses operate at a loss for a period of time. If several of your clients were forming a group to fund a start-up enterprise but wished to limit their liability and, at the same time, be able to receive favorable tax treatment for the expected losses, you would suggest forming which of the following?

A. C corporation
B. General partnership
C. LLC
D. Sole proprietorship

Answer: C. The only way to limit liability is through a corporation (C or S), LLC, or limited partnership. The LLC allows for the flow-through of operating losses to the shareholders while the C corporation does not.

KNOWLEDGE CHECK 16.2

1. Which of the following business accounts requires a minimum of two owners?
   A. A sole proprietorship
   B. A general partnership
   C. An LLC
   D. An S corporation
2. Which of the following business entities is directly responsible for paying taxes on its income?
   A. A C corporation
   B. A limited partnership
   C. An LLC
   D. An S corporation

LESSON 16.3: FIDUCIARY ACCOUNTS AND TRUSTS

LO 16.d Classify the special requirements for fiduciary accounts, including trust and estate accounts.

Fiduciary Accounts

In a **fiduciary account**, the individual granted fiduciary responsibility enters trades for the account; makes all of the investment, management, and distribution decisions; and must manage the account in the owner's best interests.

Examples of fiduciaries include the following:

- **Trustee** designated to administer a trust
- **Executor** (f. **executrix**) designated in a decedent's will to manage the estate's affairs
- **Administrator** appointed by the courts to liquidate the estate of a person who died intestate (without a will), known as an *administrator in intestacy*

- **Guardian (conservator)** designated by the courts to handle the affairs of a minor or a person judged incompetent
- **Custodian** of a UGMA account
- **Receiver** or trustee in a bankruptcy

A **fiduciary** is anyone legally appointed and authorized to represent another person, act on that person's behalf, and make decisions necessary to the prudent management of that person's account. The constraints placed on the actions of a fiduciary are described in detail in the Uniform Prudent Investors Act (UPIA). For example, a fiduciary cannot use account contents for personal benefit but may be reimbursed for reasonable expenses incurred in managing the account. Do not confuse that with transaction costs. When determining appropriate investments, the cost of the transaction (trading commissions) is not nearly as important as how well the investment meets the needs of the account. The exam tends to focus its UPIA questions on those managing qualified retirement plans, so we'll revisit the act in Unit 18.

TAKE NOTE

Any trades the fiduciary enters must be consistent with the trust's investment objectives.

Opening a Fiduciary Account

Opening a fiduciary account may require a court certification of the individual's appointment and authority. An account for a trustee must include a trust agreement detailing the limitations placed on the fiduciary. No documentation of custodial rights or court certification is required for an individual to open a UGMA or UTMA account (see Unit 18).

Power of Attorney

If a person who is not named on an account is to have trading authority, the customer must file written authorization with the broker-dealer giving that person access to the account. Without this power in writing, no matter how tempting the answer on the exam, activity in the account cannot be created by anyone other than the account owner(s). Trading authorization usually takes the form of a power of attorney. Two basic types of trading authorizations are **full** and **limited powers of attorney**.

Full Power of Attorney

A full power of attorney allows an individual who is not the owner of an account to:

- deposit or withdraw cash or securities; and/or
- make investment decisions for the account owner.

Limited Power of Attorney

A limited power of attorney allows an individual to have some, but not total, control over an account. The document specifies the level of access the person may exercise.

TEST TOPIC ALERT

Limited power of attorney, also called *limited trading authorization*, allows entering of buy and sell orders but not the withdrawal of funds. Entry of orders and withdrawal of funds is only allowed if full power of attorney is granted.

Durable Power of Attorney

A full or limited power may be made "durable" by the grantor of the power. It is designed to provide that a specifically designated person maintains power over the account even upon the grantor's incapacitation, whether due to physical or mental causes. Its most common use is when providing for aging parents. However, upon the death of either principal to the durable power of attorney, the power is terminated.

How does this differ from the living will that we will discuss shortly? A living will is a written document making your specific end-of-life wishes known. The durable POA appoints someone to act on your behalf and make the decisions. So, if you want to be sure your wishes are followed, prepare a living will.

TEST TOPIC ALERT

A durable power of attorney survives the physical or mental incompetence of the grantor but not the death of either party.

This means that orders entered after the time of death of the grantor, even if the purchase or sale was decided upon prior to death, are not accepted.

Trust and Estate Accounts

Two special kinds of accounts that may appear on the exam are those dealing with trusts and estates. What both of these have in common is that the person entering orders on behalf of the account is acting in a fiduciary capacity, whether it be the trustee of the trust or the executor (or administrator) of the estate. These fiduciaries are acting for the benefit of the beneficiary or beneficiaries of the trust or estate, so it is necessary to look at the objectives of the trust and the needs of the heirs.

Trust Accounts

A **trust** is a legal entity that offers flexibility to an individual who wishes to transfer property. Trusts may be established for a variety of personal and charitable property transfers. Trusts are also established as the legal entity for a corporate retirement plan, but that will be covered in a later unit.

The subject of trust law is very complicated and should only be addressed by one who is competent in the subject, usually an attorney.

This exam will require you to know the basics of trusts, how trusts are taxed, trustee responsibility, and your obligations when acting as an adviser to the account.

Trust Parties

For a trust to be valid, three parties must be specified in the trust document (trust agreement). These parties are a settlor, a trustee, and a beneficiary. Under certain circumstances, the settlor, trustee, and beneficiary may be the same individual. For a trust to be valid, both the settlor and the trustee must be competent parties. However, the beneficiary may be a minor or a legally incompetent adult.

The Settlor

The **settlor** is the person who supplies the property for the trust. Trust property is referred to as its principal or corpus. This party is also known as the maker, **grantor**, trustor, or donor.

Trustee

A **trustee** is an individual or another party holding legal title to property held for the benefit of another person (or persons). The trustee must administer the trust by following directions in a trust agreement or in a will. A trustee must perform certain duties relative to the trust property.

A trustee is a fiduciary and is obliged to perform in the interest of the beneficiaries. The trustee may be one or more adult individuals or an entity in the business of trusteeship that is responsible for investing, administering, and distributing trust assets for the benefit of the beneficiary (or beneficiaries).

In many ways, a trustee's duties are like those of an **executor** (for an estate). However, a trustee's duties generally continue for more time than a typical estate settlement, and the trustee is charged with the greater duty of investing trust assets.

Beneficiary

A **beneficiary** is a person for whose benefit property is held in trust. A beneficiary is one who receives or who is designated to receive benefits from property transferred by a trustor. Beneficiaries to a trust include only those persons upon whom the settlor intended to benefit from the trust property or those who would succeed their interests.

EXAMPLE

Jill establishes a trust under which her husband, Julian, is to receive all income produced by the trust property for as long as he lives. Upon Julian's death, their daughter, Janet, will receive the trust principal. Julian is a primary beneficiary. However, until Julian's death, Janet is a contingent beneficiary because her benefit depends on the occurrence of an event—in this case, Julian's death.

TEST TOPIC ALERT

Although it doesn't happen often, the grantor of the trust can also be the trustee and/or the beneficiary.

Remainderman

When a trust has run its course and all expenses and distributions have been made, the person who receives the remaining balance is called the *remainderman* (no gender preference here—there's no such term as "remainderwoman"). The most common case involves real estate. For example, the husband dies and arranges for his wife to have full use of their home until she passes away. At that time, any surviving children inherit the home. They are the remaindermen.

Simple Trusts vs. Complex Trusts

Simple Trusts

All income earned on assets placed into a **simple trust** must be distributed during the year it is received. If the trust does not distribute all of its net income at least annually, the trust is declared a complex trust. The trustee is not empowered to distribute the trust principal from a simple trust.

Complex Trust

On the other hand, a **complex trust** may accumulate income. A complex trust is permitted deductions for distributions of net income or principal. Capital gains are deemed part of the distributable net income of a complex trust unless reinvested. Furthermore, the trustee may distribute trust principal according to trust terms.

TEST TOPIC ALERT

The key difference between a simple and a complex trust is that the simple trust must distribute all of its annual income, whereas a complex trust is not obligated to do so.

Living vs. Testamentary Trusts

Living Trust

A **living trust**, also known as an **inter vivos trust**, is established during the maker's lifetime. A testamentary trust is established according to the instructions of a will—that is, not with the death of the maker.

Testamentary Trust

With a **testamentary trust**, the settlor retains control over assets until death (think "last will and testament"). The individual's will stipulates that, at death, the testator's property is to be placed in trust for the benefit of one or more beneficiaries.

The testamentary trust does not reduce the grantor's income or estate tax exposure. Furthermore, assets that pass to a testamentary trust do **not** avoid probate, because the validity of the will's instructions to pass property to the trust must be substantiated in probate court.

Living Will

Please do not confuse a living will with a living trust or even a will. The common name for these is an advance directive or medical care directive. This has nothing to do with assets or beneficiaries. It is the individual's instructions for end-of-life situations, such as withholding medical care or organ donation. The exam may show it as something like this:

PRACTICE QUESTION

A living will is used to

A. avoid the cost and time of probate.
B. eliminate, or at least reduce, estate taxes.
C. ensure that the author's assets are properly distributed after death.
D. express the author's end-of-life wishes.

Answer: D. Sometimes referred to as a medical directive or advanced care directive, a living will is used to express the author's end-of-life wishes, such as organ donation, "pulling the plug," and so forth. It has nothing to do with a living trust or a last will and testament describing the distribution of assets after death.

Foundations and Charities

One of the discoveries of the Madoff affair was the large amounts lost by charities and foundations. In most cases, certainly true for charities, they should be dealt with as the fiduciary accounts described above. In the case of foundations, because those are usually funded by the principals, a greater amount of investment flexibility may be called for.

Philanthropic Funds

Wealthy individuals may set up donor-advised funds that allow for flexibility and tax advantages. There are mutual fund sponsors and banks that offer these individuals the opportunity to donate a lump sum, take a current tax deduction, and then have the assets invested to earn over a period of time while allowing the donor to advise distributions to favored charities. If you are dealing with high net worth (HNW) clients who are of a charitable bent, there could be great merit in advising them in this direction.

PRACTICE QUESTION

For which of the following types of clients would the suitability requirements be somewhat more relaxed?

A. A guardian for an orphan
B. A charity
C. A foundation
D. An executor

Answer: C. Guardians and executors are fiduciaries controlling assets of those who cannot speak for themselves. Charities raise funds from donors expecting that the money will be invested wisely. Foundations are generally funded by their founders, who usually give those managing the money greater flexibility.

Impact Investments

Impact investing can be defined as "the intentional allocation of capital to generate a positive social or environmental impact that can be—and is—measured."

Charities and foundations usually have a specified goal, whether it be medical research (think American Cancer Society) or social goals (think Greenpeace). Impact investing is when the entity commits a portion of its funds to those companies or industries that align with those goals. It's unlikely the Cancer Society would have tobacco stocks in its portfolio, and Greenpeace probably wouldn't invest in strip mining companies.

Impact investing is a subset of Socially Responsible Investing (SRI), which attempts to generate positive social good in addition to the goals typically outlined in an SRI approach. Where socially responsible investing fund managers are generally passive and adopt a "do no harm" approach, impact investing funds typically not only seek to create positive impact but also measure and report their impact in a transparent way. The acronym "ESG" is also frequently found. This stands for environment, social, and corporate governance.

PRACTICE QUESTION

A socially responsible mutual fund would probably invest in companies

A. generating high returns.
B. acting with high ethics and morality.
C. located in a single geographic area.
D. with a major presence on social media.

Answer: B. SRI looks for companies with high ethical standards. A mutual fund promoting itself and being socially responsible is going to direct its portfolio investments to companies that meet the description.

Here is a bit more about the topic, which should enable any student encountering this or a similar question to be confident in their choice of answer. The standards involved include corporate responsibility and concerns for society as valid parts of investment decisions. ESG criteria are used in an attempt to generate long-term competitive financial returns and positive societal impact.

Program-Related Investments

Although somewhat similar to impact investing, program-related investments are those where the foundation (more common for them than charities) makes a charitable distribution. Examples of this would be helping bring new drugs to market more quickly by providing necessary funding. One caution is that the investments must be consistent with the philanthropy's mission in order to get the same favorable tax treatment by the IRS as a regular charitable gift would.

Management Obligations

In general, these foundations are managed by a board of directors having the responsibility of selecting and overseeing the activities of the investment manager. The board prepares an investment policy statement (IPS) describing their goals and objectives and uses this IPS to monitor how well the investment manager(s) adhere to the plan.

As described in the specific IPS, these managers need to evaluate the expected returns and see that they outpace inflation without taking undue risk. Diversification is the key, both with the types of industry and types of security and relative risk.

Account Opening Requirements

Opening an account for an organization is somewhat more complicated than an individual account. In addition to information about the entity, detailed information about those individuals in a control position (officers, 10% owners, etc.) must be supplied. Significant financial information about the organization is also required in order to help determine suitability. Most broker-dealers have special account opening forms, and investments advisers usually use a different contract when dealing with an organization. We don't expect you will see much in the way of detail on your exam.

LO 16.e Describe the fundamentals of insurance and trust taxation.

Income Tax Implications of Life Insurance

Premiums for individually purchased life insurance are generally nondeductible for income tax purposes. Generally, proceeds from life insurance policies made to a beneficiary are exempt from federal income tax.

Policy Loans

When you borrow cash value from your life insurance policy, the funds received are nontaxable. This is the same as any other borrowed money—it isn't your money and must be paid back at some time in the future. Note that if you never pay it back, the amount of the loan will be deducted from the death benefit (the insurance company will finally get back the money).

Policy Surrender

If a variable life insurance policy is surrendered, any cash value in excess of the basis in the policy (the premiums paid) is taxable as ordinary income.

Withdrawal of Cash Value

If there is a partial withdrawal of cash value from a variable life insurance policy, the FIFO (first in, first out) rules apply. This is unlike the LIFO treatment on an annuity (covered in Unit 24). Therefore, there are no tax consequences until the amount withdrawn exceeds the cost basis in the policy.

PRACTICE QUESTION

Which of the following are possible sources of taxable income to an individual?

I. Owning a sole proprietorship
II. Being a shareholder in a subchapter S corporation
III. Owning stocks and bonds
IV. Proceeds paid on a life insurance policy

A. I and II
B. I, II, and III
C. I, II, III, and IV
D. II and III

Answer: B. An individual can generate income from running a sole proprietorship or being a shareholder in an S corporation (the exam will probably use the obsolete term *Subchapter S)*. Of course, taxable income can be generated by investments in the form of dividends, interest, and capital gains. One very valuable feature of life insurance is that death benefits paid to the beneficiary of a life insurance policy are *not* subject to federal income tax, so choice IV is not part of the correct answer.

Taxation of Social Security

Taxation of Social Security is included in this LO because the Old Age, Survivors, and Disability Insurance program (OASDI) is the official name for Social Security in the United States. As much as 50% of Social Security benefits start becoming taxable once a single person's base income (IRS computation called *provisional income*) exceeds $25,000 and a married couple's exceeds $32,000. Once that income exceeds $34,000 (single) or $44,000 (couple), it is likely that 85% of the Social Security benefit is subject to income tax.

Although we have not heard of this being tested, individuals claiming benefits prior to full retirement age will see a reduction in those benefits once earnings reach a certain point (this changes every year).

Estate Tax Implications to Owning Life Insurance

If someone named as the insured individual on a life insurance policy holds incidents of ownership in that policy, the entire death benefit payable under that policy is included for federal estate tax purposes in the insured individual's estate.

If a person retains the right to designate a beneficiary, transfer ownership of an insurance policy (assign), choose how dividends or policy proceeds will be paid out, borrow money from the accumulated cash value of the policy, or perform any other functions that are rights of ownership, then that person has incidents of ownership in the policy.

Irrevocable Life Insurance Trust

In light of the estate tax implications, it is frequently best that a party other than the insured own the life insurance policy in order to remove the proceeds from the estate of the insured. An effective alternative to ownership of a policy on one's own life is to have the life insurance acquired by or transferred to an irrevocable life insurance trust (ILIT). If certain provisions, known as Crummey powers, are included in the ILIT document, premiums paid by the insured may qualify for the annual gift tax exclusion (currently $16,000 in 2022, per year, per beneficiary). Please note that while the tax numbers are from 2021, we are using the 2022 annual gift tax number because it is the only one that is likely to be tested.

TEST TOPIC ALERT

In those cases where the estate does have liquid assets such as stocks and bonds, life insurance still may serve a valuable need in that these income-producing assets will not have to be sold to cover the estate tax liability or other final expenses.

Trusts are considered legal persons and may be subject to taxation. In fact, if not handled properly, the taxes can be quite onerous.

Trust Tax Rates

Taxation of trusts and estates is based on what is distributed and what is retained. In the case of nondistributed income, the tax consequences can be quite severe because the tax brackets are highly compressed. For example, although a joint return filed for 2021 would have to report income in excess of $628,000 to be subject to the highest tax bracket of 37%, that rate is reached once a trust or estate has nondistributed income in excess of $13,050. Obviously, this can have a major impact on investment planning.

TEST TOPIC ALERT

If the trust or estate has income, it must be reported on IRS Form 1041.

Distributable Net Income (DNI)

Because of the onerous tax implications just described, most trusts and estates distribute their income. In the context of a trust or an estate, the taxable income is known as distributable net income (DNI). DNI determines the amount of income that may be taxable to beneficiaries (or the grantor in the case of a revocable trust), whereas the balance may be taxed to the trust as indicated above. Commissions and other fees charged for buying and selling securities held in a trust are subtracted from the trust's DNI. Realized capital gains that are reinvested in the corpus (Latin for "body") of the trust are not considered part of DNI.

EXAMPLE

The Gordon Clark Trust had dividend income of $10,000 and interest income of $7,000. In addition, the trust realized capital gains of $3,000, half of which were reinvested in the corpus of the trust. Transaction costs for the year were $2,000. The Gordon Clark Trust has DNI for the year of $16,500 ($10,000 + $7,000 + $1,500 – $2,000). The $1,500 of realized gains reinvested is not part of DNI.

Tax-exempt interest from municipal bonds remains tax exempt to trust beneficiaries.

If the trust is revocable, all income, whether distributed or not, is taxed to the **grantor**. In the case of an irrevocable trust, distributed income might be taxed to the beneficiary and/or the grantor, but the topic is so complicated that we don't expect it to be tested.

Bypass Trust

A bypass trust is an estate-planning tool used to take advantage of the lifetime estate tax exclusion. It is commonly used between spouses when both are U.S. citizens and takes advantage of the unified tax credit. The concept of the bypass trust is to enable a surviving spouse to take advantage of the unused lifetime exclusion of the first to die (currently $11.2 million) and add it to their exclusion. Tax legislation passed in 2010 has largely removed the need for this trust.

Portability of Unused Estate Tax Exemption Under ATRA

As mentioned above, the bypass trust is no longer needed. This is because the Tax Act of 2010 contained the concept of portability, which permits the surviving spouse to take the unused portion of the first deceased spouse's federal exemption and aggregate it with the surviving spouse's unused portion.

To use an example, for 2021, each living spouse has a lifetime exemption from estate tax of $11.7 million. One spouse dies in 2021, leaving their entire estate of $17 million to the other spouse. There would be no estate tax because of the unlimited marital deduction. Let's assume that the deceased spouse has not used any of their $11.7 million exemption by making taxable gifts in previous years. If the surviving spouse dies later with the estate value up to as much as $23.4 million, the executor of that estate can use all of the spouse's exemption of $11.7 million as well as the previously deceased's unused portion (up to $11.7 million) needed to reduce the federal estate tax to zero.

EXAMPLE

Each individual in a married couple has a lifetime estate tax exclusion (2021) of $11.7 million. At the time of the first to die, the gross value of the estate is $15 million. If the provisions of the will stated that the estate was to be left to the surviving spouse, then, taking advantage of the unlimited marital deduction, all $15 million passes without estate tax and without impacting the deceased lifetime exclusion. Therefore, the surviving spouse gets the $11.7 million "left over" from the deceased, meaning that no estate tax will be due after the survivor's passing unless the estate's value exceeds $23.4 million.

Generation-Skipping Trust (GST)

Just as the name implies, a generation-skipping trust is used to pass money from family members to other members more than one generation removed (grandchildren and/or great-grandchildren). Therefore, instead of the assets being taxed upon the death of the parents and then again when their children pass them to the grandchildren, one level of estate taxation is eliminated. The combination of the marital portability and the greatly increased estate tax exclusion granted by the TCJA of 2017 will result in many fewer clients needing this kind of plan.

KNOWLEDGE CHECK 16.3

1. A customer wishing to avoid probate could do so by all of the following methods **except**
   A. designating the beneficiary of the account in the will.
   B. titling the account TOD.
   C. titling the account JTWROS.
   D. using a properly designed trust.
2. A trust account figuring its distributable net income (DNI) for the year would exclude
   A. interest on tax-free municipal bonds.
   B. interest on U.S. government bonds.
   C. qualified dividends on domestic stock.
   D. capital gains reinvested in the corpus of the trust.

LESSON 16.4: ESTATE PLANNING

LO 16.f Identify estate-planning options.

Although estate planning is best left for the specialists, the exam will cover several basic concepts that will enable you to assist your clients and help identify when to call in the attorneys.

Transfer on Death (TOD) Accounts

Using a transfer on death (TOD) account is the simplest way to keep assets held in brokerage accounts from becoming subject to probate upon a client's death and, at the same time, be distributed specifically as the account owner wishes. However, the TOD account does not avoid estate taxes if applicable. TOD accounts are available for most types of paper assets, such as savings and checking accounts in banks and credit unions, certificates of deposit, stocks, bonds, and other securities.

The owner, while alive, is the only person with any rights to the property. Upon the owner's death, the property is immediately transferred to the named beneficiaries, usually without any added cost. The owner has the right to change beneficiaries at any time and provide for unequal distribution of the assets if desired. One of the other attractive features of TOD accounts is that there is no legal documentation necessary. The only types of accounts that may be opened with a TOD designation are individual accounts, JTWROS, community property with rights of survivorship (CPWROS), and tenants by the entirety accounts.

EXAMPLE

A client has an account where, upon her death, she desires that her only son will receive 50% of the account value and her four daughters will receive 12.5% each. The easiest way to accomplish this would be to title the account

A. TOD.
B. JTWROS.
C. tenants in common.
D. in trust for the children.

Answer: A. Transfer on death (TOD) requires no additional legal work and allows the account owner to designate beneficiaries in whatever percentages she wants. Furthermore, changes can be made at any time prior to death.

TAKE NOTE

You might also see this as payable on death (POD), although the term is used far more frequently for bank accounts.

Totten Trust

If you have a really old bank account, you might have a Totten trust designation using language similar to "John Doe, in trust for Jane Doe" or perhaps "John Doe as trustee for Jane Doe." Totten trusts, sometimes referred to as a "poor man's will," allowed for the transfer of ownership of a bank account to a beneficiary after the owner's death. Totten trusts were the predecessor to POD or TOD designations, but a few states still recognize them.

Avoiding Probate

There are three primary tools used to avoid probate. One of them is to designate a beneficiary. A beneficiary designation is always found in life insurance and retirement accounts, and sometimes bank and brokerage accounts. Another way is by using a POD (pay on death) or TOD (transfer on death) designation on a bank or investment account. The third tool is to have assets titled in the names of two or more people as "joint tenants with right of survivorship" or "tenants by the entirety," for example.

PRACTICE QUESTION

A customer of a broker-dealer has an IRA at the firm. Upon the death of the owner, to determine proper distribution of the assets, the broker-dealer would examine

A. the IRA's beneficiary designation.
B. the IRA's TOD designation.
C. the customer's will.
D. the determination of the probate court.

Answer: A. It is rare to find an IRA that does not have a specified beneficiary or beneficiaries. If the owner attempts to transmit the IRA through a will or trust, the beneficiary designation will control the disposition. TOD is not used with retirement plans, and designation of a beneficiary avoids probate.

Revocable vs. Irrevocable Trusts

For more elaborate estate planning, it is advised that the client consider the use of trusts. Terms of a **revocable trust** may be changed during the maker's lifetime. Terms of an **irrevocable trust** generally cannot be changed.

Revocable Trust

If the grantor retains the ability to revoke the trust and take back the trust assets, the trust is revocable and the income is taxable to the grantor under the grantor trust rules. That means the grantor is subject to tax on trust income even when not actually receiving the income. Assets in a revocable trust are included in the grantor's gross estate for federal estate tax purposes—no estate tax benefits apply. Revocable trusts are also called living trusts. They are used primarily as a will substitute. Assets in trust avoid the cost, time, expense, and publicity of probate.

Irrevocable Trust

For a trust to be considered irrevocable, the settlor must give up all ownership in property transferred into the trust. Property placed in an irrevocable trust is usually not includable in the trustor's estate for federal estate tax purposes. Certain exceptions to the general rule can jeopardize the effectiveness of an irrevocable trust to reduce estate taxes, but they are unlikely to be tested.

Grantor Retained Annuity Trusts (GRATs)

This is an estate-planning tool designed to pass assets to beneficiaries (usually children) in a way to minimize gift and/or estate taxes. The topic is very complicated, but here are the basics you might need to know.

- The key is in the words *grantor retained*. That tells you that any income from the trust is taxed to the grantor.
- The annuity portion is paid for a specified number of years. At the end of that term, the beneficiaries get whatever is left, and that could be free of estate and gift taxes.

PRACTICE QUESTION

Sam Jones has been a successful businessman and is concerned that his youngest daughter will not be able to live within her means. To protect this from happening, Mr. Jones places a large sum of money into a trust for the benefit of the daughter. Because Mr. Jones knows he won't live forever, he arranges for the Fourth Fidelity Bank and Trust Company to have control over the assets. Which of the following statements is not true?

A. Sam Jones is the grantor.
B. Sam Jones is the trustee.
C. Fidelity Bank and Trust Company is the trustee.
D. Sam Jones's daughter is the beneficiary.

Answer: B. The person (A) who funds the trust is the grantor or settlor. The bank has been appointed to be trustee (C), and the daughter is the beneficiary (D) of the trust. That makes choice B the untrue statement.

Estate Accounts

An **estate account** is an account that, like a trust account, is directed by a fiduciary on behalf of the beneficiary or beneficiaries of an estate. In the case of one who prepares a will, there is a specified executor. In the case of one who dies without a will (intestate), these functions are performed by a court-appointed administrator. The executor or administrator makes the investment, management, and distribution decisions for the account.

Per Stirpes

One common way for people to provide for their descendants is to incorporate the phrase, "to my living issue, per stirpes" in their will. In fact, some states automatically distribute in that fashion when one dies intestate. *Per stirpes* (not a typo—it is not *stripes*) is from the Latin word meaning "branch." When used, per stirpes means that the deceased intended that a beneficiary's share of the inheritance is to go to an heir.

EXAMPLE

A widow (or widower) had three children and wished the estate to be distributed equally. If one of those children died prior to the estate settlement, that child's children (the grandchildren of the widow or widower) would share their parent's one-third share (receiving one-sixth of the total each), while the two living children would each receive a one-third share.

It would look like this:

Child A	Child B	Child C (deceased)	Grandchildren 1 and 2
1/3	1/3	1/6	1/6

Per Capita

There is another Latin term used in settling estates. This one is *per capita,* and it means "by total head count." Because the procedures differ from state to state, the only question the exam can ask is that you know that per capita, along with per stirpes, is a method of determining the distribution of an estate's assets.

Suitability Issues

Just as with any other account, recommendations must be suitable when considering all of the relevant information. However, in the case of a trust or an estate, there are several considerations that do not arise in other individual accounts. Some of these are as follows:

- In virtually all cases, the trust document declares the objectives of the trust. Generally, these can only be changed by the grantor or, once in receipt of the assets, the beneficiary. The trustee is obligated to invest the funds in accordance with those objectives. For example, if the objective is income until the death of the grantor, then that is the primary consideration in any recommended transaction. Always follow the terms of the trust.
- Unless specifically stated in the trust document, margin trading is not permitted.
- In the case of an estate, the terms of the will must be followed.
- If the investment adviser managing the account is also the trustee or executor, in addition to the normal fiduciary responsibility assumed by all investment advisers, there are the formal requirements of the Uniform Prudent Investors Act (UPIA). That act is described in detail in Unit 18, dealing with retirement plans. "Wearing two hats" is an allowable practice, but it is not done very often because of the inherent conflict of interest. This, as with all potential conflicts of interest, must be disclosed to the client.
- There are unique tax considerations, which will be covered in the next learning objective.
- In the case of trusts, conflicts between the grantor and the beneficiary may exist; in the case of estates, conflicts among the beneficiaries may arise.

EXAMPLE

A widow was left a trust with her children as contingent beneficiaries. She is to receive income from the trust, and her two children will receive the principal upon her death. To maximize their value, the children ask you to allocate half of the corpus to growth stocks while leaving the balance in bonds for their mother. Because the trust document calls for the widow to receive income, the adviser must pursue that objective and cannot follow the wishes of the children until the trust's assets become theirs.

LO 16.g Recognize the difference between taxation of estates and taxation of gifts.

Gifts

When a donor makes a gift of securities or virtually any asset, the cost basis to the recipient (the donee) is the donor's cost basis (original cost and holding period beginning from the donor's date of purchase). This describes **carryover basis.**

EXAMPLE

In 2010, Joe Smith bought 1,000 shares of COD at $24 per share, for a total cost of $24,000. In 2017, when COD was trading at $32.50, Joe gave those 1,000 shares to his daughter, Sally. When Sally sells the shares, her cost basis is Joe's cost basis on the date of his original purchase—$24 per share, seven years ago—not the market value on the date of the gift. So, if Sally were to sell those shares for $33 per share one month after receiving the gift, she would be realizing a long-term capital gain of $9,000.

TAKE NOTE

It gets more complicated if the securities are worth less than the donor's cost at the time of the gift, and we don't expect the exam to deal with that situation.

TAKE NOTE

If a gift of securities held for more than one year (long term) is made to a 501(c)(3) charity (that is the IRS designation for qualifying nonprofit organizations), the tax treatment is more favorable. Under these circumstances, Joe's deduction is based on the fair market value on the date of the gift, not his cost basis. He would have received a $32,500 tax deduction and avoided capital gains taxes on the $8,500 profit.

Inherited Securities

When a person dies and leaves securities to heirs, the cost basis to the recipients is usually the fair market value on the date of the owner's death. In other words, the cost basis steps up to the date of death value. Furthermore, the IRS treats any gains to be long term, regardless of when the deceased purchased the security.

EXAMPLE

In 2010, Joe Smith bought 1,000 shares of COD at $24 per share for a total cost of $24,000. In 2017, when COD was trading at $32.50, Joe died. His daughter, Sally, is Joe's sole heir and inherits the 1,000 shares upon his death. When Sally sells the shares, her cost basis is the fair market value on the date of Joe's death—$32.50 per share—not Joe's original purchase cost, and any gain would be long term.

TEST TOPIC ALERT

The step-up provision does not apply when inheriting an annuity.

Estate Taxes

As previously mentioned, one of the purposes of establishing a trust is to minimize estate taxation. Let's look further in the process of taxing an estate.

The federal government imposes a tax on a decedent's estate based on the value of the estate, as well as on gifts conveyed to heirs, before a person dies.

Estate tax is imposed on the transfer of substantial amounts of property at death. An individual may transfer an unlimited amount to a spouse who is a U.S. citizen without the imposition of federal estate tax. This is known as the *marital deduction*. In addition, an individual may transfer unlimited amounts of money and other property to an eligible charity with no federal estate tax. For heirs other than spouses, an estate tax credit will offset estate tax on transfers of up to $ 11.7 million in 2021, indexed for inflation of property. We discussed some ways to reduce or eliminate estate taxes earlier in this unit.

The Gross Estate vs. the Taxable Estate

Federal estate tax is calculated using a formula that begins with the **gross estate**. The **gross estate** includes all interests in property held by an individual at the time of death. Although amounts of property transferred to a spouse or a charity will generally not be subject to federal estate tax, such amounts are includable in calculating the gross estate.

Certain expenses are then deducted from the gross estate to arrive at the **adjusted gross estate (AGE)**. Examples of deductions for the AGE include funeral expenses, charitable contributions, and debts of the decedent.

Once the amount of the AGE is determined, the unlimited marital and charitable deductions are subtracted to arrive at the **taxable estate.**

EXAMPLE

Caroline, who is unmarried, died in 2021, owning various properties. The amount of her gross estate is $18 million. However, her estate incurred $20,000 in funeral expenses, she had made charitable gifts of $1,000,000, and she owed mortgages of $200,000 and $30,000 in credit card balances. Thus, her adjusted gross estate is $16,750,000. In 2021, because of an estate tax credit that exempted the first $11,700,000 of property transferred after death, Caroline's estate will be taxed on the remaining $5,050,000 in transferred property.

Alternative Valuation Date

The Internal Revenue Code provides that the executor of an estate may choose to value the assets in the estate as of the date of death or, alternatively, six months later. This is particularly beneficial if the estate consists of assets that have dropped substantially in value following the date of death. What value is used if an asset that is appraised at the date of death is subsequently sold for a different price? The executor will use that sale price as long as it represents the fair market value (FMV).

In the case of mutual funds, FMV is the NAV, not the POP.

TEST TOPIC ALERT

If an asset is sold after death at a greatly reduced price from its appraised value in a transaction that does not meet the definition required under fair market value, the IRS will use the higher value.

Payment Date of Estate Taxes

Regardless of whether the date of death or alternative valuation date is used, estate taxes are due no later than nine months after death. Just as with personal income taxes, it is possible to get an extension to *file* the return, but the taxes are due at the nine months' time and interest will be charged on any amount owed that is not paid at that time.

TEST TOPIC ALERT

The computation of the estate tax is done on IRS Form 706. From the gross assets, certain expenses (such as the costs of administration of the estate, funeral expenses, payments of outstanding debts, and charitable bequests) are deducted, and the tax is levied on the remaining taxable estate.

Taxation of Estate Income

During the period of time before the estate is liquidated (and estates that are contested can drag on for years), it is likely that the executor will manage the assets in such a fashion that the estate receives income and possibly capital gains. If this is the case, the taxation to the estate is at the same rates mentioned earlier regarding trusts and, as with trusts, Form 1041 is used to report the income. Furthermore, the income is taxed using the same compressed brackets as trust income (37% for everything in excess of $13,050 in 2021).

TEST TOPIC ALERT

Just as you may have to know that the estate tax computation is done on Form 706, you may also have to know that the estate income tax computation is done on Form 1041.

Donor's Gift Tax Obligation

Gift tax is a progressive federal tax imposed on the transfer of property during the lifetime of the donor; up to $11.7 million (2021) in lifetime gifts may be made without incurring gift tax. Additionally, an individual may give up to $16,000 per year (2022, indexed for inflation in $1,000 increments) to any number of individuals without generating the federal gift tax. If a married couple joins in the gift, the allowable amount is doubled to $32,000 (2022) per person per year. Gifts of securities are valued as of the current market price on the date of the gift. Please don't confuse this with cost basis of a gift discussed earlier in this unit.

When a gift is made between spouses, the rule is somewhat different. Generally, there is an unlimited exclusion for these gifts. However, there are limits if your spouse is not a citizen of the United States. In 2021, a spouse may gift up to $159,000 to a noncitizen spouse. The number won't be tested because it changes each year, but the concept might be on your exam.

TEST TOPIC ALERT

Generally, a gift tax return must be filed whenever a gift in excess of $16,000 (or whatever the annual exclusion is at the time of the gift) is made to any individual (other than a spouse). Any excess over the annual exclusion is applied against the lifetime exclusion until it is used up.

The return is filed on *Form 709* and is due at the same time as the donor's income tax return, generally April 15.

TAKE NOTE

If a gift tax is due, it is the responsibility of the giver of the gift (donor), not the receiver of the gift (donee).

EXAMPLE

This concept is pretty simple: you have some stock worth $22,000 and give it to a child or grandchild; you've exceeded the $16,000 annual gift exclusion, so a gift tax return would have to be filed. However, it might look like this on your exam: "A grandfather received stock as a result of demutualization that is currently worth $22,000 and wishes to give it to his grandchild." Most students would waste their time trying to figure out what demutualization means and not realize how simple the question really is. It makes no difference how the stock was acquired; for gift tax purposes, the only thing that counts is the fair market value on the date of the gift.

TAKE NOTE

Taxation of estates and gifts are unified. That means that whatever is used of the lifetime gift exclusion prior to death reduces the estate tax exclusion. Both have a lifetime exclusion (2021) of 11.7 million and both have a progressive structure with rates beginning at 18% and reaching a maximum tax rate (2021) of 40%. There are two testable differences:

1. the annual gift tax exclusion ($16,000 in 2022); and
2. gift taxes are due at the same time as the individual tax return (April 15), while estate taxes are due nine months after death.

TEST TOPIC ALERT

The concept of taxation relating to gifts and inheritances can be confusing. There are two separate taxable situations: taxes due on the proceeds of a sale of gifted or inherited property and taxes due based on the amount of the gift or the estate.

The following information should help:

1. A client has received a gift of securities from someone, or the client has inherited securities.

Gift: The client's cost basis for determining if there is a taxable capital gain is that of the donor. The client is considered to have acquired the security on the donor's purchase date and at the donor's purchase price.

Inheritance: The client's cost basis for determining if there is a taxable capital gain is the fair market value (FMV) as of the date of death. The holding period is not a consideration because any gains are considered long term.

2. Your client made a gift of securities to someone, or the client has died.

Gift: The obligation to pay a gift tax is that of the donor. Anything over the annual exclusion (currently $16,000) may be subject to the gift tax (unless used against the lifetime exclusion of $11.7 million). The amount of the gift for tax purposes is the FMV as of the date of the gift.

Estate: The obligation to pay an estate tax is that of the deceased's estate. The value used to determine if there is an estate tax liability is the FMV either as of the date of death or, by using the alternative valuation date, the FMV six months after death. As with the gift tax, there is the unified credit of $11.7 million.

PRACTICE QUESTION

Bruno and Griselde have been married for 56 years. Bruno passes away in 2021 and leaves his entire estate of $10 million to his wife. During his lifetime, Bruno had used $2 million of his lifetime gift exclusion. Upon Griselde's death 2 years later, the estate is worth $22.2 million. The gross taxable estate is

A. $0.00.
B. $800,000.
C. $2 million.
D. $11 million.

Answer: B. Because Bruno used $2 million, his estate tax exclusion is now $9.7 million. The portability provisions allow that to be added to Griselde's exclusion, making the total $21.4 million ($9.7 + $11.7 = $21.4 million). With a gross value of $22.2 million and a remaining exclusion of $21.4 million, prior to any deductions, the gross taxable estate is $800,000.

KNOWLEDGE CHECK 16.4

1. All of the following are potential benefits of using trusts **except**
   A. maintaining control over the grantor's assets.
   B. reducing estate taxes.
   C. eliminating probate.
   D. eliminating income taxes.
2. One way in which taxation of gifts differs from taxation of estates is
   A. gifts can take advantage of the marital deduction while estates cannot.
   B. a gift of securities carries the donor's cost basis, while inherited securities receive a stepped-up basis.
   C. the lifetime exclusion for gifts exceeds that for estates.
   D. the tax rates on gifts is lower than for estates.

KNOWLEDGE CHECK ANSWERS

Knowledge Check 16.1

1. **B** In the case of a TIC account, the decedent's estate becomes a tenant in common with the survivors.

   LO 16.a

2. **C** Although the physical address of the customer's residence is generally required, the CIP has no questions regarding the place of birth.

   LO 16.a

Knowledge Check 16.2

1. **B** The very definition of a partnership requires at least two persons. Sole proprietorship by definition is a single person. LLCs and S corporations can consist of a single owner.

   LO 16.b

2. **A** It is the C corporation, filing Form 1120, that pays taxes. In each of the other cases, any income (or loss) flows through to the investors. In the case of the limited partnership and the LLC, Form 1065 is an information return, and the 1120S filed by an S corporation serves the same purpose. The amount of taxable income is reported to each investor on Schedule K-1.

   LO 16.c

Knowledge Check 16.3

1. **A** One of the purposes of the probate process is to ensure that the provisions of the will are upheld. In a JTWROS account, the assets automatically go to the survivor(s), so probate is not necessary. A transfer on death (TOD) account accomplishes the same purpose. One of the most common reasons for placing assets into a trust is to avowing probate.

   LO 16.d

2. **D** If a trust will reinvest its capital gains back into the body of the trust, those gains will not be included in DNI. Interest on municipal bonds is included but is not taxable to the recipient of the distribution. DNI consists of dividends and interest.

   LO 16.e

Knowledge Check 16.4

1. **D** Trusts do not eliminate income taxes. In some cases they might reduce them, while in others they might increase them, but they do not eliminate them.

   LO 16.f

2. **B** A primary difference between gift and estate taxation is the cost basis of the acquired asset. In the case of a gift, it is the donor's basis, while in the case of an inheritance, it is the cost at the date of death and is always considered long term. Both have the unlimited marital deduction, and the lifetime exclusion ($11.7 million in 2021) is the same for both. Both follow the same tax rate table.

   LO 16.g

UNIT 17

Client Profile

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- LO 17.a **Evaluate** the different methods of client data gathering used to determine the client's current and future financial situation, including financial and nonfinancial considerations.
- LO 17.b **Discover** the client's risk tolerance.
- LO 17.c **Distinguish** between investment objectives and investment constraints.
- LO 17.d **Analyze** a client's financial goals and objectives for suitable recommendations.

Your exam will include approximately seven questions from the topics covered in Unit 17.

INTRODUCTION

An adviser must be familiar with each client's circumstances, financial goals, and needs to formulate suitable investment recommendations. Without suitability information, the account cannot be opened. This is unlike broker-dealers that are permitted to open client accounts without suitability information.

LESSON 17.1: KNOW YOUR CUSTOMER

LO 17.a Evaluate the different methods of client data gathering used to determine the client's current and future financial situation, including financial and nonfinancial considerations.

Methods of Information Gathering

How is all of the information necessary to complete the customer profile obtained? Although there is no universal method, most firms rely on a combination of tools. The first step is usually having the client complete a detailed questionnaire. Optimally, this should be followed up by a personal interview, either in the office or home, on the phone, or online with one of the various video services currently available. There is only so much one can learn from a form, and both the client and the IAR benefit from the give-and-take of an interview, as that is the best way to discover qualitative information, such as risk tolerance and attitudes. As covered elsewhere in this course, confidentiality and security of these customer data is critical. Traditionally, data-gathering techniques for financial advisers involve asking clients or prospects to bring in account statements, insurance policies, 401(k) plan options, and maybe tax returns. Why is all of this information needed? Without it, there is no way to determine suitability. Furthermore, as learned in the previous unit, the CIP requires certain information.

Customer Financial Profile

A **financial profile** should include an assessment of the client's:

- current expenditures;
- debt obligations;
- tax status;
- income sources;
- a balance sheet containing the client's assets, including
  - cash, CDs, and savings accounts (usually looked at as an "emergency fund," generally considered to be a primary requirement for investing in securities),
  - real estate holdings,
  - value and composition of securities holdings,
  - pension and retirement accounts,
  - cash value in life insurance policies,
  - personal items such as jewelry and automobiles; and
- liabilities, including
  - current debt obligations (credit cards, estimated tax payments, etc.),
  - long-term debt obligations (auto loan, mortgage, etc.),
  - loans against insurance cash value, and
  - loans against a 401(k) plan.

Using this information, the adviser will prepare a family balance sheet. This balance sheet reflects all of the client's assets and liabilities in order to determine the overall net worth and liquidity of that client, while a family income statement includes income and expenses and is used to determine the client's cash flow.

Taking into consideration all of this information indicates to the securities professional the extent to which the client is able to make a lump-sum investment (the balance sheet shows a large amount of net assets available) and/or periodic investments (the income statement reveals a positive cash flow; there is "money left at the end of the month").

Because things can change, it is recommended that there be a follow-up meeting with the client at least annually.

TEST TOPIC ALERT

A family balance sheet includes only assets and liabilities, not income like salary, dividends or interest, or amounts paid for expenses.

PRACTICE QUESTION

An individual's net worth is

A. the difference between the individual's assets and the individual's liabilities.
B. best determined by examining the individual's personal income statement.
C. largely irrelevant in identifying the individual's investment objectives.
D. another term for discretionary income.

Answer: A. An individual's net worth is the difference between the individual's assets and the individual's liabilities. It is determined from the personal balance sheet rather than from the personal income statement. Net worth is relevant in determining an individual's investment objectives. Clients with a negative net worth might find it preferable to reduce their debt level before beginning an investment program.

Customer Nonfinancial Investment Considerations

The previous discussion described a number of financial considerations. How do those contrast with nonfinancial ones? In its simplest form, the contrast is that one deals with monetary numbers and the other does not. In the first case, we are gathering assets, liabilities, income, and expenses. Now, we will look at nonmonetary items.

A client's nonfinancial considerations can be more important than the financial information. Relevant nonfinancial information includes the following:

- Age
- Marital status
- Investment experience
- Attitudes and values, such as "ESG" investing
- Number and age of dependents
- Employment stability
- Employment of family members
- Demographics (where clients live can affect their investment attitudes)
- Current and future family educational needs
- Current and future family health care needs

Behavioral Finance

There is one other nonfinancial consideration that has gained greater prominence after the 2017 Nobel Prize in economic sciences was awarded to Richard H. Thaler for his work in the field. Briefly, the premise is that investors are irrational when it comes to making investment decisions. The study of this is known as *behavioral finance*. On the exam, it may be referred to as the study of how human psychology affects people's investing decisions.

The "dean" of behavioral finance, Daniel Kahneman, PhD, was awarded the Nobel Prize in this same field in 2002. In the announcement from the Royal Swedish Academy of Sciences, they stated, "His team's findings have countered some assumptions of traditional economic theory—that people make rational choices based on their self-interest—by showing that people frequently fail to fully analyze situations where they must make complex judgments. Instead, people often make decisions using rules of thumb rather than rational analysis, and they base those decisions on factors economists traditionally don't consider, such as fairness, past events, and aversion to loss."

Today, it is accepted that behavioral biases can cause investors to make financial decisions that are irrational. Here are some of the more common examples:

- Overconfidence. Experienced (and even some "rookie") investors tend to overestimate their ability and the accuracy of the information available to them.
- Conservatism. Many investors have a hard time changing their existing beliefs, even when new information is presented to them.
- Herd behavior. A market drop may be followed by panic selling.
- Anchoring. The tendency to base expectations upon the first information received which may or may not be accurate. Once a thought has been anchored in your mind, it is difficult to move away from it.
- Regret aversion. The investor prepares himself in such a way as to avoid distress over an adverse outcome (think about a trip to Las Vegas where you know you will probably lose, but you condition yourself to expect that).
- Confirmation bias. This occurs when individuals look for new information or distort new information to support an existing view. Clients who get involved with the portfolio process by researching some of their portfolio holdings may become overly attached to some holdings and only bring up information favorable to the holding. This often leads to holding a security too long or failing to adequately diversify.

EXAMPLE Confirmation Bias

Brenda has been employed by LRC Trucking for 25 years, and she feels she has more information as an employee of LRC than those who are not employed by the company. This, in fact, is not the case. Based on her perception, Brenda invests most of her portfolio in LRC stock. This will result in underdiversification of Brenda's portfolio, may likely increase her risk, and may subject her to losses that could have been mitigated had her portfolio been more diverse.

LO 17.b Discover the client's risk tolerance.

Definition: risk tolerance. Risk tolerance is the degree to which an investor is willing and able to accept the possibility of an uncertain outcome to an economic decision. A measure of risk tolerance is useful in summarizing an investor's perception about the trade-off between risk and the compensation required for bearing risk.

Risk tolerance is a two-dimensional process. First is the investor's attitude toward risk and safety. Emotionally, some investors, even very wealthy ones, cannot handle the idea of losing money. An investor may have more than enough assets to absorb a large loss, but taking that loss would cause much distress. The second dimension is the financial ability to sustain losses. An investor may be a gambler at heart, but, with limited assets, cannot take much investment risk. It is the juggling of these two dimensions that should be used to determine the overall risk tolerance and shape the portfolio. The SEC states that a recommended securities transaction must comport with the customer's risk tolerance. The mere fact that a customer may be wealthy does not provide a basis for recommending risky investments, if the customer is risk averse. ("Suitability is determined by the appropriateness of the investment for the investor, not simply whether the salesman believes that the investor can afford to lose the money invested.") The customer's risk tolerance will be determined in light of all aspects of a transaction that bear on its potential risk of loss for the customer judging:

- the relative riskiness of the security itself (for example, the relative potential for it to be profitable, the expected time horizon for achieving profitability, the volatility of its market value, and the liquidity of the market for it);
- the level of margin, if any, utilized in the transaction;
- the extent to which the investment may represent a concentration of investment risk for the customer in a single transaction or security; and
- the customer's financial capacity to hold the investment in down markets.[1]

Selection of specific types of investments (e.g., stocks, bonds, annuities) depends on several factors, including:

- Client's objectives
- Amount available for investing (client must use discretionary cash for investing, not the rent money)
- Client's aversion to risk (every investment involves some degree of risk because every investment requires transferring purchasing power from the present to the future, and no one knows what the future holds)

TEST TOPIC ALERT

An example of a question that could help an adviser determine the client's risk tolerance is: "How much of a loss of principal are you willing (or able) to accept: 5%, 15%, 30%, or even more?"

Categories of Risk Tolerance

A person's risk tolerance is often characterized as aggressive, moderate, or conservative.

Aggressive

Aggressive investors are willing to risk greater amounts and withstand market volatility in exchange for the chance to realize substantial returns. An aggressive investor may be willing to sustain losses of 10%, 25%, or even 50% on an investment.

Moderate

Moderate investors are in between the other two. They can tolerate some loss, but not nearly at the level of the aggressive investor.

Conservative

Conservative investors normally want the relative safety of guaranteed income with low risk to loss of principal. Very conservative investors are unwilling to sustain even modest losses on their investments. There is a full spectrum of risk profiles between these two extremes.

[1] re Faragalli, 52 S.E.C. 1132, 1141 (1996); In re Dambro, 51 S.E.C. 513 (1993).

EXAMPLE

The following table is a sample of how a portfolio might be structured based on the three different risk tolerances

Asset Allocation	Conservative Portfolio	Moderate Portfolio	Aggressive Portfolio
Stocks	30%	60%	80%
Bonds	50%	30%	15%
Cash	20%	10%	5%

TAKE NOTE

An investor who claims to be aggressive but is unwilling to sustain losses is actually conservative.

A client's tolerance for volatility and risk will often narrow the field of potential investments.

PRACTICE QUESTION

In designing an investment portfolio for a new client, one of the first things to do is determine the client's

A. home address.
B. Social Security or tax ID number.
C. risk tolerance.
D. beneficiary.

Answer: C. One can't adequately present any investment recommendations without having an understanding of the client's risk tolerance. Home address and Social Security number are legal requirements for opening the account, but they don't enter into the decision-making process for portfolio design. Yes, you will want to know the beneficiary of any IRAs or qualified plans, but that has little to do with the nature of your recommendations.

KNOWLEDGE CHECK 17.1

1. Knowing your customer involves more than just analyzing financial information. Nonfinancial aspects include
   A. age.
   B. attitudes.
   C. demographics.
   D. all of the above.
2. Although there are many different terms used in the industry, in most cases, an investor's risk tolerance will be described by any of the following **except**
   A. aggressive.
   B. conservative.
   C. mild.
   D. moderate.

LESSON 17.2: INVESTMENT OBJECTIVES AND CONSTRAINTS

LO 17.c Distinguish between investment objectives and investment constraints.

Investment Goals

Using the information gathered about a client's circumstances and financial resources, the agent (or IAR) and client should establish financial goals. Many investors confuse goals and objectives. A goal is where you want to be (the "end game"), while objectives are the steps taken along the way to reach the goal. Some commonly specified goals include:

- planning for college education;
- retirement;
- saving for a future purchase, such as a home;
- philanthropy;
- capital to start a business; and
- leaving a legacy.

Investment Objectives

Investment objectives are the tools used to reach these goals. There are three primary objectives:

- Growth
- Income
- Stability (capital preservation)

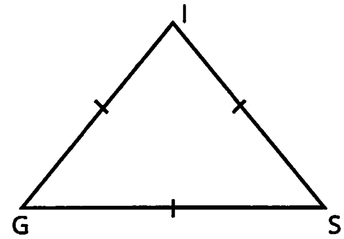
However, in attempting to meet these objectives, there may be some obstacles, properly referred to as *investment constraints*, which must be considered. Let's examine some objectives in greater detail.

As stated previously, when it comes to investment objectives, there are three broad classes with many shades in between:

- Growth (can be aggressive, moderate, or even conservative)
- Income (can be current, future, or high risk)
- Preservation of capital (safety)

There is a specific term for an objective that can be maximum income or maximum growth without regard to stability—that term is *speculation*.

Matching Client Objectives



You might find the concepts of investment objectives easier to understand if we use a little geometry. The picture is of an equilateral triangle. That means each of the sides (legs) is of the same length (equal). You will notice a letter at each point. The *G* is for growth, the *I* is for income, and the *S* is for safety (preservation of capital). Borrowing another term from geometry, it is axiomatic (true) that the closer you move on the leg to one of these points (objective), the farther you move from the others.

For example, if you wish to maximize your growth, you go all the way to the *G* and move farther away from the *I* and the *S*. As a result, you sacrifice income and safety. Total safety (all the way to the *S*) sacrifices growth and income, and maximum income sacrifices growth and safety. The role of the registered representative is to determine where in this triangle the customer's objectives lie. They can be between the *G* and *I* when the objective is growth with income. Or, if the objective is income with safety, the point will be between the *I* and the *S*. It is important to understand that you can't maximize all three—something has to give.

PRACTICE QUESTION

Which of the following is properly referred to as an investment goal rather than an objective?

A. Current income
B. Endowing a scholarship at your alma mater
C. Conservative growth
D. Speculation

Answer: B. *Goals* are what you hope to have the money for. *Objectives* are the way to get there. Remember the triangle for *G*, *I*, and *S*. The *S* is for *stability*. The opposite of *stability* is *speculation*, and that is another one of the objectives. For some investors, that is the route they choose to take.

Within the parameters determined by a client's circumstances and financial resources, the adviser and client should establish financial goals. As stated previously, the most commonly specified goals include education, retirement, philanthropy, or a future special purchase. Then, as shown in our "triangle," the investment objectives chosen to help meet those goals include capital preservation, current income, capital growth, and speculation.

However, in attempting to meet these objectives, there may be some obstacles, properly referred to as *investment constraints*, which must be considered. When an investment adviser or IAR prepares a plan for a client, all of these factors are used to prepare an investment policy statement (IPS) as we described in the previous unit. The following chart may be helpful in your review of objectives and constraints

Investment Policy Statements: Objectives and Constraints

Objectives	Description
Return requirements	Minimum current income requirements; accumulation amount needed to meet financial goals, preservation of capital, growth, and so forth
Risk objective	Investor's risk tolerance based on self-evaluation, objective questionnaire, and past experience
Constraints	**Description**
Time horizon	Time frame in which goals must be attained
Liquidity	What is the cash need? High if close to goals (retirement or education); low if long time horizon
Taxes	Tax characteristics of investor and desired level of tax management
Laws and regulations	Any legal prohibitions on types of investments or transactions—is the investor accredited?
Unique circumstances and/or preferences	Investor preferences or desires to avoid particular types of assets

Investment Objectives

Preservation of Capital

Many people are averse to any decline in value of their investments. For such investors, bank-insured CDs, savings accounts, and money market funds offer the safety they seek. However, by reducing market risk (there is little or no market price fluctuation in these instruments), the investor is sacrificing the opportunity for higher income. In addition, as fixed-income investments, they are exposed to inflation (purchasing power) risk.

Bank-Insured Certificates of Deposit (CDs)

In addition to the questions about the jumbo (negotiable) CDs that trade in the money market, there are questions on the exam about the certificates of deposit that you can get at your local bank. Here are some points that will help you get the right answer.

- Bank CDs eliminate interest rate risk (their value remains constant, even when interest rates change).
- They are *not* savings accounts with a maturity date.
- They would be included as an asset on a family balance sheet.
- They are the preferred answer when the question asks about a client who wants capital preservation with no risk of loss.
- They are insured by the FDIC up to the current limit (limits are not tested).
- Each bank sets the interest rate it will pay on those CDs, with smaller banks typically offering more competitive rates.

TEST TOPIC ALERT

On the exam, the first choice for preservation of capital should always be bank-insured CDs. In addition, because they are not marketable (traded in any marketplace), bank CDs (we're referring to the ones retail investors purchase at their local branches—not the jumbo CDs traded in the money market) have no interest rate risk. That is, because their value is fixed, you can always redeem them at face value, regardless of the direction of interest rates. The exam will ignore the fact that there may be a penalty for cashing in before maturity.

Current Income

Investors seeking current income will normally focus on individual securities or mutual funds that invest in fixed-income investments such as:

- government bonds and notes, and agency bonds;
- corporate bonds;
- preferred stock; and
- utility company common stock.

When the investor's goal is income, a primary factor is the amount of risk the investor is willing and/or able to take. The risk/reward principle is quite clear—the more risk, the greater the potential reward and, logically, the lower the risk, the lower the potential reward. That is why, at least for those with a low risk tolerance but with a time horizon that doesn't require money market instruments, U.S. Treasury and agency issues, along with investment grade bonds, are usually the recommendations. On the other end of the spectrum are bonds of corporations with very low credit ratings (the high-yield, or junk, bonds). These bonds tend to yield high income with principal subject to credit (default) risk. In the middle might be those investing in preferred stock or public utility stocks.

Capital Growth

Common stock investments generally provide a means to preserve and increase the buying power of an investor's money over and above the inflation rate. Although subject to short-term volatility, the equity market tends to provide higher investment returns over time.

As with income, the term *growth* refers to a broad spectrum of investments. Aggressive growth stocks may be very appropriate for a person with a very high tolerance for risk and the ability to remain invested for many years. At the other end of the spectrum are large capitalization stock funds that invest in some of the largest and most respected companies. These funds may be a better choice for older investors, who may need to liquidate the investment in three to five years, or investors who are more comfortable knowing they have invested in a fund that is less risky.

Speculation

A customer may want to speculate with a portion of their investments. Speculative investments offer the opportunity to earn substantial returns but carry a commensurate amount of risk. Speculative investments may include:

- highly volatile stocks;
- high-yield (junk) bonds;
- options on stocks or stock indexes; and
- commodity futures.

PRACTICE QUESTION

An 83-year-old widower explains to you that he is risk averse and wishes to find an investment that will provide him with preservation of capital. Which of the following might you recommend?

A. An index fund
B. Bank-insured CDs
C. Long-term U.S. government bonds
D. Preferred stock

Answer: B. There are two answers for preservation of capital on this exam. The strongest is a bank-insured CD, followed by a money market fund (you'll never have both in the same question). Aren't U.S. government bonds safe, you ask? Yes, but, with maturities of 10 years or longer, that long duration involves interest rate risk. So, if the client needs money now and interest rates have increased, the principal has declined in value.

College Tuition

In addition to other types of investments, investors planning for college tuition often invest in zero-coupon bonds that mature when the tuition expenses are due. It may be advisable to establish college tuition investment programs such as Coverdell ESAs and Section 529 plans because of their tax advantages. The investments selected for either of these two have time horizon as a major constraint; that is, if the plan is started when the child is very young, the portfolio can be more aggressive than if started only a few years before the funds are needed.

Retirement

In determining a client's retirement needs, Social Security, company pensions, retirement savings accounts, and insurance (as well as investments outside of a retirement planning framework) should all be considered.

Once again, time horizon is an important constraint. The earlier an individual begins to save for retirement, the more time the investment assets are able to grow. A long-term retirement planning time horizon may enable an investor to assume additional risk in the portfolio, generally through equities. This helps a client accumulate significant funds to support a long retirement period. As life expectancy has risen, the topic of decumulation has come into focus. How do we make sure that the money accumulated lasts long enough? One way to minimize longevity risk is through the purchase of annuities (fixed, index, and variable), because payout is guaranteed for life. In fact, there is a specialized annuity product known as the *longevity annuity*, or *deferred income annuity*, designed specifically to cover that risk.

Social Security

The OASDI (Old-Age, Survivors, and Disability Income) program, which for most Americans means Social Security, provides monthly benefits designed to replace, in part, the loss of income due to retirement, disability, or death. For too many individuals, Social Security remains their primary source of retirement income. It was never designed to be the sole source and should be thought of as a supplement to funds created in retirement plans such as IRAs and 401(k) plans (these will be covered in Unit 18). The exam may ask several questions about this topic, including length of time necessary for full coverage, spousal benefits, and timing of beginning benefit payout. Here are the key points:

- In order to qualify for full benefits, an individual must have at least 40 quarters of employment.

- Waiting until age 70 to claim benefits gives the individual an 8% annual simple interest increase in the benefit from full retirement age. If you don't need the funds and are in good health, it is generally worth the wait.
- Benefits for an ex-spouse. Let's use a male with an ex-wife and a current wife. Basically, both women are entitled to benefits when the man is still alive, and both can be entitled to widow's benefits. The topic is complicated, so any test questions probably deal with the most important basics. The most important rules are:
  - If you're divorced and were married to the man for at least **10 years**, you're eligible for some of your ex's Social Security;
  - In addition to the 10-year requirement, you must be **unmarried** at the time you become eligible to place a claim on your ex's Social Security; and
  - Any benefits paid to a divorced spouse DO NOT reduce any payments due the ex's current spouse if he remarried. That can mean two (or more) women receiving identical benefits while the man receives his as well.

Death Benefits

Because death can eliminate a family's primary income earner, life insurance is an important component of customer portfolios. Most experts feel that an investment plan should not commence without the breadwinner(s) having adequate life insurance. One commonly used tool to determine that amount is the capital needs analysis.

Capital Needs Analysis

A capital needs analysis is used to determine how much life insurance is necessary to meet future needs. At a minimum, life insurance coverage should provide for:

- payoff of the client's mortgage and other debts;
- income for the survivor(s) for a reasonable time;
- tuition for higher education; and
- estate taxes if the taxable estate will exceed $11.7 million in 2021.

There are several factors used in the computation to evaluate how much is necessary to meet these needs. First, we try to project the client's future earnings. Then, we estimate life expectancy, and, of course, we must account for inflation. Because the death benefit in a life insurance policy is generally a fixed amount, we are not concerned about market volatility. Finally, we look at existing assets such as savings and investments, including those that offer tax deferrals such as IRAs and employer-sponsored plans.

PRACTICE QUESTION

When performing a life insurance needs analysis, all of the following would be evaluated **except**

A. projected future earnings.
B. mortgage amortization schedule.
C. stock market volatility.
D. anticipated inflation rate.

Answer: C. Typically, a life insurance policy has a guaranteed death benefit, so, even with a variable life policy, market fluctuations will not lead to a benefit below that minimum. The needs analysis must look into the future (we don't expect the insured to die today), so future earnings and inflation must be taken into consideration. The mortgage schedule shows the outstanding balance until the mortgage is paid off—the insurance policy needs to be able to cover that.

Disability

Should a client become disabled, there are three possible sources of replacement income: workers' compensation, Social Security, and disability insurance.

Workers' Compensation

If an employee is injured on the job, workers' compensation can provide protection to cover medical expenses, replace lost income, and provide death benefits to the family. Although the worker's compensation benefits in some states (benefits vary from state to state) are quite generous (usually higher than Social Security disability), payments are made only when the disability results from a work-related injury.

Social Security

Like other Social Security benefits, a worker's disability benefit will depend on a number of factors, such as age and income. However, in order to receive payments, you must meet their strict definition of *disabled*, which is:

You must not be able to engage in any substantial gainful activity (SGA) because of a medically determinable physical or mental impairment(s)

- that is expected to result in death; or
- that has lasted or is expected to last for a continuous period of at least 12 months.

Disability Insurance

Because workers' compensation only covers people in limited cases and because Social Security's definition of *disabled* is relatively strict, most agree that it is wise to purchase a private disability insurance policy. Waiting and benefit periods can be adjusted based on the client's needs and finances. The amount of insurance can be determined by the information derived from the client's income, assets, and occupation.

TEST TOPIC ALERT

An application for disability insurance coverage can be denied in the case of a hazardous occupation.

Tax Planning

A client's tax situation is often an important factor in determining suitable investments. Taxes may be reduced by using the following three strategies: asset and income shifting, tax deferral, or tax-free income.

Asset and Income Shifting

A client can shift investment assets and income to a person in a lower tax bracket. Until early 2006, it was common to place income-producing assets in the name of a child aged 14 or older to avoid the "kiddie" tax (see Unit 24), but because it now includes all children under age 19 and full-time students under age 24, the practice has lost much of its luster. However, with many of today's baby boomers supporting elderly parents, placing those assets in the parent's name will remove the income from your client and let the parent receive the income directly, with little or no tax liability. As mentioned previously, trusts may also be used to shift assets and income.

Tax Deferral

Contributions to a qualified retirement plan or tax-sheltered annuity are not taxed until withdrawn. Investing funds that have not been taxed allows a substantially larger portion of the investor's money to earn income or capital gains, also not taxed until withdrawn.

Tax-Free Income

Most municipal bonds pay interest that is free from federal taxation, although they are generally subject to state income tax unless issued in the taxpayer's state of residence. Municipal bonds generally pay a lower interest rate than taxable bonds but, depending on the investor's tax bracket, may result in higher returns on an after-tax basis.

Lifecycle Considerations

An investor's goals may change over time. This is especially true as investors move from one phase of life to another. For example, a young couple may have a primary goal of funding a child's education. Later, the same family, having provided for their children's education, may turn their attention to the aggressive accumulation of wealth, perhaps to provide for an early retirement or a dream home. Upon retirement, this couple may need to move toward income-producing investments. Income and net worth change over time, as do investment goals and lifecycle considerations. Because the adviser's responsibility to know your client is ongoing, the account form should be updated regularly to reflect the client's new goals and financial considerations.

As the baby boomer generation reaches retirement age, regulators have increased their focus on protecting senior investors. Among the suggested practices is to take detailed notes of conversations and, when it becomes apparent that the client is not grasping information as well as before, recommend that a family member or other competent person participate in all discussions.

TAKE NOTE

Other potential sources of tax-free earnings are Section 529 plans, Roth IRAs, and Coverdell ESAs, all covered in Unit 18.

Investment Constraints

Time Horizon

An investor's time horizon and liquidity needs will determine the level of volatility the client should assume. Over a 20- or 30-year time frame, dramatic short-term volatility is acceptable, even to those who are risk averse. Money that will be needed within 3 to 5 years should be invested for safety and liquidity. Time horizon is a particularly important investment constraint when planning for college education and for retirement.

TEST TOPIC ALERT

The longer the time horizon, the more market risk the account can accept, and vice versa.

EXAMPLE

A married couple is 55 and 57 years old. The older of the two plans to retire at 62 and the younger at 65, and both are healthy. What is the most appropriate estimate of the time horizon for their retirement portfolio?

A. 5 years
B. 7 years
C. 8 years
D. More than 20 years

Answer: D. Time horizon does not end at retirement age. The portfolio will have to last them throughout their retirement until their death. On the basis of current life expectancy tables, the money will have to last them at least 20 years.

TAKE NOTE

On January 22, 2016, NASAA adopted a Model Rule to protect senior investors from exploitation. To date, we have heard nothing from students about this topic other than the general responsibility to act with high standards of conduct. As is the case with all new rules, check the Content Updates.

Liquidity

Some investors have a need for a certain sum, such as an upcoming home purchase or college tuition. Or they might just like the idea that they can get their money literally at a moment's notice. They need liquid assets in their portfolio. A product is *liquid* if a customer can sell it quickly at face amount (or very close to it) or at a fair market price.

Remember that a liquid investment does not mean you won't lose money on your investment. It simply means you can get the current market value of the investment quickly. Liquid investments include:

- securities listed on an exchange or Nasdaq;
- mutual funds;
- exchange-traded funds; and
- most real estate investment trusts (REITs).

Illiquid investments include:

- annuities, when initially purchased and/or when the annuitant is under age 59½;
- real estate;
- securities purchased in a private placement;
- DPPs; and
- hedge funds.

Taxes

A client's tax situation is often an important factor in determining suitable investments. For exam purposes, there are two ways to reduce taxes—tax deferral and tax-free income.

Tax Deferral

Contributions to an IRA, a qualified retirement plan, or a TSA may be tax deductible and are not taxed until withdrawn. This gives two benefits to the investor. First, the investments are made with pre-tax money. Second, there are no taxes on the income or growth until the money is paid out. That is the power of deferring taxes.

Tax-Free Income

Municipal bonds pay interest that is free from federal taxation. There are cases where the income would be taxed on the state level; that was covered in Unit 2. Municipal bonds generally pay interest at a lower rate than taxable bonds. That is because the interest is tax free. Depending on the investor's tax bracket, the municipal bond may result in higher returns on an after-tax basis. As will be covered in Unit 18, it is also possible to generate tax-free income using a Roth IRA, a Coverdell ESA, and a Section 529 plan.

Laws and Regulations

An example of how laws or regulations could be an investment constraint is the case of the accredited investor. A registered representative may find the absolutely perfect investment to meet the client's objectives only to find out the client can't make the purchase because of lack of accredited investor status. Another case might be when the desired security is not registered for sale in the client's state of residence. As we've learned, there are certain investments that are illegal or inappropriate for an IRA. That is what an investment constraint is all about: we'd like to buy this, but we can't.

Unique Circumstances and/or Preferences

Investors share many common characteristics. When you speak to a customer about goals, you will notice how often the same ones keep coming up. That said, it is important to understand that these are all unique individuals with their own needs and wants. We'll take a look at how some of those are investment constraints.

The most common case on the exam is the desire to avoid investing in certain industries. The term *ESG (Environmental, Social, and Governance) investing* has become more popular with each passing year. Those investors who have a strong feeling about environmental issues won't invest in companies that are considered polluters or create other health issues. A test question might ask about an investor whose parent died of lung cancer. The question might say, "Which stock would be least likely to be attractive to this client?" You should select *tobacco companies.*

Unique cases could be receiving a large inheritance or a multi-million-dollar lottery win. Objectives can change pretty quickly with those additional dollars. On the flip side, a client's business going bankrupt will cause the registered representative to rethink some recommendations. An extended period of unemployment or serious illness can do the same.

What is the takeaway? Matching your recommendations to the customer's goals and objectives takes careful thought.

PRACTICE QUESTION

Which of the following is an investment constraint?

A. Retirement
B. Income
C. College education
D. Time horizon

Answer: D. One of the most important investment constraints is the investor's time horizon. If you start saving for retirement (a goal) at age 55, you don't have much time to accumulate funds. A short time horizon limits how aggressive the portfolio can be. If you started at age 25, with that long a time horizon, there are many more investment options available. Income is an objective, and college education is a goal. That goal is also affected by time horizon. It is much better to start saving for college when a child is very young. You don't want to wait until the teenage years.

KNOWLEDGE CHECK 17.2

1. An individual with a very low risk tolerance would find which of the following to be the most appropriate recommendation for meeting a specific goal in six years?
   A. A bank-insured CD
   B. An income fund
   C. A balanced fund
   D. Commodity futures
2. A 66-year-old individual plans to retire in four years. At this time, savings include $100,000 equity in the home, $45,000 in an IRA, and anticipated Social Security payments of $1,560 per month. The individual would like to be able to travel extensively, buy nice gifts for their grandchildren, and live in a nice retirement village. Which of the following is the most likely investment constraint facing this individual?
   A. Laws and regulations
   B. Liquidity
   C. Taxation
   D. Time horizon

LESSON 17.3: MAKING SUITABLE RECOMMENDATIONS

LO 17.d Analyze a client's financial goals and objectives for suitable recommendations.

Because the highest percentage of stock market investing by "Main Street America" is in pooled investment vehicles (mutual funds, ETFs, and variable annuities), whether through direct investment or an employer-sponsored retirement plan such as a 401(k) or 403(b) plan, the exam tends to use these vehicles as proxies for meeting investor objectives.

Mutual Fund Suitability

Once a mutual fund or variable annuity subaccount defines its objective, its portfolio is invested to match it. The objective must be clearly stated in the fund's prospectus and can be changed only by a majority vote of the fund's outstanding shares.

Stock Funds

Common stocks normally provide the growth component of any mutual fund that has growth as a primary objective. Preferred, utility, and large-cap stocks are typically used to provide the income component of any stock mutual fund that has income as a primary objective.

Although there are other categories (to be covered in Unit 21), at this point you need to know the difference between large-cap and small-cap stocks. The term "cap" refers to the company's market capitalization (the number of outstanding common shares multiplied by the current market price per share). For example, a company with 30 million shares outstanding where the price per share is $30 has a market cap of $900 million. As you will see again in Unit 21, a market cap of $300 million to $2 billion is considered small-cap, while that of more than $10 billion is considered large-cap. It is generally felt that the larger the market cap, the more conservative the investment.

Growth Funds

Growth funds invest in stocks of rapidly growing corporations. Growth companies tend to reinvest all or most of their profits for research and development rather than pay dividends. Growth funds are focused on generating capital gains rather than income. Aggressive growth funds tend to concentrate more in small-cap stocks, while conservative growth funds have a preponderance of large-cap issues.

Income Funds

An income fund stresses current income over growth. The fund's objective may be accomplished by investing in the stocks of companies with long histories of dividend payments, such as utility company stocks, large-cap stocks, and preferred stocks.

Combination Funds

A combination fund (also called a *growth and income fund*) may attempt to combine the objectives of growth and current income by diversifying its portfolio among companies showing long-term growth potential and companies paying high dividends.

Specialized (Sector) Funds

Many funds specialize in particular economic sectors or industries. Others specialize in geographic areas such as the BRIC countries or the Pacific Rim. The funds have 25–100% of their assets invested in their specialties and are more likely than other funds to stick to a relatively fixed allocation.

EXAMPLE

Gold funds (gold mining stocks), insurance funds (insurance company stocks), technology funds, and utility funds are examples of *sector funds*. Sector funds offer high appreciation potential but may also pose higher risks to the investor because of their lack of diversification among industries or geographic areas.

Special Situation Funds

Special situation funds buy securities of companies that may benefit from a change within the corporations or in the economy. Takeover candidates and turnaround situations are common investments. These funds tend to be on the speculative side because the hoped-for takeover or turnaround might not happen.

Index Funds

Index funds invest in securities to mirror a market index, such as the S&P 500. An index fund buys and sells securities in a manner that mirrors the composition of the selected index. The fund's performance tracks the underlying index's performance. This approach reflects the *passive* style of portfolio management, as opposed to *active* portfolio management (more on those in Unit 21).

Turnover of securities in an index fund's portfolio is minimal. As a result, an index fund generally has lower management costs than other types of funds. Furthermore, because index funds have little turnover, they frequently appeal to investors seeking minimal taxable capital gains. One concern with index investing is the presence of tracking error. Simply stated, some index funds do not do a good job of tracking the index. We'll have more to say about that in Lesson 20.5.

Foreign Stock Funds

Foreign stock funds invest mostly in the securities of companies that have their principal business activities outside the United States. Long-term capital appreciation is their primary objective, although some funds also seek current income. Foreign investments involve foreign currency risks, as well as the usual risks associated with stock investments.

TAKE NOTE

There are two terms generally used to describe funds that invest in foreign securities.

- *International* funds have their entire portfolio invested in securities issued outside of the United States. The way to remember that is if you will be traveling internationally, you'll be outside the United States.
- *Global* funds have the portfolio invested "around the globe," and that includes U.S. securities. Once again, using the travel example, if you were to travel around the globe, a portion of your trip would be in the United States.

Bond Funds

Bond funds have income as their primary investment objective. Some funds invest solely in investment-grade corporate bonds. Others, for enhanced safety, invest only in government issues. Others seek maximum income by investing in lower-rated issues that entail greater risk but potentially higher returns.

Tax-Free (Tax-Exempt) Bond Funds

These funds invest in municipal bonds that produce income exempt from federal income tax. As a result, their income distributions are free from federal income tax to the investor. Some funds are *double* tax-free in that they are **state-specific funds**. That means the portfolio is 100% bonds issued by a political subdivision of a single state that levies a personal income tax. Therefore, the income is tax free on both state and federal income tax returns. Please note that any capital gains distributions from the fund are taxable, just as with any other fund. A key to remember for the exam is that municipal bonds or municipal bond funds are only suitable for those in higher tax brackets.

U.S. Government and Agency Securities Funds

U.S. government funds purchase securities issued by the U.S. Treasury or an agency of the U.S. government, such as Ginnie Mae. Investors in these funds seek current income and maximum safety.

Foreign Bond Funds

These funds invest in foreign sovereign and/or corporate debt issues. Although they carry the same general risks as investing directly into foreign debt, they tend to be reduced because of the professional management and diversification offered by fund investing.

PRACTICE QUESTION

If ABC Fund pays regular dividends, offers a high degree of safety of principal, and appeals especially to investors in the higher tax brackets, ABC is

A. an aggressive growth fund.
B. a corporate bond fund.
C. a money market fund.
D. a municipal bond fund.

Answer: D. Municipal bonds are considered second only to U.S. government securities in terms of safety. Furthermore, whenever you see a question about an investor in a high tax bracket, always look for the answer choice with municipal bonds; the tax-free income is the key. That is what makes choice D correct. On the other hand, when you see *growth*, dividends will probably not be part of the equation.

Balanced Funds

Balanced funds invest in stocks for appreciation and bonds for income. The exact mix is determined according to a formula used by the portfolio manager. These tend to be the most conservative of the stock funds.

EXAMPLE

A balanced fund's portfolio might contain 60% stocks and 40% bonds.

Asset Allocation Funds

Asset allocation funds split investments between stocks for growth, bonds for income, and money market instruments or cash for stability. Fund advisers switch the percentage of holdings in each asset category according to the performance (or expected performance) of that group. These funds can also hold hard assets, such as precious metals like gold and silver, and real estate.

A fund may have 60% of its investments in stock, 20% in bonds, and the remaining 20% in cash. If the stock market is expected to do well, the adviser may switch from cash and bonds to stock. The result may be a portfolio of 80% in stock, 10% in bonds, and 10% in cash.

Conversely, if the stock market is expected to decline, the fund may invest heavily in cash and sell stocks.

Many asset allocation funds are target funds (see the following) that target a specific goal—such as retirement—in a 5-, 10-, 15-, or 20-year period. As the target year gets closer, the mix of investments becomes more conservative.

EXAMPLE

An investor seeks an investment for retirement in 20 years that performs well under most market conditions and is diversified by purchasing multiple types of securities. An asset allocation fund that targets the year of retirement may be appropriate.

Target-Date Funds

One of the most popular investment options, especially in retirement plans, is a **target-date fund**. You might see the term *lifecycle fund* instead. According to a report by a large retirement plan provider, target-date funds are offered by nearly 90% of employer-sponsored defined contribution plans, such as 401(k) plans.

Target-date funds are designed to help manage investment risk. This is done by selecting a fund with a target date in mind that is closest to the year an investor anticipates needing the money (i.e., retiring in 2030). For example, a *2030 fund* gradually reduces risk by changing the investments within the fund to a more conservative mix as the target date approaches. That said, target-date funds are not risk free, even when the target date has been reached. These funds are sometimes called **lifecycle funds**, a reference to the term *lifecycle* we described in the previous LO.

FINRA is concerned that many investors surveyed do not understand that target-date funds do not provide guaranteed income. Many investors also do not realize that similar-sounding funds may, in fact, have different investments and risk profiles.

Like all investments, target-date funds can lose money if the stocks and bonds owned by the fund drop in value. And even though funds with identical target dates may look the same, they may have very different investment strategies and asset allocations that can affect how risky they are and what they are worth, at any given point in time, including when and after retirement takes place.

Money Market Funds

Money market funds are no-load, open-end investment companies (mutual funds) that serve as temporary holding accounts for investors' money. As the name implies, the portfolio of a money market fund consists of money market securities. The term *no-load* means that investors pay no sales or liquidation fees. Money market mutual funds are most suitable for investors whose financial goals require liquidity above all.

The interest these funds earn and distribute as dividends is computed daily and credited to customer accounts monthly. In general, money market mutual funds offer check-writing privileges, making for extraordinary liquidity.

The NAV of money market funds is generally fixed at $1 per share. Although this price is not guaranteed, a fund is managed in order not to "break the buck" regardless of market changes. Thus, the price of money market shares does not fluctuate in response to changing interest rates.

Restrictions on Money Market Funds

SEC rules limit the investments available to money market funds and require certain disclosures to investors.

Restrictions include the following:

- Investments are limited to securities with remaining maturities of 397 days or less, with average portfolio maturity not exceeding 60 days.
- Investments are limited to securities that have received a rating from a recognized rating agency in one of the two highest short-term rating categories.

PRACTICE QUESTION

An investor has a portfolio diversified among many different asset classes. If there was an immediate need for cash, which of the following would probably be the most liquid?

A. Cash value from a universal life insurance policy
B. CDL Common Stock Mutual Fund
C. QRS Money Market Mutual Fund
D. XYZ International Stock Mutual Fund

Answer: C. Money market funds generally come with a check-writing privilege, offering investors the opportunity to convert the asset to cash at once. Although all mutual funds are readily redeemable, under the Investment Company Act of 1940, the fund has 7 days to redeem. One must request the cash value from the insurance company and, in many cases, can take 30 days or longer.

TEST TOPIC ALERT

Be aware that an investment in a money market fund is not insured or guaranteed by the FDIC or any other government agency. Although a money market fund seeks to preserve the value of the investment at $1.00 per share, it is possible to lose money by investing in a money market fund.

Alternative Investments

As described in Unit 5, there are a number of alternative pooled investments. The risks and rewards were covered there, but, as a refresher, in almost all cases, these are speculative investments and will only be suitable on that basis. For example, ETNs can provide attractive short-term returns based on the performance of the selected index, but with a number of risks pointed out earlier. Leveraged or inverse ETFs or funds can offer dynamic profits, but only for those with a very short time horizon and high appetite for risk. The following chart summarizes common investor objectives and appropriate recommendations. Be ready for a significant number of situational questions that require determining the best solution for the investor.

Investor Objective	Suitable Recommendation
Preservation of capital; safety	▪ Insured bank CDs, money market instruments or funds, T-bills
Growth	Common stock or common stock mutual funds
▪ Balanced/moderate growth →	▪ Large-cap stocks, defensive stocks
▪ Aggressive growth →	▪ Technology stocks, sector funds, or cyclical stocks
Income	Bonds (but not zero coupons)
▪ Greatest safety →	▪ U.S. government bonds
▪ Tax-free income →	▪ Municipal bonds or municipal bond funds
▪ High-yield income →	▪ Corporate bonds or corporate bond funds
▪ From a stock portfolio →	▪ Preferred stock and utility stocks
Liquidity	▪ Money market funds (DPPs, real estate, and annuities are not considered liquid.)
Speculation	▪ Volatile stocks, high-yield bonds, stock/index options, leveraged and inverse ETFs

KNOWLEDGE CHECK 17.3

1. One of your clients has received sales literature on a lifecycle fund. A common name for this kind of fund is
   A. asset allocation.
   B. balanced.
   C. growth/income.
   D. target date.
2. Based on reports indicating a likely slowdown in economic activity, the portfolio manager of the UVW mutual fund has reduced the fund's exposure to equities and increased the cash. UVW is *most* likely
   A. an asset allocation fund.
   B. a balanced fund.
   C. a growth fund.
   D. a money market fund.

KNOWLEDGE CHECK ANSWERS

Knowledge Check 17.1

1. **D** These and a number of other items listed in the LEM are the common nonfinancial considerations that go into designing a portfolio for a customer.

   LO 17.a

2. **C** *Mild* is not a term you will see used to describe an investor's risk tolerance. Those with a high risk tolerance are aggressive; those with a low risk tolerance are conservative; those in between have a moderate risk tolerance. Another term that might be shown on the exam is *speculative* risk tolerance. That is another way of saying aggressive.

   LO 17.b

Knowledge Check 17.2

1. **A** It should be easy to eliminate one of the choices immediately. Commodity futures are for speculators, not conservative investors. An income fund or a balance fund has the problem of being subject to market fluctuation. When the money needs to be there in six years, if the market is in the middle of a downturn, it is likely the funds will be less than needed. The bank-insured CD will never fluctuate and, with FDIC insurance, is the safest bet.

   LO 17.c

2. **D** With four years to go and $145,000 in claimed assets, there isn't much time for them to grow to a level commensurate with the cash flow that will be needed for this individual's goals. There is no liquidity problem with the IRA—this investor is past the 10% penalty age. There don't appear to be any laws or regulations that would have an impact, and the income does not appear to be at a level where taxation is a primary concern.

   LO 17.c

Knowledge Check 17.3

1. **D** Because the target date fund changes its allocation as the investor's life moves ahead, the term *lifecycle fund* is often used as a descriptor.

   LO 17.d

2. **A** Although most funds are able to adjust a portion of their portfolios, it is the asset allocation funds where this is the purpose of the fund. The manager's job is to allocate the fund's assets into and out of equity, debt, or cash as market conditions dictate.

   LO 17.d

UNIT 18

Retirement Plans, Including ERISA Issues and Educational Funding Programs

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- › LO 18.a **Recall** the features of traditional, Roth, and simplified employee pension plan individual retirement accounts.
- › LO 18.b **Recognize** the tax treatment of distributions from IRAs.
- › LO 18.c **Differentiate** between the different types of employer-sponsored qualified retirement plans.
- › LO 18.d **Identify** the characteristics of a 403(b) plan.
- › LO 18.e **Contrast** qualified and nonqualified retirement plans.
- › LO 18.f **Identify** the tax treatment of distributions from qualified plans.
- › LO 18.g **Identify** the purpose of the Employee Retirement Income Security Act of 1974 and its primary features, including the fiduciary obligations under the Uniform Prudent Investor Act.
- › LO 18.h **Compare** the differences between the two major types of education funding programs.
- › LO 18.i **Contrast** UGMA and UTMA accounts.
- › LO 18.j **Recall** when health savings accounts (HSAs) may be used.

Your exam will include approximately seven questions from the topics covered in Unit 18.

INTRODUCTION

Retirement plans allow investors to accumulate resources to fund their retirement. Individuals accomplish this through business-sponsored retirement plans, personal plans, or individual and corporate retirement plans. To encourage Americans to save for retirement, Congress has passed legislation that allows investors to invest in certain retirement plans on a tax-deductible and/or tax-deferred basis.

Throughout this unit, we give you the contribution limits for all plans described that are current for those filing 2021 tax returns. It is highly unlikely that any of those numbers, other than perhaps the IRA contribution limit, will be asked on the exam. Therefore, you should consider these as included for reference purposes, not for testing.

LESSON 18.1: INDIVIDUAL RETIREMENT ARRANGEMENTS

LO 18.a Recall the features of traditional, Roth, and simplified employee pension plan individual retirement accounts.

As with so much in this course, there are similar terms with sometimes dissimilar meanings. Here is a useful list of terms used in the discussion of retirement plans:

Tax-deferred: Simply, income tax is put off (deferred) to a later time. In most retirement plans, tax on the amount of the contribution is usually deferred until withdrawal. Tax on the earnings is always deferred until withdrawal.

Qualified plan: An employer-sponsored plan, such as a pension, 401(k), or 403(b), where the contributions are made with pre-tax dollars and earnings in the account grow without any tax (tax-deferred) until the funds are withdrawn.

Qualified: This term by itself means that contributions are made with pre-tax dollars, and earnings in the account are tax deferred until the funds are withdrawn. This can apply to either a qualified plan or an IRA.

Nonqualified plan: An employer-sponsored plan, such as a deferred compensation plan, where there are no tax advantages other than that the payout is not received until sometime later when the individual should be in a lower tax bracket. Another advantage is that the employer can discriminate between employees. The term can also apply to an annuity purchased on an individual basis outside of a retirement plan, as will be described in Unit 24.

Deductible contribution: The contribution made by the individual, whether an employee contribution to a qualified plan such as a 401(k) plan or by any individual to an IRA. This means the amount contributed is pre-tax or otherwise deductible on the tax return.

Nondeductible contribution: A contribution to a qualified plan or an IRA that is made with after-tax dollars. The funds do grow tax deferred, but there is no tax benefit derived from the contribution.

TAKE NOTE

Although *individual retirement arrangements* is the technical IRS term (not tested), because everyone refers to these as individual retirement accounts (IRAs), we're going to use the common phrase to avoid confusion.

Individual retirement accounts (IRAs) were created to encourage people to save for their retirement. Most individuals with earned income can open and contribute to an IRA. Three types of IRAs are available, with different contribution, tax, and distribution characteristics: traditional IRAs, Roth IRAs, and simplified employee pension plan (SEP) IRAs.

IRAs are not to be confused with qualified plans or nonqualified plans used by businesses. Later in this unit we will cover topics such as pension plans, 401(k) plans, and deferred compensation plans. At this point, keep in mind that a qualified plan means that it meets the IRS requirements for the contributions to the plan to be tax deductible and the earnings to grow tax deferred. Nonqualified plans do not enjoy most of the tax benefits of qualified plans.

TAKE NOTE

Although we may include some actual contribution limits, it is unlikely that you will have to know any others than the IRA and Coverdell numbers.

Traditional IRAs

The first of the IRAs we'll cover is generally referred to as the **traditional IRA**, although there is no such term in the IRS regulations. This was the first IRA, and as others have been introduced, this first one acquired its name. A **traditional IRA** allows a maximum *tax-deductible* annual contribution of the lesser of $6,500 per individual or $13,000 per couple, or 100% of taxable compensation for the taxable year 2023. The income and capital gains earned in the account are tax deferred until the funds are withdrawn.

Compensation for IRA Purposes

For purposes of contributing to an IRA, the IRS considers the following to be compensation:

- Wages, salaries, and tips
- Commissions and bonuses
- Self-employment income
- Alimony*
- Nontaxable combat pay

TAKE NOTE

*For divorce decrees signed prior to January 1, 2019, alimony is considered earned income to the recipient. That makes it eligible compensation for purposes of an IRA contribution.

Not Compensation for IRA Purposes

For purposes of contributing to an IRA, the IRS does not consider the following to be compensation:

- Capital gains
- Interest and dividend income
- Pension or annuity income
- Child support
- Alimony*
- Passive income from DPPs

Although it is taxable, income from required minimum distributions (RMDs) is not compensation for the purposes of an IRA contribution.

TAKE NOTE

*For divorce decrees signed **after** December 31, 2018, under the TCJA of 2017, alimony payments are not considered compensation. Alimony is not deductible by the payer and is not taxable to the payee. If the date of the divorce decree is not given, assume it is post-2018 and is not compensation for IRA purposes.

Catch-Up Contributions for Older IRA Owners

The **Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)** was the source of the legislation permitting certain individuals to make additional contributions to their IRAs. Individuals aged 50 and older are allowed to make **catch-up contributions** to their IRAs above the scheduled maximum annual contribution limit, which will enable them to save more for retirement. These catch-up payments can go either to a traditional IRA or to a Roth IRA.

Year	Additional Catch-Up Amount Allowed
2006+	$1,000

TEST TOPIC ALERT

The exam may want you to know that the EGTRRA is responsible for the catch-up provisions. Any taxpayer of any age who reports earned income for a given tax year may contribute to a traditional IRA. If one spouse has little or no earned income and a joint tax return is filed, a spousal IRA may be opened for that person and the contribution limits are the same as for any other IRA.

PRACTICE QUESTION

One member of a married couple in their 30s earns an annual salary of $45,000, while the other earns $2,000 annually from a home-based business. If they file a joint tax return, their maximum IRA contribution for 2023 is

A. $6,500.
B. $8,500.
C. $13,000.
D. $15,000.

Answer: C. When one spouse's annual earnings are less than $6,500, the spousal IRA benefit permits that spouse to contribute the maximum as long as a joint return is filed showing combined income of at least $13,000. In this case, their income exceeds that, so they can each have an IRA with a contribution of $6,500, making for a total of $13,000 (choice C). Please note that when using the spousal IRA, the higher-earning spouse cannot have more than the maximum contributed to their account (currently $6,500). One can't look at this and say the couple has $13,000 to be split however they wish. If this question had stated the couple were in their 50s, then, because of the catch-up provision, $15,000 would have been the correct choice.

Time for Contributions

IRA contributions for a specific taxable year may be made anytime from January 1 of that year through the required filing date of that year's return (generally April 15 of the next year, unless the 15 falls on a holiday or weekend day). If the individual obtains a filing extension, the deadline is still April 15.

TEST TOPIC ALERT

The exam may try to trick you into thinking that you can make a contribution later than April 15 if you have received an extension to file your taxes. You can't! You should know that an extension does not give you more time to **pay** your taxes; it only extends the time that you have to **file** your return.

Excess Contributions

Annual IRA contributions exceeding the maximum allowed are subject to a 6% penalty tax if the excess is not removed by the taxpayer in a timely manner.

Roth IRAs

Much of what has been stated about the traditional IRA applies to the Roth IRA—what is important are the differences. The most significant difference relates to the taxation of contributions and withdrawals. Contributions to Roth IRAs, unlike those of traditional IRAs, are **not** tax deductible. And earnings are not merely tax deferred; they can be tax free.

Earnings accumulated may be withdrawn tax-free, **five** years following the initial deposit, provided:

- the account holder is 59½ or older;
- the money withdrawn is used for the first-time purchase of a principal residence (up to $10,000); or
- the account holder has died or become disabled.

Regular contributions may always be withdrawn tax-free because they are made with nondeductible contributions.

PRACTICE QUESTION

Among the requirements for accumulated earnings in a Roth IRA to be withdrawn free of tax is

A. the owner of the account is at least 73 years old.
B. the money is withdrawn for a first-time purchase of a vacation home.
C. the initial deposit to a Roth IRA was made at least 5 years ago.
D. the owner's spouse is declared disabled.

Answer: C. The first requirement for tax-free withdrawals from a Roth IRA is that the initial deposit to a Roth must have been made at least 5 years ago (choice C). The other primary requirement is that the owner must be at least 59½, not 73. If the 5-year requirement is met, then owners under 59½ can receive tax-free distributions of accumulated earnings they wish to use, up to $10,000, for a first-time purchase of a primary residence, not a vacation home. The disability requirement only applies to the owner of the Roth, not a spouse.

Contribution Limits

Contribution limits to Roth IRAs are the same as those for traditional IRAs. Like a traditional IRA, contributions may be made at any age as long as the taxpayer has earned income.

An individual may contribute to both a traditional and a Roth IRA. However, the maximum combined contribution is $6,500 (or $7,500, if 50 or older).

Eligibility Requirements

Unlike the traditional IRA, there are limits placed on Roth eligibility based on income. Anyone with earned income is eligible to open a Roth IRA, provided the person's adjusted gross income (AGI) falls below specified income levels. The following numbers (which are **never** tested) are effective for those filing a tax return for 2021. A single person with an

AGI of less than $125,000 may contribute the full amount to a Roth IRA. The ability to contribute to a Roth IRA is gradually phased out if the taxpayer's AGI is between $125,000 and $140,000.

For married taxpayers who file joint tax returns, the AGI limit is $198,000, with the contribution phased out for couples whose income is between $198,000 and $208,000.

Adjusted Gross Income (AGI)

Adjusted gross income, generally referred to as AGI, is computed on the bottom of the first page of Form 1040. It might help you to take a look at yours. When you do your taxes, you begin by listing all of your earned income (salary, wages, and bonuses) plus other income such as interest and dividends, capital gains, alimony received, and profits from a business you may own. From that total, you deduct certain items to arrive at the AGI. Among the more testable items that are deductible are:

- traditional IRA contributions;
- alimony paid as part of a pre-January 1, 2019, divorce decree;
- self-employment tax; and
- penalties paid on early withdrawal from a savings account.

TEST TOPIC ALERT

Please note that although tax-exempt income from municipal securities is shown on Form 1040, it is **not** included in AGI.

TAKE NOTE

These eligibility numbers will **not** be tested because they change every year. It is the concept that is important.

Roth Conversions

Anyone with a traditional IRA is permitted to convert it to a Roth IRA. However, there are income tax consequences. Basically, the entire amount converted is added to the investor's ordinary income. As long as the funds are moved in a direct rollover trustee to trustee, or, if distributed to the owner, are rolled over within 60 days, there will be no 10% early distribution tax penalty for those under age 59½. If some portion of the contributions to the traditional IRA were made with after-tax money, the IRS uses a proportionate system to determine how much is nontaxable, but that type of computation will not be tested. Conversions may also be done from any qualified employer plan such as 401(k) and 403(b) plans, as well as SIMPLE and SEP IRAs.

Key Points to Remember About the Roth IRA

- Contributions are not tax deductible.
- Distributions are tax free if taken after age 59½ and a Roth account has been open for at least five years.
- Contributions can be made at any age as long as there is earned income.
- Distributions are not required to begin at age 73.

- If due to death, disability, or a first-time home purchase, the distribution is qualified and not subject to tax or the 10% penalty.
- A minor can be named as beneficiary.

Characteristics of IRAs

IRA Investments

Funds in an IRA account may be used to buy stocks, bonds, mutual funds, UITs, limited partnerships, REITs, U.S. government securities, or gold or silver coins minted by the U.S. Treasury Department (American Eagles), as well as certain platinum coins and bullion (gold, silver, palladium, and platinum), annuities, and many other investments.

TAKE NOTE

The list of allowable coins goes beyond those minted by the Treasury. We have never heard of any of these asked on the exam, but the more those TV commercials rave about gold in your IRA, the greater the chance NASAA will start asking. In addition to the American Eagles, the IRS will permit the following coins:

- American Buffalo
- Canadian Gold Maple Leaf
- Australian Gold Nugget
- Platinum Maple Leafs and nonproof coins

IRA investments should be relatively conservative and should reflect the investor's age and risk tolerance profile. Because an IRA serves as a source of retirement funds, it is important that the account be managed for adequate long-term growth.

Ineligible and Inappropriate Investments

Collectibles, including antiques, gems, rare coins, works of art, and stamps, are not acceptable IRA investments. Life insurance contracts (such as whole life and term) may not be purchased in an IRA. Tax-free municipal bonds, municipal bond funds, and municipal bond UITs are eligible, but they are generally considered inappropriate for an IRA (or any tax-qualified plan) because their yields are typically lower than those of other similar investments, and the income generated is taxable on withdrawal from the IRA.

Ineligible Investment Practices

No short sales of stock, trading on margin (covered in detail in Unit 23), or speculative option strategies (think *uncoveredcalls*) is permitted in an IRA or any other retirement plan. Covered call writing, described in Unit 4, is allowed.

Ineligible Investments	Ineligible Investment Practices
Collectibles	Short sales of stock
Whole life insurance	Speculative option strategies
Term life Insurance	Margin account trading

Real Estate in an IRA (or Qualified Plan)

Legally, you may invest in real estate in your IRA or as a participant in a 401(k) or any other qualified plan. It is not commonly something that is written into the documents, but it could be. Probably the biggest reason why the provision is rarely found is because of the extra care that must be taken when making a real estate investment. If done improperly, serious problems with the IRS can result. If it is done as a truly hands-off investment, it is unlikely that there will be an issue. However, the moment the participant derives any personal benefit from the property—such as staying in a condo purchased in a resort area that is rented out most of the year, or allowing prohibited persons to use the property—look out.

TEST TOPIC ALERT

The IRS defines *prohibited persons* (people who can't benefit from real estate held in an IRA or qualified plan) as any "member of the family." Who are they? A member of the family includes a spouse, ancestors (parents and grandparents), children, grandchildren, great-grandchildren, and spouses of children, grandchildren, and great-grandchildren. Believe it or not, for the purpose of this rule, a brother or sister of an individual is not a member of the family, while a legally adopted child of an individual is treated as a child by blood.

Simplified Employee Pension Plans (SEP IRAs)

The third type of IRA is somewhat different in that it is funded by an employer rather than the individual. Simplified employee pension plans (SEPs) offer self-employed persons and small businesses easy-to-administer pension plans. A SEP is a qualified plan that allows an employer to contribute money directly to an individual retirement account (IRA) set up for each employee; hence the name SEP IRA. Following is a list of the key points of which to be aware:

Eligibility. To be eligible, an employee must be at least 21 years of age, have performed services for the employer during at least three of the last five years, and have received at least $650 (for 2021) in compensation from the employer in the current year (the annual compensation figure is indexed for inflation).

Participation. SEP rules require the employer to allow all eligible employees to participate.

Funding. A SEP allows the employer to contribute up to 25% of an employee's salary to the employee's SEP IRA each year, up to a maximum of $58,000 per employee per year in 2021. The employer determines the level of contributions each year and must contribute the same percentage for each employee, as well as the employer.

Catch-up provision. Unlike the IRA and most qualified plans, there is NO catch-up provision for a SEP. However (and this is unlikely to be tested), if the SEP IRA permits non-SEP contributions, they can make regular IRA contributions (including IRA catch-up contributions if they are age 50 and older) to the SEP IRA, up to the maximum annual limit.

Vesting. Participants in a SEP IRA are fully vested immediately, meaning that once the money is deposited in an employee's SEP IRA, it belongs to the employee.

Taxation. Employer contributions are tax deductible to the employer. Contributions are not taxable to an employee until withdrawn, and earnings in the account accumulate tax deferred.

PRACTICE QUESTION

SEP IRAs

A. are used primarily by large corporations.
B. are used primarily by small businesses.
C. are set up by nonemployees.
D. cannot be set up by self-employed persons.

Answer: B. Small businesses and self-employed persons typically establish SEP IRAs because they are easier and less expensive than other plans for an employer to set up and administer.

KNOWLEDGE CHECK 18.1

1. A taxpayer has earned income of $25,000 in 2021. Contributions to that individual's IRA may be made on
   I. November 15, 2021.
   II. January 4, 2022.
   III. April 15, 2022.
   IV. October 15, 2022 (if the automatic extension has been filed).
   A. I and II
   B. I, II, and III
   C. I, II, III, and IV
   D. II and III
2. A 52-year-old taxpayer has earned income of $50,000 in 2023. If the individual has a traditional IRA and a Roth IRA, the maximum contribution for the year is
   A. $6,500 combined in any fashion.
   B. $7,500 combined in any fashion.
   C. $6,500 into the traditional IRA and a like amount into the Roth IRA.
   D. $7,500 into the traditional IRA and a like amount into the Roth IRA.

LESSON 18.2: IRA TAXATION

LO 18.b Recognize the tax treatment of distributions from IRAs.

Withdrawals from Traditional IRAs and SEP IRAs

Up until this point, we've discussed contributions to IRAs; now let's look at taking the money out. When it comes to traditional IRAs and SEP IRAs, distributions without penalty may begin after age 59½ and must begin by April 1 of the year following the year an individual turns 73. Distributions before age 59½ may be subject to a tax penalty, and withdrawals less than the required minimum distributions (RMDs) after age 73 may also incur tax penalties.

TAKE NOTE

When is the deadline for receiving an RMD from an IRA? Under SECURE 2.0, an account owner must take the first RMD for the year in which the account owner turns 73. However, the first RMD payment can be delayed until April 1 of the year following the year in which the account owner turns 73. For all subsequent years, including the year in which the first RMD was paid by April 1, the account owner must take the RMD by December 31 of the year.

To the extent withdrawals are from tax-deductible contributions, they are taxable as ordinary income. When there are both deductible and nondeductible contributions, a formula is used whereby a portion of the withdrawal represents a nontaxable return of principal.

Taxable withdrawals before age 59½ are also subject to a 10% early withdrawal penalty unless they are due to:

- death;
- disability;
- first-time purchase of a primary residence ($10,000 lifetime maximum);
- qualified higher education expenses for the IRA owner, spouse, children, and grandchildren (but not nieces or nephews);
- certain medical expenses;
- up to $5,000 during the first year after a child is born; or
- up to $5,000 during the first year after an eligible person is adopted.
  - "Eligible adoptee" means anybody under age 18 or who is physically or mentally incapable of self-support regardless of age.
  - If married, each spouse can make the $5,000 penalty-free withdrawal.
  - These qualified birth or adoption distributions (QBOADs) are also available for qualified plans, but only if the sponsor provides for them.

These exceptions also apply in the case of a nonqualified (taxable) distribution from a Roth IRA.

PRACTICE QUESTION

Who of the following will **not** incur a penalty on an IRA withdrawal?

A. Man who has just become totally disabled
B. Woman who turned 59 a month before the withdrawal
C. Woman, age 50, who decides on early retirement
D. Man in his early 40s who uses the money to buy a second home

Answer: A. Early withdrawals, without penalty, are permitted only in certain situations (such as death or qualifying disability).

As stated, withdrawals must begin by April 1 of the year following the year in which the account owner reaches age 73. Under SECURE 2.0, if the RMD is not taken by the IRS deadline, a 25% excise tax on insufficient RMD withdrawals applies. If the RMD is corrected timely, the penalty can be reduced down to 10%.

One important respect in which the Roth IRA differs from other retirement plans is that the age 73 is irrelevant. There are no required minimum distributions. An account holder reaching 73 who does not need the money and who is in good health could let the money continue to grow tax-free for decades.

There is one other way to tap your IRA before age 59½ without penalty—through the **substantially equal periodic payment (SEPP) exception.** The **substantially equal periodic payment exception** under IRS rule 72(t) states that if you receive IRA payments at least annually based on your life expectancy (or the joint life expectancies of you and your beneficiary), the withdrawals are not subject to the 10% penalty. The IRS has tables for determining the appropriate amount of each payment at any given age.

TAKE NOTE

For exam purposes, other than with a Roth IRA, you can postpone beginning distributions until the later of:

- April 1 of the calendar year after you turn age 73; or
- April 1 of the calendar year following your retirement (but only for qualified plans, not an IRA).

EXAMPLE

An IRA owner who reaches age 73 on January 1, 2023, must begin withdrawals by April 1, 2024. However, if this individual is covered by an employer-sponsored plan other than a SEP IRA, there are no RMDs from that plan (but there are from any traditional IRAs) until after retirement.

Nondeductible Capital Withdrawals

IRA investors who contribute after-tax dollars to an IRA are not taxed on those funds when they are withdrawn from the account, but taxpayers are taxed at the ordinary income tax rate when they withdraw funds resulting from investment gains or income. As stated above, if the client is in the middle part of the phase-out range resulting in some of the contribution being pre-tax (deductible) and the rest post-tax, the IRS has a formula to determine how much of the money withdrawn is nontaxable.

EXAMPLE

A client has invested $25,000 in after-tax dollars in an IRA currently worth $75,000. If the client were to withdraw $75,000, only $50,000 would be taxable.

TAKE NOTE

The early withdrawal penalties for all IRAs are waived in the event of death or disability.

TEST TOPIC ALERT

Assume questions are about traditional IRAs unless they specifically state *otherwise*.

TEST TOPIC ALERT

Income and capital gains earned from investments in any IRA account are not taxed until the funds are withdrawn and, if a qualified withdrawal, are not taxed at all in the case of a Roth.

Moving IRAs

Individuals may move their funds and investments from one IRA to another IRA through one of two methods:

- 60-day rollover; or
- trustee to trustee transfer.

60-Day Rollovers

If you just see "IRA rollover," it will be the 60-day rollover. An IRA account owner may take temporary possession of the account funds to move the retirement account to another custodian. The account owner may do so only once per 12-month period, and the rollover must be completed within 60 calendar days of the fund's withdrawal from the original plan. However, 100% of the withdrawn amount must be rolled into the new account, or the unrolled balance will be subject to income tax and, if applicable, early withdrawal penalty.

A participant in a business-sponsored qualified plan may move her plan assets to an IRA if she leaves the company and elects to take a lump-sum distribution. If the participant does take possession of the funds, she must complete the rollover within *60 calendar days* of withdrawing the funds from the qualified plan.

When the participant takes possession of the funds from a qualified plan to make a rollover, the payor of the distribution must, by law, withhold 20% of the distribution as a withholding tax. The participant must, nonetheless, roll over 100% of the plan distribution, including the funds withheld, or be subject to income tax and, if applicable, early withdrawal penalty.

EXAMPLE

A 50-year-old individual with $100,000 in her company retirement plan changes employers. Her pension plan may be distributed to her in a lump-sum payment, minus the mandatory 20% withholding of $20,000. She must then deposit $100,000 in an IRA rollover account within 60 days. Any portion not rolled over, including the $20,000 withheld, is considered a distribution subject to ordinary income tax and early distribution penalty. If she deposits the entire $100,000 into the IRA, she will apply on her next income tax return for a refund of the $20,000 withheld.

Trustee to Trustee Transfers

Sometimes simply referred to as an IRA transfer, this is when account assets are sent directly from one IRA custodian to another, and the account owner never takes possession of the funds. Unlike the one per 12 months with an IRA rollover, the number of IRA transfers an account owner may make per year is unlimited. Direct rollovers and transfers generally make better sense than 60-day rollovers because the 20% federal tax withholding does not apply to direct transfers of portfolios and, because the transfer is basically immediate, the holder doesn't have to be concerned about meeting the 60-day requirement.

There is another way of receiving funds in an IRA, and that is when moving funds from an employer-sponsored qualified plan—that is the direct rollover.

Direct Rollovers from Retirement Plans to IRAs

A direct rollover is a distribution from an employer-sponsored retirement plan to an IRA, either traditional or Roth. When you terminate employment (or retire), you have the option of moving your employer-sponsored plan assets to an IRA. In some cases, if you go to a new job, your new employer's plan may permit a direct rollover into that plan. The key to a direct rollover is that the money is never seen by the employee and moves directly from the current plan administrator directly to another administrator.

TAKE NOTE

How does a direct rollover differ from a transfer? A direct rollover is different from a transfer because it involves two different types of plans. For example, one would use a direct rollover to move funds from a 401(k) plan to an IRA, while the transfer is from an IRA at one brokerage firm to an IRA at another.

Earnings Limitations for Tax Benefits

Traditional and certain SEP IRA participants may deduct contributions to their IRAs from their taxable income. The deductibility limits are reduced or even eliminated for individuals who are covered by other employer-sponsored qualified plans.

These AGI limits increase every year and will **not** be tested. Individuals who do not participate in qualified plans may deduct IRA contributions regardless of income level.

For those filing 2021 tax returns, the IRA deductibility phase-out range is expressed in the table below.

Year	Phase-out Range: Single Filers	Phase-out Range: Joint Filers
2021	$66,000–$76,000	$105,000–$125,000

TAKE NOTE

The limits are higher ($198,000–$208,000) if only one of the spouses participates in a qualified plan, but, as with all of these numbers, it is only the concept that is tested, never the numbers themselves.

These limits deal only with the deductibility of contributions. If your client earns in excess of the limits, the full contribution can still be made, but none of it can be deducted. The test refers to those as *post-tax* or *after-tax* contributions. The earnings still grow tax deferred.

EXAMPLE

Two persons who are part of a married couple, each of whom does not participate in a qualified plan and whose combined income is $200,000, may contribute and deduct a total of $12,000 ($14,000 if both individuals are 50 or older). No deduction is allowed for a married couple where both are covered by a qualified plan and whose combined income is $125,000 (for 2021) or more. Nevertheless, their contributions are permitted, and all earnings are tax deferred.

Inheriting an IRA

The rules on the treatment of an inherited IRA depend on whether the beneficiary is the spouse or is some other relative (or nonrelative) of the deceased. Another factor is if the deceased had already begun taking RMDs. This issue is very technical, and we will only cover points that might be tested.

TAKE NOTE

IRAs and employer-sponsored qualified plans have a beneficiary designation. That designation supersedes any contrary provision in a will.

Spousal Beneficiary

When the beneficiary is the spouse, there are two choices that can be made:

- Do a spousal rollover, meaning the amount of the inheritance is rolled over into the spouse's own IRA
- Continue to own the IRA as the beneficiary

When doing a spousal rollover, this is treated, logically, as your own with all of the normal rules applying (withdrawal ages, RMDs, and so forth). That means that if the spouse is younger than 59½, any distributions prior to then will be subject to the 10% penalty (unless meeting one of the exceptions).

If, however, the spouse elects to continue the account as the beneficiary, then there is no 10% penalty for withdrawals prior to age 59½. That's the good news. The bad news is that RMDs (from a traditional IRA or SEP IRA) must begin when the deceased would have had to take them, a disappointment if the survivor is the younger partner. However, the RMDs will be computed based on the beneficiary's age, not that of the deceased. Also, if it is a Roth IRA and the account hasn't been open for at least five years, any withdrawal of earnings will be subject to income tax but not the 10% penalty.

Nonspouse Beneficiary

Things are different when the person inheriting a traditional IRA is not the spouse of the deceased. For one thing, unlike the spouse, the beneficiary will not be allowed to rollover the inherited IRA into their own IRA—this is simply *not* an option. In general, there are two primary options available.

- **Take the cash now:** The nonspouse IRA beneficiary can withdraw 100% of the IRA account immediately. If this option is chosen, then 100% of the amount withdrawn (assuming the IRA was funded completely with pre-tax contributions) will be included in taxable income during the year of withdrawal.
- **Cash out the IRA in 10 years:** For those who passed away in 2020 or later, unless qualifying for one of the exceptions listed below, the beneficiary must comply with the 10-year rule. If a beneficiary is subject to the 10-year rule, the requirement is to empty the entire account by the end of the 10th year following the account owner's death. The IRS does not require the payments to be made with any designated frequency. That is, you can take a portion the first year because you need some cash, nothing for the next eight years, and the balance no later than December 31 of the tenth year. Regardless of the frequency of payments, the only requirement is that it is all gone by the last day of the calendar year ten years after death. For example, a grandchild inheriting from a grandparent who died on July 2, 2021, would be obligated to empty the account no later than December 31, 2031.

There are exceptions to the 10-year rule as follows:

- The surviving spouse (as described above)
- A minor child (10-year rule applies once the minor reaches the age of majority)
- A disabled individual
- A chronically ill individual
- An individual who is not more than 10 years younger than the deceased participant or IRA owner

If the beneficiary does nothing by December 31 of the year following the year of death, the default option used by the IRA is the 10-year withdrawal option.

PRACTICE QUESTION

Grandma Abigail died at age 82 with a traditional IRA valued at $100,000. Her daughter Betsy, 53 years old, was the sole beneficiary. Betsy's choices would include

A. rolling over this IRA to her own IRA.
B. taking distributions over a period not to exceed 10 years.
C. taking the cash by December 31 and paying the 10% tax penalty because she is under 59½.
D. leave the IRA in the name of the deceased and continue with the RMDs.

Answer: B. Among the options available to a nonspouse beneficiary is receiving the payout over a 10-year period. The distributions may be taken as desired but must be completed within 10 years. Betsy, being a daughter and not a spouse, could not roll over the IRA into her own IRA. Even though she is under 59½, inheritors of IRAs do not incur the 10% penalty tax on withdrawals.

TAKE NOTE

Just as with the spouse continuing the IRA as the beneficiary, if the account were a Roth IRA and had not been opened for the five-year minimum, any earnings distributed will be subject to ordinary income tax but not the 10% penalty.

Disclaiming an IRA

Believe it or not, there are actually people who inherit IRAs who don't want the money. There are any number of reasons why (none of which will be tested), but what will be tested is what happens when the beneficiary **disclaims** the proceeds.

A disclaimer is a refusal to accept a gift or inheritance. Perhaps it is easier to understand it like this: If you accept an item left to you by someone who has died, you are claiming that asset; if you refuse it, you are disclaiming it. In order for the disclaimer to be effective, it must be done within nine months of death, it must be in writing, and, of course, you cannot disclaim any money you have already taken.

If the named beneficiary of an IRA disclaims all or part of the inherited IRA, the disclaimer has the effect of changing the beneficiary of the retirement plan. In general, the assets pass to the contingent beneficiary(ies). What if no contingent beneficiary has been named? Unless the IRA adoption document provides for it, the person disclaiming cannot decide where the money goes—it will follow the provisions of the deceased's will.

EXAMPLE

Joseph Miller passes away at the age of 72 and leaves his wife, Josephine, his traditional IRA with a value of $1,800,000. There are many other assets in the estate, and Mrs. Miller decides to disclaim the entire IRA. She would like to pass on the assets to her three grandchildren, none of whom are minors, in equal shares, with another share going to her favorite charity. Assuming the IRA adoption document permits the beneficiary to designate in this matter, the charity will receive $450,000 with no tax liability at all, and the three grandchildren will each receive $450,000 on which distributions may be stretched out over a maximum of 10 years.

Unit 18

KNOWLEDGE CHECK 18.2

1. Taxable withdrawals before age 59½ are subject to a 10% early withdrawal penalty in addition to the normal income tax unless they are due to
   I. death.
   II. disability.
   III. qualified education expenses for a nephew.
   IV. the purchase of a vacation home, but not to exceed $10,000 lifetime.
   A. I and II
   B. I and III
   C. I, II, and III
   D. I, II, and IV

2. A taxpayer opened a Roth IRA seven years ago. Last year, the individual opened a new Roth IRA at your brokerage firm. The individual is 60 years of age and liquidates $3,000 from the new Roth IRA. $1,000 of the withdrawal represents earnings in the account. The tax consequence of this withdrawal is
   A. no tax is due.
   B. tax is due on the $1,000 from earnings.
   C. tax plus the 10% penalty is due on the $1,000 from earnings.
   D. tax is due on the entire $3,000 withdrawal.

LESSON 18.3: EMPLOYER-SPONSORED RETIREMENT PLANS

LO 18.c Differentiate between the different types of employer-sponsored qualified retirement plans.

In this lesson, we will be describing the various retirement plans offered by employers to their employees. We will be addressing plans offered for the self-employed, the different plans offered by corporations, and, finally, plans designed for employees of tax-exempt organizations.

Keogh Plans

Keogh plans, technically called H.R. 10 plans and named after the Congressman who introduced the bill, are qualified plans intended for self-employed individuals and owner-employees of unincorporated business concerns or professional practices. Included in the self-employed category are independent contractors, consultants, freelancers, and anyone else who files and pays self-employment Social Security taxes. The term *owner-employee* refers to sole proprietors. A corporation cannot use a Keogh plan.

TAKE NOTE

Whenever the term *qualified plan* is used, it refers specifically to an employer-sponsored plan, such as a 401(k) plan, a pension plan, or a Keogh plan, not an IRA.

Contributions

Contribution limits for a Keogh plan are significantly higher than those for an IRA. For those filing tax returns in 2021, as much as $58,000 may be contributed on behalf of a plan participant. Those who are eligible for a Keogh plan may also maintain an IRA, but, as described previously, if the earning limits are exceeded, the IRA contribution will not be deductible. If the business has employees, they must be covered at the same contribution percentage as the owner in order for the plan to be nondiscriminatory.

TEST TOPIC ALERT

Only earnings from self-employment count toward determining the maximum that may be contributed. For example, if a corporate employee had a part-time consulting job, only that income, not the corporate salary, could be included in the computation.

Eligibility

Employee participation in a Keogh plan is subject to these eligibility rules:

- **Full-time employees** are employees who receive compensation for at least 1,000 hours of work per year.
- **Tenured employees** are employees who have completed one or more years of continuous employment.
- **Adult employees** are employees 21 years of age and older, and there is no age limit as long as the individual is employed.

Comparison of IRAs and Keogh Plans

Keogh plans and IRAs are designed to encourage individuals to set aside funds for retirement income. Although both IRAs and Keoghs are tax advantaged, an IRA does not involve employer contributions and, thus, is not a plan qualified by **ERISA**. The principal similarities between Keoghs and IRAs are listed in the following:

- **Tax deferral of contributions to plans.** Taxes are deferred on contributions until the individual receives distributions.
- **Tax sheltered income.** Investment income and capital gains are not taxed until withdrawn, at which time they are subject to taxation at ordinary income rates.
- **Contributions.** Only cash may be contributed to a plan. In the event of a rollover or transfer, cash and securities from the transferring account can be deposited.
- **Distributions.** Distributions without penalty can begin as early as age 59½.
- **Penalties for early withdrawal.** The individual pays income tax on the total amount withdrawn plus a 10% penalty. Early withdrawals without penalty are permitted in the event of death or disability.
- **Payout options.** Distributions may be in a lump sum or periodic payments.
- **Beneficiary.** Upon the plan holder's death, payments are made to a designated beneficiary (or beneficiaries).

PRACTICE QUESTION

Which of the following may participate in a Keogh plan?

I. Self-employed doctor
II. Analyst who makes money giving speeches outside regular working hours
III. Individual with a full-time job who also has income from freelancing
IV. Corporate executive who receives $5,000 in stock options from her corporation

A. I only
B. I and II
C. I, II, and III
D. I, II, III, and IV

Answer: C. A person with self-employment income may deduct contributions to a Keogh plan. Keogh plans are not available to corporations or their employees. That would make choice C the correct answer.

Corporate Sponsored Retirement Plans

Plans offered by corporations include pension plans, profit-sharing plans, and the highly popular 401(k) plans.

The **Employee Retirement Income Security Act of 1974 (ERISA)** is federal legislation that regulates the establishment and management of corporate pension or retirement plans, also known as **private sector plans.**

All qualified corporate plans must be established under a trust agreement. A trustee is appointed for each plan and has a fiduciary responsibility for the plan and the beneficial owners (the plan holders). We'll cover ERISA in greater detail later in this unit in Lesson 18.5.

Defined Contribution and Defined Benefit Plans

All qualified retirement plans fall into one of two categories. Those that offer no specific end result but instead focus on current, tax-deductible contributions are **defined contribution plans.** Those that promise a specific retirement benefit but do not specify the level of current contributions are **defined benefit plans.** It is important to distinguish between these two approaches.

TAKE NOTE

Although we will be including 2021 contribution limits, these are never tested on the exam because they change each year. As stated earlier in the course, they are simply to give students an idea of the difference between the amount that may be contributed here compared to an IRA.

Defined Contribution Plans. Defined contribution plans include money-purchase pension plans as well as profit-sharing plans and 401(k) plans. As with other business plans (as compared to an IRA), the maximum employer contribution is currently (2021) $58,000.

Defined contribution plan participants' funds accumulate until a future event, generally retirement, when the funds may be withdrawn. The ultimate account value depends on the total amount contributed, along with interest and capital gains from the plan investments. In this type of plan, the plan participant assumes the investment risk. The deduction for contributions to a defined contribution plan, such as a profit-sharing plan (including 401(k)) or money purchase pension plan, cannot be more than *25% of the total payroll* for the year to the eligible employees participating in the plan.

Defined Benefit Plans. Defined benefit plans are designed to provide specific retirement benefits for participants, such as fixed monthly income. Regardless of investment performance, the promised benefit is paid under the contract terms. A defined benefit plan sponsor assumes the investment risk. It can happen that the portfolio performance is so good that, in certain years, the plan is fully funded without a contribution needed for that year.

The benefit is usually determined by a formula that takes into account years of service and average salary for the last five years prior to retirement. Older, highly compensated employees are likely to have the largest annual contributions on their behalf. Because of the expenses and complexities involved (the plan's annual return must be signed by an actuary), 16% of workers had defined benefit plans in 2019, whereas in 1979, that number was 28%.

TAKE NOTE

Because of the actuarial assumptions and computations, the amount of the annual employer contribution has to be figured by an actuary. When the proper amount has been contributed, the plan is considered to be *fully funded*. If the year's portfolio performance exceeds the actuarial assumptions, the plan is over-funded and a smaller or possibly no contribution is necessary for the year. Unfortunately, many plans, including state employee plans, are under-funded.

Contributory versus noncontributory plans. In a contributory plan, both the employer and employee make contributions to the account. In a noncontributory plan, only the employer makes the contributions. Probably the most common example of a contributory plan is the 401(k) plan, where the employee determines how much to contribute and the employer may match up to a certain percentage.

Employer Deductions. The employer can usually deduct, subject to limits, contributions made to a qualified plan. The deduction limit for those contributions to a qualified plan depends on the kind of plan in place.

TEST TOPIC ALERT

Unlike an annuity payout or life insurance premium, contributions to a defined benefit plan are not affected by the participant's sex.

TEST TOPIC ALERT

Employer contributions to defined benefit or defined contribution, (money purchase), pension plans are mandatory. Although profit profit-sharing plans and 401(k) plans are technically defined contribution plans, they are not pension plans, and employer contributions are not mandatory. In all cases, allowable employer contributions are 100% deductible to the corporation. There is no tax obligation to the employee until withdrawal.

Profit-Sharing Plans

A **profit-sharing plan** established by an employer allows employees to participate in the business's profits. The benefits may be paid directly to the employee or deferred into an account for future payment, such as retirement, or a combination of both. This discussion concerns profit-sharing plans that defer benefits toward retirement.

Profit-sharing plans need not have a predetermined contribution formula. Plans that do include such a formula generally express contributions as a fixed percentage of profits.

In either event, to be qualified, a profit-sharing plan must have substantial and recurring contributions according to the Internal Revenue Code.

Profit-sharing plans are popular because they offer employers the greatest amount of contribution flexibility. The ability to skip contributions during years of low profits appeals to corporations with unpredictable cash flows. They are also relatively easy to install, administer, and communicate to employees.

401(k) Plans

In a 401(k) plan, an employee directs an employer to deduct a percentage of the employee's salary that will be a contribution to a retirement account. 401(k) plans permit an employer to make matching contributions up to a set percentage of the employee-directed contributions, making this a type of defined contribution plan. All contributions are made with pre-tax dollars. In effect, participating employees are reducing their salary by the amount of their contribution and, therefore, their W2 will show the actual salary less the 401(k) contribution. However, even though income taxes are based on this lower amount, FICA (Social Security) taxes are levied against gross salary, not this reduced amount. In 2021, the maximum employee elective deferral is set at $19,500 with an additional "catch-up" contribution limit of $6,500.

TEST TOPIC ALERT

An employer-sponsored 401(k) plan may be established with no required employer or employee contributions. As we will shortly learn, there is one case where employer contributions would be mandatory, but, for exam purposes, unless that case is specified, it is up to the employer to determine if it will incorporate matching contributions into the plan.

TAKE NOTE

When one includes the catch-up amount, the maximum combined employer and employee contribution in a defined contribution plan increases from $58,000 to $64,500 per year.

TEST TOPIC ALERT

One of the benefits of investing through a 401(k) plan is that it takes advantage of *dollar cost averaging*, a technique described in Unit 21, which always results in a lower cost per share in a fluctuating market.

Roth 401(k) Plans

The Roth 401(k) is an option that may be added to an existing 401(k) plan. The Roth 401(k) option combines features of Roth IRAs and 401(k) retirement plans. Just as with a Roth IRA, these plans require after-tax contributions but allow tax-free withdrawals, provided the retiring person is at least 59½ years old at the time of the withdrawal. Once again, paralleling the Roth IRA, the account must be at least five years old to take tax-free withdrawals.

Like a regular 401(k) plan, the Roth 401(k) plan has employer-matching contributions; however, the employer's match must be deposited into a regular 401(k) plan and be fully taxable upon withdrawal. Thus, the employee must have two accounts: a regular 401(k) and a Roth 401(k). Employees may contribute to either account but may not transfer money between accounts once the money has been contributed.

Unlike Roth IRAs, Roth 401(k) plans have no income limit restriction on who may participate. One may have both a Roth 401(k) plan and a Roth IRA, but the income limits would still apply to the Roth IRA. Unlike Roth IRAs, Roth 401(k) plans require withdrawals to begin no later than age 73, following the same rules that apply to all RMDs.

SIMPLE Plans

Savings Incentive Match Plans for Employees (SIMPLEs) are retirement plans for a business with **100** or fewer employees who earned $5,000 or more during the preceding calendar year. In addition, the business cannot currently have another retirement plan in place.

The plans are easy to set up and inexpensive to administer. The employee's contribution, up to $13,500 with a $3,000 catch-up provision (2021), is pre-tax and may be matched by the employer using either of the following two options:

- A 2% nonelective employer contribution, where employees eligible to participate receive an employer contribution equal to 2% of their compensation (limited to $290,000 per year for 2021 and subject to cost-of-living adjustments for later years), regardless of whether they make their own contributions.
- A dollar-for-dollar match up to 3% of compensation, where only the participating employees who have elected to make contributions will receive an employer contribution (i.e., the matching contribution).

For small businesses looking for a way to have an inexpensive retirement plan for their employees, the SIMPLE is the way to go.

TAKE NOTE

We've never heard of this being on the test, but, just in case, you might need to know about a penalty tax levied under these plans that is unique. Unless qualifying for an exception from the 10% penalty tax, such as that offered with traditional IRAs (over 59½, death or disability, etc.), withdrawals from a SIMPLE IRA within the first two years after beginning participation in the plan are subject to a penalty tax of 25%.

It is easy to confuse the SEP IRA (covered at LO 18.a) with the SIMPLE. The following chart will help you spot the differences:

Comparison of Plans

	SIMPLE IRA	SEP-IRA
Tax status	Tax-deferred	Tax-deferred
Contributor	Employees and/or employer	Employer
Contribution Limit	$15,500 (in 2023); catch-up limit of $3,500	25% of an employee's salary, or up to $66,000 (in 2023), whichever is less
Good For	Businesses with no more than 100 employees	Any size business

LO 18.d Identify the characteristics of a 403(b) plan.

403(b) Plan

A 403(b) plan, also known as a tax-sheltered annuity plan, is a retirement plan for certain employees of public schools, employees of certain IRS Code Section 501(c)(3) tax-exempt organizations, and certain ministers. A 403(b) plan allows employees to contribute some of their salary to the plan. The employer may also contribute to the plan for employees.

403(b) plans, also known as a **tax-sheltered annuity plan (TSA)**, are qualified tax-deferred retirement plans for employees of public school systems (403(b) employees) and tax-exempt organizations under IRS Code Section 501(c)(3), such as churches and private nonprofit organizations (501(c)(3) employees). A 403(b) plan allows qualified employees to contribute some of their salary to the plan. The employer may also contribute to the plan for employees. Like other retirement plans, these are intended to encourage retirement savings. To ensure this objective, 403(b)s, like IRAs and other retirement plans, are subject to tax penalties if savings are withdrawn before a participant reaches age 59½.

Tax Advantages

The following tax advantages apply to 403(b) plans.

Income exclusion. If an eligible employee elects to make annual contributions to a 403(b), those contributions are excluded from the employee's gross income for that year. The amount of the contribution is not reported as income, resulting in lower current income taxes.

Tax-deferred accumulation. Earnings in a 403(b) accumulate with no current taxation of earnings or gains and do not increase the participant's taxable income until the dollars are withdrawn at retirement, usually when that person is in a lower tax bracket.

Investments. Historically, these plans were (and still are) referred to as tax-sheltered annuity plans (TSAs) because annuities were the only investment option. In 1974, a provision was made to permit the purchase of mutual funds as well, although it is estimated that more than 85% of all 403(b) money is invested in either fixed or variable annuities.

Guaranteed investment contracts (GICs). Another option for 403(b) plans (as well as 401(k) plans) is the guaranteed investment contract, almost always referred to by its initials, GIC. These are contracts issued by insurance companies that offer a guaranteed return of principal at a certain date in the future and come with a fixed rate of return that is generally a bit higher than that offered by comparable bank CDs. However, unlike CDs, GICs are not federally insured; therefore, despite the inclusion of the word *guaranteed* in the title, GICs carry slightly more investment risk than CDs, and that is why their return is higher.

Eligibility Requirements

To be eligible to establish a 403(b), an employer must qualify as a:

- public educational 403(b) institution;
- tax-exempt 501(c)(3) organization; or
- church organization.

Public Educational 403(b)

To qualify as a public educational institution, an organization must be state supported, a political subdivision, or an agency of a state. Private school systems have a separate set of qualifying rules. State-run educational systems include:

- elementary schools;
- secondary schools;
- colleges and universities; and
- medical schools.

Individuals employed by the above school systems in the following job classifications may enroll in a 403(b) plan. These include:

- teachers and other faculty members;
- administrators, managers, principals, supervisors, and other members of the administrative staff;
- counselors;
- clerical staff and maintenance workers; and
- individuals who perform services for the institution, such as doctors or nurses.

Tax-Exempt 501(c)(3)

As stated earlier, 501(c)(3) organizations are tax-exempt entities specifically cited in the IRC as eligible to establish 403(b)s for their employees. Typical 501(c)(3) organizations include:

- private colleges and universities;
- trade schools;
- parochial schools;
- zoos and museums;
- research and scientific foundations;
- religious and charitable institutions; and
- private hospitals and medical schools.

TAKE NOTE

Some 403(b) plans are subject to ERISA while others are not. Two of the most important exclusions from ERISA coverage are:

- governmental plans (e.g., plans sponsored by a state, county, or municipality or one of their agencies, schools, or instrumentalities); and
- church plans, unless the plan sponsor has voluntarily elected to have the plan covered by ERISA.

Definition: employee. Only employees of qualified employers are eligible to participate in a 403(b) plan. Independent contractors are not eligible. It is the employer's responsibility to determine an individual's status or definition.

Similar to other qualified plans, all 403(b)s (whether employer contribution or employee elective deferral) must be made available to each full-time employee who has both reached age 21 and completed one year of service.

Plan Requirements

A 403(b) plan must meet two requirements.

- The plan must be in writing and must be made through a plan instrument, a trust agreement, or both.
- The employer must remit plan contributions to an annuity contract, a mutual fund, or another approved investment.

Contribution Limits

An employer can make contributions to a 403(b) solely on behalf of the covered employee or in conjunction with an employee deferral.

Salary Reduction

403(b) contributions are made by having the employee take a salary reduction. As such, the money is withdrawn prior to taxation. For 2021, the maximum is $19,500 with a $6,000 catch-up provision.

Employer Contributions

Employer contributions to a 403(b) are generally subject to the same maximums that apply to all defined contribution plans: the lesser of 100% of the participant's compensation or $58,000 per year.

PRACTICE QUESTION

A retirement plan that allows the employee to make pre-tax contributions (within certain limits), provides for tax deferral of earnings, and is available for employees of public school systems and certain tax-exempt organizations is

A. a 403(b) plan.
B. a 401(k) plan.
C. an SEP IRA.
D. a payroll deduction plan.

Answer: A. The giveaway here is the public school employees—the 403(b) is their plan as well as the plan offered to other employees of certain, but not all, tax-exempt organizations.

Section 457 Plans

Although technically a **nonqualified**, unfunded deferred compensation plan, because of the many similarities to qualified corporate plans, and because they may be offered to the same tax-exempt organizations as the 403(b) plan, we are including them here.

A **Section 457(b) plan** is a deferred compensation plan set up under Section 457 of the tax code that may be used by employees of a state, political subdivision of a state, and any agency or instrumentality of a state. This plan may also be offered to employees of certain tax-exempt organizations (hospitals, charitable organizations, unions, and so forth, but **not** churches).

In a 457 plan, employees can defer compensation, and the amount deferred is not reportable for tax purposes. Therefore, the employee receives a deduction each year for the amount deferred.

There are several important facts to know about 457 plans.

- These plans are not covered under ERISA—nongovernmental plans must be unfunded to qualify for tax benefits, while government plans must be funded.
- These plans are generally not required to follow the nondiscrimination rules of other retirement plans.
- While any employee or independent contractor of a governmental entity can be a participant, tax-exempt organizations that are nongovernmental must limit participation to management and highly compensated employee. Distributions from 457(b) plans of nongovernmental tax-exempt employees may not be rolled over into an IRA, but there is no 10% penalty for early withdrawal.
- It is possible to maintain both a 457 and a 403(b), or a 457 and a 401(k), and make maximum contributions to both ($19,500 × 2 = $39,000 in 2021). As a result, those 50 or older, using the "catch-up" provision in each plan, could actually contribute as much as $52,000. You could also have an IRA along with the 457.
- Loans from a 457(b) plan are available in governmental plans only, and only if the entity decides to include that feature in the plan. Furthermore, the requirements for "unforeseen emergency" withdrawals are much stricter than for hardship withdrawals under a 401(k) plan.

PRACTICE QUESTION

A basic difference between a Section 457 plan established on behalf of a governmental entity and one established by a private tax-exempt organization is that

A. a governmental plan must hold its assets in trust or custodial accounts for the benefit of individual participants.
B. a tax-exempt plan participant does not have to include plan distributions in his or her taxable income.
C. a governmental plan cannot make a distribution before the participant attains age 73.
D. a tax-exempt plan's distributions are not eligible for a favorable lump-sum 10-year averaging treatment.

Answer: A. A governmental Section 457 plan must be funded—that is, it must hold plan assets in trusts or custodial accounts for the benefit of individual participants. Conversely, a tax-exempt (nongovernmental) Section 457 plan may not be funded.

LO 18.e Contrast qualified and nonqualified retirement plans.

Up until now, we have discussed qualified plans (and, because of its many similarities, the 457 plan). Corporations often elect to provide a nonqualified plan. *Nonqualified* means that the plan is not subject to the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). A nonqualified plan does not allow the employer a current tax deduction for contributions. Instead, the employer receives the tax deduction when the money is actually paid out to the employee. If the plan is currently funded (many employers wait until the time to pay and use current earnings), depending on the way the plan is structured, earnings may or may not accumulate on a tax-deferred basis. That is an infrequently tested item. A nonqualified plan need not comply with nondiscrimination rules that apply to qualified plans. The employer can make nonqualified benefits available to key employees and exclude others.

Nonqualified plans are not subject to the same reporting and disclosure requirements as qualified plans; as mentioned, they are not covered by ERISA. However, nonqualified plans still must be in writing and communicated to the plan participants. Even though these plans are exempt from ERISA requirements, sponsors of nonqualified plans are fiduciaries and can be held liable for acting contrary to fiduciary standards.

Taxation of Contributions

The corporation cannot deduct nonqualified plan contributions made on behalf of participants until paid to the participant. However, if the nonqualified plan is properly designed, contributions are not taxable to the employee until the benefit is received.

Contributions to nonqualified plans that have already been taxed make up the investor's cost base. When the investor withdraws money from the nonqualified plan, the cost base is not taxed. However, earnings are taxed when withdrawn.

Types of Nonqualified Plans

Three types of nonqualified plans are payroll deduction plans, deferred compensation plans, and supplemental executive retirement (or retention) plans.

Payroll Deduction Plans

A **payroll deduction plan** involves a deduction from an employee's check on a weekly, monthly, or quarterly basis as authorized by the employee. This is the primary case where the money is deducted after taxes are paid and may be invested in investment vehicles at the employee's option. As mentioned above, when withdrawn, only the excess over the cost basis (those after-tax contributions) is subject to tax. The most common investments are employer stock or United States savings bonds.

Deferred Compensation Plans

A **nonqualified deferred compensation (NQDC) plan** is a contractual agreement between a firm and an employee in which the employee agrees to defer receipt of current compensation in favor of a payout at retirement. The agreement underlying a deferred compensation plan usually includes the following:

- Conditions and circumstances under which some or all of the benefits may be forfeited, such as if the employee moves to a competing firm
- A statement to the effect that the employee is not entitled to any claim against the employer's assets until retirement, death, or disability
- A disclaimer that the agreement may be void if the firm suffers a business failure or bankruptcy

TEST TOPIC ALERT

Because the employer can discriminate, one of the most common uses of deferred compensation plans is to provide benefits to retain key employees.

Generally, an employee enjoys no benefits from a deferred compensation plan until retirement. If the business fails, the employee is a general creditor of the business with no guarantee that he will receive the deferred payment.

Qualified Plans vs. Nonqualified Plans

Qualified Plans	Nonqualified Plans
Contributions tax deductible	Contributions not tax deductible
Plan approved by the IRS	Plan does not need IRS approval
Plan cannot discriminate	Plan can discriminate
Subject to ERISA	Not subject to ERISA
Tax on accumulation is deferred	Tax on accumulation is deferred
All withdrawals taxed	Excess over cost base taxed
Plan is a trust	Plan is not a trust

PRACTICE QUESTION

Which of the following objectives would **not** be met by an employer's use of a nonqualified retirement plan?

A. The employer desires current tax savings.

B. The employer desires an alternative to the qualified plan because of the complexity of legislative changes.

C. The employer needs to bring executive retirement benefits up to desired levels by adding a second tier of benefits on top of the qualified plan.

D. The employer desires a plan in which benefits may legally discriminate in favor of highly compensated employees.

Answer: A. Tax benefits on a NQDC plan only result when the employee receives payment, so choice A is correct. All of the other statements describe situations in which employers might benefit from establishing a nonqualified retirement plan.

SERP

A supplemental executive retirement plan (SERP) provides benefits to executives over and above the benefits available from a qualified plan and is funded entirely with employer funds. The plan can be either completely unfunded (like an excess benefit plan) or informally funded. The plan rewards an executive's continued employment or encourages the early retirement of the executive. A SERP also may be established to protect the executive from involuntary termination if the company changes ownership by awarding her increased benefits from the plan. The "R" sometimes refers to *retention* because these plans do encourage key employees to remain until they qualify for the benefit.

KNOWLEDGE CHECK 18.3

1. A corporation has set up a qualified retirement plan for its employees. Which of the following plans requires mandatory contributions from the employer?

   I. 401(k) plan
   II. Defined contribution pension plan
   III. Defined benefit pension plan
   IV. Profit-sharing plan

   A. I and III
   B. I and IV
   C. II and III
   D. II and IV

2. Who of the following would *not* be eligible to contribute to a 403(b) plan?
   A. A nurse working in the local public school who also helps out in the local hospital on weekends
   B. The maintenance supervisor in the local high school who does office cleanups on the weekends
   C. A retired math teacher who works most evenings tutoring local high school students for the SAT exams
   D. The principal of the local elementary school
3. Which of the following is designed to help a corporation retain high-value executives?
   A. SEP IRA
   B. SERP
   C. SIMPLE plan
   D. TSA

LESSON 18.4: TAXATION OF QUALIFIED PLANS

LO 18.f Identify the tax treatment of distributions from qualified plans.

If all of the funds were contributed by the employer (known as a noncontributory plan), the employee's tax basis (cost) is zero. If the employee contribution were pre-tax, the basis for that is zero as well. Because everything above the cost is taxed at the employee's ordinary income rate at the time of distribution, in most cases all funds received are fully taxable.

Distributions from a 403(b) must follow the same rules as distributions from all qualified plans. Because the employee's 403(b) contributions are made with pre-tax dollars and all earnings were tax deferred, any distribution is subject to ordinary income tax rates in the year it is received. A normal distribution can start at age 59½. Premature distribution is subject to a 10% penalty tax, and the RMD rules apply as well.

Hardship Withdrawals

401(k) plans are permitted to make hardship withdrawals available to participants facing serious and immediate financial difficulty. There are maximum limits: the amount withdrawn is not eligible for a rollover and, therefore, is taxable as ordinary income and possibly the 10% penalty. It differs from a 401(k) loan, which is not taxable as long as the repayment requirements of the IRS are met.

401(k) Plan Loans

Somewhat different from the hardship withdrawal is the ability to borrow from the 401(k). This has the advantage of not being treated as a distribution, so there is no tax. However, if certain IRS rules are not followed, it will be considered a premature distribution and taxed as such. The IRS maximum loan amount is 50% of the participant's vested share or $50,000, whichever is smaller. All loans must carry what the IRS considers to be a "reasonable rate of interest." Specifically, the interest rate charged for a loan can't be more favorable than what the participant can get from a financial institution for a similarly secured loan. Other than if used for a home mortgage, the loan must be paid back on a regular schedule (usually through payroll deduction) in a period not to exceed 60 months.

PRACTICE QUESTION

Susan participates in a Section 401(k) plan at work that includes loan provisions. Susan has recently enrolled in college and has inquired about the possible consequences of borrowing from the plan to help pay for her education. As her financial planner, what is your advice to her?

A. The loan will statutorily be treated as a taxable distribution from the plan.
B. The loan must be repayable within five years at a reasonable rate of interest.
C. The 401(k) plan needs to be rewritten, as loans are only available from qualified plans.
D. The loan is not being made for reasons of an unforeseeable emergency and therefore is not possible.

Answer: B. For a loan not to be treated as a taxable distribution for tax purposes, it must be repayable within five years at a reasonable rate of interest. The unforeseeable emergency requirements are found in a Section 457 plan.

Net Unrealized Appreciation (NUA)

Many employers enable employees to buy the stock or bonds of their company inside the 401(k) or other retirement plans. The distribution of employer securities is sometimes eligible for special treatment under the tax code. Those receiving a distribution of employer securities from a qualified retirement plan may be able to defer the tax on the net unrealized appreciation (NUA) in the securities. The NUA is the net increase in the securities' value while they were in the plan's trust. If taken as a lump-sum distribution, the participant has the option of deferring tax on all of the NUA. A lump-sum distribution is defined as the disbursement of the entire vested account balance within one taxable year as the result of a triggering event. Triggering events are limited to:

- separation from service;
- attainment of age 59½; or
- death.

In order to qualify for the NUA treatment, an employee must complete the entire distribution within the same calendar year. How does this work? Normally, the entire value of a distribution from a qualified plan is taxed as ordinary income. Even if rolled over into an IRA, when ultimately distributed, the entire value will be taxed as ordinary income. However, when using the NUA approach, only the original cost basis (as supplied by the employer) is subject to tax. Any unrealized appreciation will be taxed as a long-term capital gain whenever sold. And, to make things even sweeter, as long as it is held more than 12 months, any further appreciation is taxed as a long-term capital gain. Let's take a look at an example.

EXAMPLE

George has been an employee of KAPCO Manufacturing Company for 20 years. He is turning 65 this year and plans to retire. In his 401(k) plan, he has assets of $600,000 of which $250,000 is KAPCO stock with a cost basis of $100,000. At retirement, George should transfer the $350,000 that is not KAPCO stock into an IRA. That will defer taxes on that money. Then, the $250,000 of KAPCO stock should be transferred into a regular, taxable brokerage account. In the year of retirement, George will have to report the $100,000 cost basis as ordinary income. However, the $150,000 in unrealized appreciation will receive the more favorable long-term capital gains rate when sold. If George holds onto the stock for another five years and it appreciates by another $50,000, then, upon sale, the entire $200,000 of gain is considered long term.

Summary of Distribution Rules from Both Qualified Plans and IRAs

Even though we have previously discussed IRA withdrawals, it is worth repeating them here to compare and contrast them with distributions from qualified plans.

Distributions from traditional IRAs must generally begin no later than April 1 of the year following the year in which the taxpayer attains age 73.

In applying distribution rules, all traditional IRAs and SEPs are treated as a single account and must be liquidated at least to the extent of percentages specified on IRS tables. Qualified plans, however, are not aggregated; distributions from one qualified plan are not affected by distributions from another. What that means is an individual with multiple IRAs computes the RMD from each but can elect to distribute the amounts from each IRA or select the IRA(s) from which to make the distribution. In the case of multiple qualified plans (the individual worked for more than one employer and did not rollover the earlier employer's plan), the required RMD must be taken from each plan; there is no combining as there is with IRAs.

Early Withdrawal Penalties

In general, withdrawals from both IRAs and qualified plans are taxed as ordinary income. However, withdrawals from such arrangements occurring before owners turn age 59½ are subject to an additional 10% early withdrawal tax. Withdrawals from both escape that 10% tax when they are made on account of death or total disability, correcting excess contributions, or as a series of substantially equal payments over the life of the plan participant and beneficiary, if applicable. Only in the case of a *qualified plan* is the penalty avoided by using a qualified domestic relations order (QDRO).

Qualified Domestic Relations Order (QDRO)

As just stated, premature distributions that are taken pursuant to a qualified domestic relations order, or QDRO, are exempt from the 10% early withdrawal tax. That is, when the plan participant distributes a portion of the plan to a spouse or former spouse who is under 59½ years of age, the participant is not charged the 10% tax for an early withdrawal.

A QDRO is a judgment, decree, or order, usually issued in the course of divorce proceedings, for a retirement plan to pay child support, alimony, or marital property rights to a spouse, former spouse, child, or other dependent of a participant. The QDRO must contain certain specific information, such as:

- the plan participant and each alternate payee's name and last known mailing address; and
- the amount or percentage of the participant's benefits to be paid to each alternate payee.

A spouse or former spouse who receives QDRO benefits from a retirement plan reports the payments received as if they were a plan participant. That means if they are under 59½, they are liable for the 10% early withdrawal tax.

An individual may be able to roll over tax-free all or part of a distribution from a qualified retirement plan that they received under a QDRO, but only if they are the employee's spouse or former spouse. In that case, they can roll it over, just as if they were the employee receiving a plan distribution and choosing to roll it over.

A QDRO distribution that is paid to a child or other dependent is taxed to the plan participant and will incur the 10% early withdrawal tax if the recipient is under 59½.

A QDRO applies only to assets in a qualified employer plan; it would not be applicable to an IRA or a SEP.

TEST TOPIC ALERT

Although pre-age 59½ withdrawals from IRAs for education and a first-time home purchase escape the early withdrawal penalty, withdrawals from qualified plans for those purposes do not.

The 10% tax will not apply on withdrawals from either of these before age 59½, however, if:

- the distribution is made to a beneficiary on or after the death of the employee/individual;
- the distribution is made because the employee/individual acquires a qualifying disability; or
- the distribution is made as a part of a series of substantially equal periodic payments under IRS Rule 72(t), beginning after separation from service with the employer maintaining the plan before the payments begin, and made at least annually for the life or life expectancy of the employee/individual or the joint lives or life expectancies of the employee/individual and his designated beneficiary. (Except in the case of death or disability, the payments under this exception must continue for at least five years or until the employee/individual reaches age 59½, whichever is the longer period.) This applies when the separation of service occurs once the employee has attained age 55.

TAKE NOTE

After a person begins taking distributions from an IRA under Rule 72(t), contributions, asset transfers, or rollovers are not permitted while receiving payments.

Penalty Tax on Failure to Make Required Minimum Distributions

As with traditional IRAs, failure to distribute the required amount from qualified plans generates a 25% penalty tax on the amount of money required to be withdrawn. Prompt correction can reduce the penalty to 10%. However, as mentioned earlier, and of particular importance as employees are working to much later ages than in previous generations, there are no RMDs from a qualified plan while still employed by the sponsor of that plan, regardless of your age.

Withholding on Eligible Rollover Distributions from Qualified Plans

Distributions paid to an employee are subjected to a mandatory federal withholding of 20% if the distribution is an eligible rollover distribution. Eligible rollover distributions (those which can be rolled over or transferred without current taxation) do not include the following:

- RMDs;
- a hardship distribution;
- substantially equal lifetime payments (SEPP);
- a distribution of an excess contribution; or
- a loan that is treated as a deemed distribution.

TAKE NOTE

An employee may avoid the 20% withholding by having the distribution processed as a direct rollover to an eligible retirement plan. In a direct rollover the distribution check is made payable to the trustee or custodian of the receiving retirement plan.

10% Early Distribution Penalty Exceptions by Plan Types

	Qualified Pension, Profit-Sharing, and TSA (403(b)) Plans	401(k) and SIMPLE Plans	Traditional, Roth, and SEP IRAs
Death	X	X	X
Disability	X	X	X
Separation from service after reaching age 55	X	X	
Certain medical expenses	X	X	X
QDROs	X	X	
To reduce excess contributions or deferrals	X	X	X
As substantially equal payments over life	X	X	X
First-time home purchase			X
Higher education expenses			X
Health insurance premiums while unemployed			X

Summary of Rollover and Transfer Rules

Following is a summary of the rules that apply to moving money from one tax-deferred account to another. Here are the three key points:

1. **Direct rollover**—In the event the qualified plan calls for a distribution upon separation from service, a request can be made to the plan administrator to send the payment directly to another retirement plan or to an IRA. In this case, there are no taxes withheld from the amount transferred, and no income is reported for tax purposes.
2. **Trustee to trustee transfer**—If an investor wishes to change trustees for an IRA, such as moving the account to another firm or mutual fund group, upon request, the trustee or custodian for the "old" IRA will make the payment directly to the trustee of the "new" IRA. In some cases, the IRA distribution may be made to the trustees of an employer-sponsored plan in this fashion. In either case, there are no taxes withheld from the amount transferred, and no income is reported for tax purposes.
3. **60-day rollover**—In the event the distribution from an IRA or qualified employer plan is paid directly to the participant, there is the option to deposit all or any part of it to another IRA or qualified plan within 60 calendar days. However, there will be a 20% withholding tax on this distribution from the qualified plan (withholding is optional on the IRA distribution). That means, in order to avoid any tax, the individual will have to find other funds to deposit to cover the withheld amount. Any portion of the distribution that is not rolled over will be subject to tax and, if under age 59½, will be subject to the 10% (unless qualifying for one of the exemptions from the penalty tax).

KNOWLEDGE CHECK 18.4

1. Withdrawals from a traditional IRA made by an owner aged 54 would be exempt from the 10% penalty in all of the following circumstances **except**
   A. when the taxpayer is disabled.
   B. when the withdrawal is done under a qualified domestic relations order (QDRO).
   C. to pay for certain medical expenses.
   D. the first-time purchase of a primary residence ($10,000 lifetime maximum).
2. A taxpayer is a participant in a 401(k) plan. The vested value in the account is $90,000. If the individual wishes to take out a loan, the maximum permitted amount is
   A. $9,000.
   B. $45,000.
   C. $50,000.
   D. $90,000.
3. Which of the following parties may be an alternate payee pursuant to a qualified domestic relations order (QDRO)?
   I. An aunt or uncle of the plan participant
   II. A spouse or former spouse
   III. A child
   IV. An individual who is legally a dependent of the plan participant
   A. I, II, III, and IV
   B. II, III, and IV
   C. II and III
   D. I and IV

Unit 18

LESSON 18.5: ERISA

LO 18.g Identify the purpose of the Employee Retirement Income Security Act of 1974 and its primary features, including the fiduciary obligations under the Uniform Prudent Investor Act.

ERISA

ERISA guidelines for the regulation of retirement plans include the following:

- **Eligibility.** If a company offers a retirement plan, all employees must be covered if they are 21 years old or older, have one year of service, and work 1,000 hours per year. The SECURE Act added a provision for permanent part-time employees covered under a 401(k) plan. These are individuals who worked at least 500 hours per year for the previous three consecutive years.
- **Funding.** Funds contributed to the plan must be segregated from other corporate assets. The plan's trustees have a fiduciary responsibility to invest prudently and manage funds in a way that represents the best interests of all participants.
- **Vesting.** Employees must be entitled to their entire retirement benefit amounts within a certain time, even if they no longer work for the employer.
- **Communication.** The retirement plan must be in writing, and employees must be kept informed of plan benefits, availability, account status, and vesting procedure no less frequently than annually.
- **Nondiscrimination.** A uniformly applied formula determines employee benefits and contributions. Such a method ensures equitable and impartial treatment.

TAKE NOTE

ERISA is often referred to as the **Pension Reform Act**, but it regulates almost all types of employee benefit plans and personal retirement plans.

ERISA regulations apply to *private sector* (corporate or private tax-exempt entities) plans only. Plans for federal or state government workers (*public sector* plans) are not subject to ERISA.

Fiduciary Responsibility Under ERISA

Because most retirement plans were set up under trust agreements, when it became time for ERISA to address fiduciary responsibilities of plan trustees, there was a long history of trust law to fall back on.

It all began with the Prudent Man Rule. That legal standard was established in 1830 by a Massachusetts Court decision (*Harvard College v. Amory,* 9 Pick. [26 Mass.] 446, 461 [1830]):

"All that is required of a trustee to invest is, that he shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

Although it was possible to place common stock in a trust portfolio, the emphasis seemed to be on taking defensive positions that, while preserving capital, did expose the portfolio to inflation risk. It was clear that some updating was necessary.

Beginning with the dynamic growth of the stock markets in the late 1960s, the investment practices of fiduciaries experienced significant change. As a result, the Uniform Prudent Investor Act (UPIA) was adopted in 1994 as an attempt to update trust investment laws in recognition of those many changes. One of the major influences on this legislation was the growing acceptance of modern portfolio theory. The UPIA (now used in almost every state) makes five fundamental alterations in the former criteria for prudent investing. Those changes are as follows:

- The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In this context, the term *portfolio* means all of the trust's or estate's assets.
- The trade-off in all investments between risk and return is identified as the fiduciary's primary consideration.
- All categorical restrictions on types of investments have been removed; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and meets the other requirements of prudent investing.
- The well-accepted requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing.
- The much-criticized former rule forbidding the trustee to delegate investment functions has been reversed. Delegation is now permitted, subject to safeguards.

With greater numbers of trustees delegating investment decisions to investment advisers, NASAA has determined that you must know how the UPIA affects your role. Here are some thoughts that will help you on the exam.

- A trustee must invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee must exercise reasonable care, skill, and caution.

- A trustee's investment and management decisions about individual assets must be evaluated not in isolation but in the context of the total portfolio and as a part of an overall investment strategy with risk and return objectives that are reasonably suited to the trust.
- Among circumstances that a trustee must consider in investing and managing trust assets are any of the following that are relevant to the trust or its beneficiaries:
  - General economic conditions
  - The possible effect of inflation or deflation
  - The expected tax consequences of investment decisions or strategies
  - The role that each asset plays within the total portfolio, including financial assets, tangible and intangible personal property, and real property
  - The expected total return from income and the appreciation of capital
  - Other resources of the beneficiaries
  - Needs for liquidity, regularity of income, and preservation or appreciation of capital
  - An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries
- A trustee who has special skills or expertise, or who is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise. This particular item led to the most stringent standard, that of the **prudent expert** for one acting as a professional money manager.
- For those without special skills or expertise, a trustee may delegate investment and management functions as long as the trustee exercises reasonable care, skill, and caution in:
  - selecting the adviser,
  - establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust, and
  - periodically reviewing the adviser's actions to monitor the adviser's performance and compliance with the terms of the delegation. (However, something that cannot be delegated is the amount and timing of distributions. If it is for a trust, the trust document usually spells out those provisions, and, in the case of a qualified retirement plan, the plan document accomplishes the same purpose.)
- A trustee who complies with all of the above is not liable to the beneficiaries or the trust for the decisions or actions of the adviser to whom the function was delegated.
- In performing a delegated function, the adviser owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

Unit 18

PRACTICE QUESTION

Which of the following would best describe a prudent investor?

A. A person in a fiduciary capacity who invests in a prudent manner
B. A trustee who invests with reasonable care, skill, and caution
C. An investment adviser representative handling a discretionary account
D. The custodian for a minor under the Uniform Transfers to Minors Act

Answer: B. Although all of these may have a fiduciary responsibility, the definition, as expressed in the Uniform Prudent Investor Act of 1994, requires reasonable care, skill, and caution.

Section 404 of ERISA

Specifically, there are a number of regulations that apply directly to retirement plan fiduciaries. The details are spelled out in ERISA Section 404.

Under Section 404 of ERISA, every person who acts as a fiduciary for an employee benefit plan must perform his responsibilities in accordance with the plan document specifications. Under ERISA, trustees cannot delegate fiduciary duties, but they can delegate investment management responsibilities to a qualified investment manager.

TEST TOPIC ALERT

Although the UPIA permits the delegation of portfolio management decisions, trustees cannot delegate certain fiduciary duties, such as determining the amount and timing of distributions.

Fiduciary responsibilities to the plan are explicit. With respect to the plan, fiduciaries must act:

- solely in the interest of plan participants and beneficiaries;
- for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable plan expenses;
- with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent professional would use (known as the **prudent expert rule**);
- to diversify investments to minimize the risk of large losses, unless doing so is clearly not prudent under the circumstances; and
- in accordance with the governing plan documents unless they are not consistent with ERISA.

Under ERISA provisions, the fiduciary must be as prudent as the average expert, not the average person. To act with care, skill, prudence, and caution, the fiduciary must also:

- diversify plan assets;
- make investment decisions under the prudent expert standard;
- monitor investment performance;
- control investment expenses; and
- not engage in prohibited transactions.

TAKE NOTE

A plan participant or beneficiary who controls his or her specific plan account is not a fiduciary.

TEST TOPIC ALERT

You may be required to know that transaction cost is not a determining factor in security selection. That is, when the fiduciary is deciding what security will fit the needs of the portfolio, the amount of commission involved in the purchase is not considered when determining if that security is an appropriate addition.

Investment Policy Statement

Although it is not specifically mandated under ERISA, it is strongly suggested that each employee benefit plan have an investment policy statement, preferably in writing, that serves as a guideline for the plan's fiduciary regarding funding and investment management decisions. Investment policy statements address the specific needs of the plan.

For employee benefit plans that use outside investment managers (such as mutual funds), the fiduciary must ensure that the investment alternatives available to plan members are consistent with the policy statement.

A typical investment policy statement (IPS) will include:

- investment objectives for the plan;
- determination for meeting future cash flow needs;
- investment philosophy including asset allocation style;
- investment selection criteria (but *not* the specific securities themselves); and
- methods for monitoring procedures and performance.

TEST TOPIC ALERT

The IPS will **not** include specific security selection.

Prohibited Investments Under ERISA

It is important to differentiate between prohibited investments and prohibited transactions. Similar to IRAs, qualified plans cannot invest in art, antiques, gems, coins, collectibles, or alcoholic beverages. They can invest in precious metals, such as gold and silver coins minted by the U.S. Treasury, only if they meet various federal requirements. ERISA also limits how much some plans can invest in the employer's stock. Although not specifically prohibited under ERISA, the exam will never find writing uncovered calls in a retirement plan to be a prudent decision.

Prohibited Transactions by the Plan Fiduciary

ERISA allows for a wide range of investments and investment practices, but a plan fiduciary is strictly prohibited from any conflicts of interest, such as:

- self-dealing—dealing with plan assets in his own interest or for his own account;
- acting in a transaction involving the plan on behalf of a party with interests adverse to the plan; and
- receiving any compensation for his personal account from any party dealing with the plan in connection with plan transactions.

TEST TOPIC ALERT

Under Section 407 of ERISA, a plan may not acquire any security or real (or personal) property of the employer, if immediately after such acquisition the aggregate fair market value of employer securities and employer real property held by the plan exceeds 10% of the fair market value of the assets of the plan.

Party in Interest

ERISA has a rather broad definition of the term *party in interest*, but it basically includes anyone who can have an impact on an employee benefit plan, including those who render advice to the plan. It is not an overstatement to say that all transactions involving parties in interest to an ERISA-covered plan are prohibited, unless there is an exemption for them.

TEST TOPIC ALERT

Anyone in the position of trustee over the assets of a qualified plan may not use the plan assets to make loans to the employer, even if failure to do so could lead to the company suffering a financial failure.

Safe Harbor Provisions of Section 404(c)

Several times, we have mentioned the requirement for the plan fiduciary to diversify the plan's investments. There is a particular part of ERISA, Section 404(c), dealing with 401(k) plans that provides a safe harbor from liability for the trustee if certain conditions are met. Under ERISA Section 404(c), a fiduciary is not liable for losses to the plan resulting from the participant's selection of investment in his or her own account, provided the participant exercised control over the investment and the plan met the detailed requirements of a Department of Labor regulation—that is, the 404(c) regulation.

There are three basic conditions of this regulation:

- Investment selection
- Investment control
- Communicating required information

Let's look at these individually.

Investment Selection

A 404(c) plan participant must be able to:

- materially affect portfolio return potential and risk level;
- choose between at least three investment alternatives; and
- diversify the investment to minimize the risk of large losses.

The practical effect of this is that it would be highly unlikely for the plan to meet the requirements by limiting the available choices to highly speculative funds, such as junk bond funds and highly aggressive growth funds.

TEST TOPIC ALERT

The trustee of a 401(k) would be able to reduce her ERISA fiduciary exposure and meet the safe harbor provisions of 404(c) if the plan offered a broad index fund, a medium-term government bond fund, and a cash equivalent fund. It isn't the number of funds that counts; it is the different asset classes available. For example, if the plan offered 10 investment options instead of 3, but they were all of the same asset class, such as 10 equity funds or 10 bond funds, that would not comply with 404(c).

Investment Control

Investment control is defined as:

- allowing employees the opportunity to exercise independent control over the assets in their account by letting them make their own choices among the investment options companies have selected (at least three);
- informing employees that they can change their investment allocations at least quarterly (a growing number of plans allow employees to make plan changes daily); and
- even though the employees maintain investment control, the plan fiduciary is not relieved of the responsibility to monitor the performance of the investment alternatives being offered and replace them when necessary.

Communicating Required Information

Communicating required information means:

- making certain information available upon request, such as prospectuses and financial statements or reports relating to the investment options (included must be information such as annual operating expenses and portfolio composition);
- a statement that the plan is intended to constitute an ERISA Section 404(c) plan and that plan fiduciaries may be relieved of liability for investment losses;
- a description of the risk and return characteristics of each of the investment alternatives available under the plan;
- an explanation of how to give investment instructions; and
- allowing real-time access to employee accounts, either by telephone or the internet.

Unit 18

TEST TOPIC ALERT

Although we have made extensive reference to **control** in the previous pages, that must be taken in context. Participants in a 401(k) do have a choice of investments, but that choice is limited to the package included in the employer's plan. Participants in a 403(b) plan have even fewer choices; annuities are the primary investment asset in those plans. If investment choice is the criteria, then the greatest control is with an IRA (see the earlier discussion on IRA investments).

PRACTICE QUESTION

To comply with the safe harbor requirements of Section 404(c) of ERISA, the trustee of a 401(k) plan must

I. offer plan participants at least 10 different investment alternatives.
II. allow plan participants to exercise control over their investments.
III. allow plan participants to change their investment options no less frequently than monthly.
IV. provide plan participants with information relating to the risks and performance of each investment alternative offered.

A. I and III
B. I and IV
C. II and III
D. II and IV

Answer: D. To comply with the safe harbor provisions of ERISA's Section 404(c), the plan trustee must allow each participant control over their investments and furnish them with full performance and risk information. Choice D contains both of these. The rule only mandates a minimum of three alternatives and quarterly changes.

Summary Plan Description (SPD)

Sometimes referred to as the *summary plan document,* one of the most important documents participants are entitled to receive automatically when becoming a participant of an ERISA-covered retirement plan or a beneficiary receiving benefits under such a plan is a summary of the plan, called the *summary plan description (SPD).* Under regulations of the U.S. Department of Labor (DOL), the plan administrator is legally obligated to provide to participants, free of charge, the SPD. The summary plan description is an important document that tells participants what the plan provides and how it operates. It provides information on when an employee can begin to participate in the plan, how service and benefits are calculated, when benefits become vested, when and in what form benefits are paid, and how to file a claim for benefits. Unlike the investment policy statement, it does not deal with the investment characteristics of the plan.

Top-Heavy Plan

Because all qualified plans must be nondiscriminatory, the IRS has defined a **top-heavy 401(k) plan** as one in which a disproportionate amount of the benefit goes to key employees. The plan must be tested on an annual basis to ensure that it complies with the regulations. On the exam, you may be asked to define a top-heavy plan and will have to choose between key employees and highly compensated employees. The easiest way to remember is to match the (k) in 401(k) with the word *key.*

Safe Harbor 401(k) Plan

Several years after the top-heavy rules were written, relief was offered in the form of the safe harbor 401(k). A plan does not have to undergo annual top-heavy testing if set up properly.

There are two basic choices for setting up a safe harbor plan. The employer will either match employee contributions or use a nonelective formula (the employees don't have to contribute) of eligible employee compensation to satisfy IRS requirements. If a matching formula is elected:

In either case, all employer contributions are *immediately* vested.

- The base formula is 100% of elective deferrals up to 3% of compensation and then 50% of elective deferrals on the next 2% of compensation. This means the maximum match is 4% (100% × 3% + 50% × 2% = 3% + 1%); or
- The employer may elect the nonelective formula (minimum of 3%) of all eligible participants' compensation. Under this formula, all eligible employees would receive this nonelective contribution, whether making salary reduction contributions or not.

KNOWLEDGE CHECK 18.5

1. Complying with the safe harbor provisions of ERISA Section 404(c) requires meeting three specific conditions. Which of the following is *not* one of those three?
   A. Investment control
   B. Investment performance
   C. Investment selection
   D. Communicating required information
2. A significant portion of ERISA deals with fiduciary responsibility. Which of the following would be considered a prohibited transaction?
   A. The fiduciary selling 1,000 shares of a personally owned stock to the plan
   B. The purchase of art or antiques for the plan
   C. Investing more than 50% of the plan's assets in the company's stock
   D. Using plan assets to build a collection of rare automobiles

LESSON 18.6: EDUCATION FUNDING PROGRAMS

LO 18.h Compare the differences between the two major types of education funding programs.

The examination will deal with two different types of programs designed to offer tax benefits when saving for education. We will begin with the Coverdell ESA and then move on to the Section 529 plan.

Coverdell Education Savings Accounts (ESAs)

The Taxpayer Relief Act of 1997 also created **Education IRAs.** In 2002, these were renamed **Coverdell ESAs.** ESAs allow after-tax contributions for student beneficiaries. Contributions must be made in cash and must be made on or before the date on which the beneficiary attains age 18 unless the beneficiary is a **special-needs beneficiary**—an individual who because of a physical, mental, or emotional condition requires additional time to complete their education. Coverdell ESAs fund educational expenses of a designated beneficiary by allowing after-tax (nondeductible) contributions to accumulate on a tax-deferred basis.

When distributions are made from a Coverdell ESA, the earnings portion of the distribution is excluded from income when it is used to pay qualified education expenses. Withdrawn earnings are taxed to the recipient (beneficiary) and subject to a 10% tax penalty when they are not used to pay qualified education expenses.

TAKE NOTE

If the money is not used by a beneficiary's 30th birthday (except for a special-needs beneficiary), it must be distributed, and the earnings are subject to ordinary income taxes and a 10% penalty.

ESA Contributions

Under current law, the maximum annual contribution limit to a Coverdell ESA is $2,000 per beneficiary. Because this number is considered permanent, it can and does appear on the exam.

In addition to qualified higher education expenses (postsecondary education), the account can also be used for elementary and secondary education expenses and for public, private, or religious schools.

The contribution to a Coverdell ESA may be limited depending on the amount of AGI and filing status.

Allowable Contribution	Single Filers	Joint Filers
Full contribution of $2,000 at AGI of and below	$95,000	$190,000
Partial phase-out begins at	$95,001	$190,001
No contributions may be made at AGI of and above	$110,000	$220,000

TAKE NOTE

There is nothing to prevent more than one individual from contributing to a Coverdell ESA; the annual limit applies to each beneficiary. Parents and grandparents can contribute to a single account as long as the $2,000 limit per child is not exceeded in any given year.

Other changes made since the original Education IRA include:

- provisions that allow contributions to continue past age 18 for beneficiaries with special needs;
- extending the period during which corrective withdrawals can be made to avoid the early distribution and excess contribution penalties; and
- allowing Coverdell ESA contributions, for any year, to be made up to April 15 of the following year (just like contributions to your IRA).

TEST TOPIC ALERT

Here are some key test points about Coverdell ESAs:

- Contributions can be made by parents and other adults; the total for one child is still $2,000.
- Contribution limit is $2,000 per year per child until the child's 18th birthday.
- Contributions are not tax deductible, but all earnings are tax deferred.
- Distributions are tax free if they are taken before age 30 and used for eligible education expenses.
- If the accumulated value in the account is not used by age 30, the funds must be distributed and subject to income tax and a 10% penalty on the earnings or rolled over into a different Coverdell ESA for another family member. Their definition of family is extremely broad and, in addition to the obvious, includes cousins, aunts and uncles, and even in-laws.

PRACTICE QUESTION

The maximum amount that may be invested in a Coverdell ESA in one year is

A. $500 per parent.
B. $2,000 per child.
C. $500 per couple.
D. $2,000 per couple.

Answer: B. Only $2,000 may be invested in each child's ESA per year. If a couple has three children, they may contribute $6,000 in total, or $2,000 per child, per year.

TAKE NOTE

A special-needs beneficiary has different rules. Contributions may be made after age 18 and withdrawals may be delayed past age 30.

Section 529 Plans

Section 529 plans, legally known as qualified tuition programs (QTPs), are state-operated investment plans that were designed to give families a way to save money for college with substantial tax benefits. With the passage of the Tax Cuts and Jobs Act of 2017, these plans extended the qualification to K–12 schooling as well. That change will be covered separately. There are two basic types of 529 plans: prepaid tuition plans and college savings plans.

Prepaid Tuition Plans

Prepaid tuition plans generally allow college savers to prepay for tuition at participating colleges and universities, and, in some cases, room and board can be prepaid as well. Most prepaid tuition plans are sponsored by state governments and have residency requirements. The basic concept is that if you pay for the tuition at today's rates, the child will be able to attend in the future, regardless of how much higher the tuition is.

College Savings Plans

College savings plans generally permit the contributor, known as the account holder, to establish an account for a student (the beneficiary) for the purpose of paying the beneficiary's qualified college expenses. The typical plan offers a number of investment options, including stock mutual funds, bond mutual funds, and money market funds. A very popular option is the age-based portfolio that automatically shifts toward more conservative investments as the beneficiary gets closer to college age. Withdrawals from college savings plans can generally be used at any college or university regardless of the state carrying the plan or the state of residence.

Differences Between the Two QTPs

The following chart outlines some of the major differences between prepaid tuition plans and college savings plans.

Prepaid Tuition Plan	College Savings Plan
Locks in tuition prices at eligible public and private colleges and universities.	No lock on college costs.
All plans cover tuition and mandatory fees only. Some plans allow families to purchase a room and board option or use excess tuition credits for other qualified expenses.	Covers all qualified higher education expenses, including the following: - Tuition - Room and board - Mandatory fees - Books, computers, etc. (if required)
Most plans set lump-sum and installment payments prior to purchase based on age of beneficiary and number of years of college tuition purchased.	Many plans have contribution limits in excess of $250,000.
Many state plans guaranteed or backed by state.	No state guarantee. Most investment options are subject to market risk. Your investment may make no profit or even decline in value.
Most plans have age/grade limits for beneficiary.	No age limits. Open to adults and children.
Most state plans require either owner or beneficiary of plan to be a state resident.	No residency requirement. However, nonresidents may only be able to purchase some plans through financial advisers or brokers.
Most plans have limited enrollment period.	Enrollment open all year.

Source: Smart Saving for College, FINRA®

PRACTICE QUESTION

One of your clients is a successful professional couple with earnings in excess of $500,000 per year. They are interested in providing a funding source for postsecondary education for their grandchildren. Which would be appropriate to discuss with them?

A. The Coverdell ESA
B. The Section 529 plan
C. Both the Coverdell ESA and the Section 529 plan
D. Neither the Coverdell ESA nor the Section 529 plan

Answer: B. Although both plans will help them with their objective, their earnings are above the Coverdell ESA limits, so choice B is the best answer.

Tax Treatment of 529 Plans

A major factor in investing in a 529 plan is tax benefits. Although contributions are made with after-tax money, earnings in 529 plans are not subject to federal tax and, in most cases, state tax, so long as withdrawals are for eligible college expenses, such as tuition and room and board and even a computer.

However, money representing earnings that is withdrawn from a 529 plan for ineligible expenses will be subject to income tax and an additional 10% federal tax penalty. Unlike the IRS, many states offer deductions or credits against state income tax for investing in a 529 plan. But eligibility for these benefits is generally limited to participants in a 529 plan sponsored by your state of residence.

Withdrawal Restrictions

Both plans place restrictions on withdrawals. With limited exceptions, you can only withdraw money that you invest in a 529 plan for eligible college expenses without incurring taxes and penalties. However, you can roll over any unused funds to a member of the beneficiary's family without incurring any tax liability as long as the rollover is completed within 60 days of the distribution. Immediate family includes the following:

- Son, daughter, stepchild, foster child, adopted child, or a descendant of any of them
- Brother, sister, stepbrother, or stepsister
- Father or mother or ancestor of either
- Stepfather or stepmother
- Son or daughter of a brother or sister
- Brother or sister of the father or mother
- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law
- The spouse of any individual listed above
- First cousin

TEST TOPIC ALERT

The earnings portion of a nonqualified distribution is taxable to the individual who receives the payment, either the account owner or the designated beneficiary. If the payment is not made to the designated beneficiary or to an eligible educational institution for the benefit of the designated beneficiary, it will be deemed to have been made to the account owner.

TEST TOPIC ALERT

What if you don't like the 529 plan you are invested in—can you make a change? Federal tax law allows a tax-free rollover of any or all of a 529 account from the current 529 plan to a different 529 plan, but only once in any 12-month period unless there is a change in beneficiary. Just as with an IRA, if the proceeds are distributed, they must be reinvested in the new plan within 60 days. Therefore, assets in the QTP may be moved from the plan of one state to the plan of another no more frequently than once per 12 months.

TEST TOPIC ALERT

As of the date of this question, there are more than 400 institutions of higher learning located outside of the United States where Section 529 plans (and Coverdell ESAs) may be used to pay qualified expenses. The expense for room and board (residence cost) qualifies only to the extent that it isn't more than the greater of the following two amounts:

1. The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student; or

2. The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

Impact on Financial Eligibility

Investing in a 529 plan (or Coverdell ESA) will generally impact a student's eligibility to participate in need-based financial aid. Both types of plans are treated as parental assets in the calculation of the expected family contribution toward college costs regardless of whether the owner is the parent or the student. This computation is done on the FAFSA Form (Free Application for Federal Student Aid). Having money in a 529 plan is a better deal than if they were non-529 assets of the student, because parental assets are assessed on the FAFSA at a maximum 5.64% rate in determining the student's expected family contribution (EFC) rather than the 20% rate on non-529 (or ESA) assets owned by the student, such as those in a UTMA account. These rates will not be tested, but the concept may be.

Contributions to a 529 Plan

Any adult can open a 529 plan for a future college student. The donor does not have to be related to the student.

With a 529 plan, the donor can invest a small or substantial lump sum or make periodic payments. When the student is ready for college, the donor withdraws the amount needed to pay for qualified education expenses (e.g., tuition, room and board, and books). Contributions are made with after-tax dollars, but qualified withdrawals are exempt from federal taxation. As stated above, taxation varies from state to state. If any tax is due on withdrawal, it is the responsibility of the student, not the donor.

A donor (typically a parent or grandparent) may contribute a maximum of $80,000 ($160,000 if married) in a single year for each Section 529 plan beneficiary without gift tax consequences. This represents a five-year advance on the (2022) $16,000 per recipient annual gift tax exclusion.

The donor of the 529 plan assets retains control of most 529 accounts and may take the money back at any time (although a 10% penalty tax may apply).

TAKE NOTE

Although it probably won't be tested, for those who bunch the annual gift exclusion allowing five years' worth at one time, this is not limited to one time per beneficiary. If started with a one-year-old grandchild, the grandparents can do this again when the child is six (five years have elapsed) and then again at 11, and so forth, as long as the total contribution does not exceed the state's limit. It surely would be nice to have grandparents like that, wouldn't it?

Offering Circular

These plans are considered "municipal fund securities" and, under the rules of the Municipal Securities Rulemaking Board (MSRB), require delivery of an official statement, sometimes called an offering circular but never referred to as a prospectus on the exam.

Investment Options for 529 Plans

In general, these plans offer several different portfolio options, ranging from aggressive (for those with a longer time horizon) to guaranteed (for those in college using the funds). In most cases, these portfolios are registered mutual funds; in others, they are separately managed accounts containing stocks and/or bonds. Some portfolios include bank-insured CDs, and some of the states offer managed fixed-income pools.

TEST TOPIC ALERT

However, U.S. savings bonds are not available as investment options in Section 529 plans.

TEST TOPIC ALERT

One significant difference between investments in an ESA and in a 529 is that the ESA functions like a self-directed IRA. That is, the investments are chosen at the discretion of the individual managing the account. In the case of the 529, you are limited to the choices offered by the plan.

Effect of TCJA 2017

The rule permits K–12 withdrawals as qualified expenses for attendance at a public, private, or religious elementary or secondary school. The definition of qualified expenses for K–12 is $10,000 per student annually for tuition only.

Effect of the Setting Every Community Up for Retirement Enhancement (SECURE) Act

Qualified expenses include payment of interest or repayment of principal on qualified student loans with a lifetime limit per beneficiary of $10,000.

TAKE NOTE

Key points to remember about Section 529 plans include the following:

- The dollar amount of allowable contribution varies from state to state and may be as high as $500,000.
- Assets in the account remain under the donor's control even after the student is of legal age.
- There are no income limitations on donors making contributions to a 529 plan.
- Similar to Coverdell ESAs, these can be used for educational expenses incurred below the postsecondary level (after high school), but with expense limitations.
- There are no age restrictions; that is, if at any age an individual desires to go back to school, a 529 plan may be used.
- Earnings are exempt from federal taxes (as are withdrawals) if they go toward qualified postsecondary educational expenses.
- Most states hire experienced investment management companies to manage their accounts.
- In almost all cases, residents do not pay state income tax on qualified withdrawals from home-state plans.
- In a majority of the states with an income tax, residents are afforded an income tax deduction or credit for a portion of their contribution.
- If funds are withdrawn for purposes other than education, earnings are subject to a 10% penalty as well as federal income tax. States may assess their own penalties. The tax is the obligation of the distributee (student/beneficiary).
- A child can be a beneficiary of an ESA and a 529.

- Because of their legal status as municipal fund securities, it is required that an official statement or offering circular is delivered when opening a 529 plan account.

PRACTICE QUESTION

While in your office, you see that your firm is going to be holding a training session on municipal fund securities. You wish to attend because you are interested in being able to speak intelligently to your clients about

A. the difference between GO bonds and revenue bonds.
B. the difference between using mutual funds or UITs to invest in municipal bonds.
C. Section 529 plans.
D. Section 457 plans.

Answer: C. The Securities and Exchange Commission has stated that certain Section 529 college savings plans established by states or local governmental entities are municipal fund securities. Accordingly, the purchase and sale of state-sponsored Section 529 plans are governed by the rules of the Municipal Securities Rulemaking Board (MSRB).

KNOWLEDGE CHECK 18.6

1. All of the following are characteristics of Section 529 savings plans **except**
   A. contributions are deductible on the donor's federal tax return.
   B. contributions may be state tax deductible.
   C. contributions grow tax deferred.
   D. withdrawals are tax free if used for qualified education expenses.
2. Two of the most popular methods for saving for education are the Coverdell ESA and the Section 529 plan. Although there are many similarities, there are some significant differences between the two. One of those differences is that the Section 529 plan
   A. allows the funds to be used for any K–12 expense, while the ESA considers tuition to be the only qualified expense.
   B. has a federally imposed maximum annual contribution, while the ESA's limit is determined by each state.
   C. places a limit on the age by which the funds may be used, while the ESA permits the funds to be used by a beneficiary of any age.
   D. does not place a limit on the earnings of the donor, while the ESA does place such a limit.

LESSON 18.7: CUSTODIAL ACCOUNTS AND HEALTH SAVINGS PLANS

LO 18.i Contrast UGMA and UTMA accounts.

Long before there were Education IRAs and Section 529 plans, a favored way of saving for a child's education (or anything else for that matter) was by the use of a custodial account under the Uniform Gift to Minors Act. In a **custodial account**, the custodian for the beneficial owner enters all trades. UGMA and UTMA accounts require an adult or a trustee to act as custodian for a minor (the beneficial owner). Any kind of security or cash may be gifted to the account without limitation.

The Uniform Law Commissioners adopted the Uniform Gift to Minors Act (UGMA) in 1956 (the same year as the Uniform Securities Act). The primary focus then was to provide a convenient way to make gifts of money and securities to minors. Later, it became clear that a more flexible law was desirable. The Uniform Law Commissioners adopted the Uniform

Transfers to Minors Act (UTMA) in 1986. UTMA expands the types of property you can transfer to a minor and provides that you can make other types of transfers besides gifts.

Nearly all states have adopted UTMA, but people still tend to refer to UGMA out of habit. For exam purposes, it doesn't matter which law is in effect in your state, because the essential principles of both acts are the same.

Opening a UGMA/UTMA Account

UGMA/UTMA account applications must contain the custodian's name, minor's name and Social Security number, and the state in which the UGMA/UTMA is registered.

TEST TOPIC ALERT

The minor's Social Security number is used on the account.

Custodian

Securities in a UGMA/UTMA account are managed by a custodian until the minor reaches the age of majority or, in the case of a UTMA, the age determined by the specific state. The custodian has full control over the minor's account and can:

- buy or sell securities;
- exercise rights or warrants; and
- liquidate, trade, or hold securities.

The custodian also may use the property in the account in any way the custodian deems proper for the minor's support, education, maintenance, general use, or benefit. However, the account is *not* normally used to pay expenses associated with raising a child, such as the three basic needs of food, clothing, and shelter.

Fiduciary Responsibility

A UGMA/UTMA custodian assumes fiduciary responsibilities in managing a minor's account. Restrictions are placed on improper handling of investments in a UGMA/UTMA. The most important limitations follow:

- UGMAs/UTMAs may be opened and managed as cash accounts only.
- A custodian may never purchase securities on margin or pledge them as collateral for a loan.
- A custodian must reinvest all cash proceeds, dividends, and interest within a reasonable period of time. Cash proceeds may be held in an interest-bearing custodial account for a reasonable period.
- Investment decisions must consider a minor's age and the custodial relationship; examples of inappropriate investments are commodity futures, naked options, and high-risk securities.
- Options may not be bought in a custodial account, because no evidence of ownership is issued to an options buyer.
- Covered call writing is normally allowed.
- Stock subscription rights or warrants must be either exercised or sold.

A custodian may be reimbursed for any reasonable expenses incurred in managing the account. Compensation may be paid to the custodian unless the custodian is also the donor.

Donating Securities

When a person makes a gift of securities to a minor under the UGMA/UTMA laws, that person is the securities' **donor**. A gift under UGMA/UTMA conveys an **indefeasible title**—that is, the donor may not take back the gift, nor may the minor return the gift until the minor has reached the age of majority. Once a gift is donated, the donor gives up all rights to the property. When the minor reaches the specified age, the property in the account is transferred into the minor's name.

UGMA/UTMA Rules

Securities professionals should know the following UGMA/UTMA custodial account rules:

- All gifts are irrevocable. Gifts may be in the form of cash or fully paid securities.
- An account may have only one custodian and one minor or beneficial owner.
- A donor of securities can act as custodian or appoint someone to do so.
- Unless acting as a custodian, parents have no legal control over a UGMA/UTMA account or the securities in it.
- A minor can be the beneficiary of more than one account, and a person may serve as custodian for more than one UGMA/UTMA, provided each account benefits only one minor.
- The minor has the right to sue the custodian for improper actions.

TAKE NOTE

Although an investment adviser representative is not responsible for determining whether an appointment is valid or a custodian's activities are appropriate, he should always be sensitive to the appearance of unethical behavior.

PRACTICE QUESTION

If a customer would like to open a custodial UGMA or UTMA account for his nephew, a minor, the uncle can

A. open the account, provided the proper trust arrangements are filed first.
B. open the account and name himself custodian.
C. open the account, but he needs a legal document evidencing the nephew's parents' prior approval of the account.
D. be custodian for the account only if he is also the minor's legal guardian.

Answer: B. The donor may name himself the custodian of a UGMA or UTMA account. No documentation of custodial status is required to open these accounts, and the custodian is not required to be the minor's legal guardian.

Registration of UGMA/UTMA Securities

Any securities in a UGMA/UTMA account are generally registered in the custodian's name for the benefit of the minor and *cannot be solely in the minor's name.*

So that transfers may be accomplished more expeditiously, securities may be held by custodians in street name.

EXAMPLE

In an account where Marilyn Johns, the donor, has appointed her daughter's aunt, Barbara Wood, as custodian for the account of her minor daughter, Alexis, the account and the certificates would read "Barbara Wood as custodian for Alexis Johns" (or a variation of this form).

When the minor reaches the age of transfer, all of the securities in the account are registered in her name. However, that change in registration is not automatic—the new adult must initiate the transfer.

Death of the Minor or Custodian

If the beneficiary of a UGMA/UTMA dies, the securities in the account pass to the minor's estate, not to the parents or the custodian. If the custodian dies or resigns, either a court of law or the donor must appoint a new custodian.

Unique Features of the Uniform Transfers to Minors Act (UTMA) Account

Although UTMA and UGMA accounts share many characteristics, there are a few important differences. First, although UGMA accounts may not hold real estate (real property), certain partnership interests, and other types of intangible property, UTMA accounts may. Thus, UTMA accounts offer greater investment choice.

In many states, UTMA account assets are not required to be transferred upon the age of majority of the beneficial owner (the child). In many UTMA states, the custodian may delay transferring the UTMA assets to the beneficial owner until he reaches age 21 or 25 (depending on the particular state statute).

PRACTICE QUESTION

One of the reasons you might suggest that a client with an eight-year-old child open a UTMA account rather than a UGMA is that the UTMA offers

A. better tax advantages.
B. more investment flexibility.
C. more investment control to the parent.
D. greater flexibility in the appointment of a custodian.

Answer: B. There are two testable UTMA advantages:

1. The money does not have to automatically transfer to the child once the age of majority is reached—it can be delayed, depending on the state, until as long as age 25; and
2. The range of investments permitted under a UTMA is much larger, giving the custodian greater flexibility in building the portfolio, which makes B the best choice.

There is a problem with this question (although not one recognized by NASAA)—you can't select between a UTMA and a UGMA—clients can only use what is available in their state of residence. As of the print date, there is only one state remaining that has UGMA on their books; all of the rest plus Washington, D.C. use UTMA.

Taxation

The minor's Social Security number appears on a UGMA/UTMA account, and the minor must file an annual income tax return and pay taxes on any **earned** income produced by the UGMA/UTMA account as would any other taxpayer. However, in the case of **unearned** income, such as from dividends and interest, until the minor reaches age 19 or the individual is a full-time student under 24, that unearned income in excess of $2,300 is taxed at the parent's marginal tax rate. This is commonly referred to as the **kiddie tax**.

Although the minor is the account's beneficiary and is responsible for any and all taxes on the account, in most states it is the custodian's responsibility to see that the taxes are paid from the account.

FAFSA and Custodial Accounts

In our discussion of educational funding programs, it was mentioned that money in Coverdell ESAs and Section 529 plans is only counted at a 5.64% rate when determining the family's financial contribution toward college. Assets held in a custodial account (UTMA or UGMA) are counted at a 20% rate—a true disadvantage when compared to the other plans.

LO 18.j Recall when health savings accounts (HSAs) may be used.

Health Savings Accounts (HSAs)

A health savings account (HSA) is a tax-exempt trust or custodial account that individuals can set up with a qualified HSA trustee to pay or reimburse certain medical expenses they incur.

Benefits of an HSA

- You can claim a tax deduction for contributions you, or someone other than your employer, make to your HSA even if you do not itemize your deductions on Form 1040.
- Contributions to your HSA made by your employer (including contributions made through a cafeteria plan) may be excluded from your gross income.
- The contributions remain in your account until you use them.
- The interest or other earnings on the assets in the account are tax free.
- Distributions may be tax free if you pay qualified medical expenses.
- An HSA is portable—it stays with you if you change employers or leave the work force.

Eligibility for an HSA

To be an eligible individual and qualify for an HSA, you must meet the following requirements:

- You must be covered under a high-deductible health plan (HDHP) on the first day of the month. That means you are considered to be an eligible individual for the entire year if you are an eligible individual on the first day of the last month of your tax year (December 1 for most taxpayers).
- You have no other health coverage except what is permitted under the rules.
- You are not enrolled in Medicare.

- You cannot be claimed as a dependent on someone else's tax return.
- Each spouse who is an eligible individual who wants an HSA must open a separate HSA. You cannot have a joint HSA.

An HDHP has:

- A higher annual deductible than typical health plans; and
- A maximum limit on the sum of the annual deductible and out-of-pocket medical expenses that you must pay for covered expenses. Out-of-pocket expenses include copayments and other amounts but do not include premiums.

Contributions to an HSA

Any eligible individual can contribute to an HSA. For an employee's HSA, the employee, the employee's employer, or both may contribute to the employee's HSA in the same year. For an HSA established by a self-employed (or unemployed) individual, the individual can contribute. Family members or any other person may also make contributions on behalf of an eligible individual. Contributions to an HSA must be made in cash, but the law permits investments to be made into stocks, bonds, and mutual funds. Contributions of stock or property are not allowed. There is a limit on the amount that may be contributed, but, because it is a number that changes each year, it will not be tested. The only facts that could be important are that the contribution for those with family coverage is higher (logically) than that for self-only coverage and that the amount the individual may contribute is reduced by any amounts contributed by the employer. One number that does not seem to change annually is one that we learned earlier in this unit: Just as with IRAs, a catch-up contribution of an additional $1,000 is permitted, but in this case, the participant must be at least age 55.

TAKE NOTE

Do not confuse an HSA with an FSA (flexible spending account). The FSA holds money deducted from the employee's pay and remains with the company—it is not investible, and, if you don't use it, you lose it.

Qualified Expenses

Besides the cost of medical care, there are some insurance premiums that are considered qualified expenses. You can't treat insurance premiums as qualified medical expenses unless the premiums are for any of the following:

- Long-term care insurance
- Health care continuation coverage (such as coverage under COBRA)
- Health care coverage while receiving unemployment compensation under federal or state law
- Medicare and other health care coverage if you are 65 or older (other than premiums for a Medicare supplemental policy, such as Medigap)

KNOWLEDGE CHECK 18.7

1. One of your customers has a 14-year-old child with a high level of interest in investing. The child's special passion is real estate. What would you suggest that would probably be the best type of account to open for the child?
   A. Coverdell ESA
   B. Joint account with right of survivorship (JTWROS)
   C. Uniform Gifts to Minors Act (UGMA)
   D. Uniform Transfer to Minors Act (UTMA)

2. It is not uncommon to find individuals working full time well after normal retirement age. You have a 79-year-old client who still puts in a 40-hour work week. The employing company offers an HSA to those employees who qualify. If this is your customer, one thing to note that likely could affect eligibility is
   A. the individual is claimed as a dependent on their grandchild's tax return.
   B. the individual is covered under Medicare.
   C. the individual has selected a high-deductible health plan provided by the employer.
   D. the individual is over 72 years of age.

KNOWLEDGE CHECK ANSWERS

Knowledge Check 18.1

1. **B** A contribution for the current year may be made anytime that year. The contribution may also be made anytime the following year up until the due date for payment of the previous year's income taxes. Note that an extension is only extending the time for filing, not the time for payment of taxes. That day is April 15.

   LO 18.a

2. **B** Because the taxpayer is 52, the catch-up provision of $1,000 additional applies. That makes the annual limit (currently) $7,500. That total combines traditional and Roth IRAs. It can be split however desired, but the total cannot exceed $7,500.

   LO 18.a

Knowledge Check 18.2

1. **A** There aren't many Roman numeral questions on the exam, probably because NASAA realizes how easy they can be. After all, choice I is in every answer and, because most test takers can put disability together with death, I and II must be correct choices. Then, what about the other two? The education expense allowance does not include nieces and nephews (it does include grandchildren). The $10,000 first-time purchase is of a primary residence, not a vacation home.

   LO 18.b

2. **A** Withdrawals from a Roth IRA are tax free when two conditions are met. The first is that the taxpayer must have a Roth IRA that is at least five years old. That condition is met here because the first Roth IRA was opened seven years ago. The second condition is that the taxpayer must be at least 59½ years of age. Ours is 60, so that condition is met. Having met both conditions, the entire withdrawal is tax free.

   LO 18.b

Knowledge Check 18.3

1. **C** Employer contributions are mandatory for all pension plans. It is true that better-than-projected performance can lead to the actuaries reporting that no contribution is necessary for a specific year, but that just means the obligation has been met through performance. Profit-sharing plans and 401(k) plans allow the employer to determine how much, if anything, will be contributed each year.

   LO 18.c

2. **C** The retired math teacher has self-employment income that could be used to fund a Keogh plan, but this person is not eligible for the 403(b) plan because the income is not from the school system (or other eligible employer). The school nurse, maintenance person, and principal are all employees of a school system and can participate in the plan. Do not read anything into this question that is not there. In other words, the question is not asking if money earned from the weekend work at the hospital, cleaning offices, or tutoring during the evenings is compensation that may be used for a 403(b) plan (it can't be).

   LO 18.d

3. **B** The SERP (supplemental executive retirement plan) is sometimes called the ***supplemental executive retention plan***. Its purpose is to go beyond the normal retirement plan with extra benefits for these executives. Because it is a nonqualified plan, discrimination is permitted. TSA is the general term used in the field to describe 403(b) plans, and corporations don't offer them. The contribution level on a SIMPLE is too low to retain the talent, and the company will need more than a SEP IRA. In fact, SERPs are always on top of an existing qualified plan.

   LO 18.e

Knowledge Check 18.4

1. **B** The QDRO is applicable to qualified plans, not to an IRA. Death or disability evades the 10% penalty for those under 59½. The same is true for certain medical expenses (the exam will not get into the specific details) and the first-time purchase of a primary residence.

   LO 18.f

2. **B** Assuming the plan permits loans, the IRS limits them to a maximum of the lesser of 50% of the vested value or $50,000. In this case, 50% of $90,000 is less than $50,000.

   LO 18.f

3. **B** For purposes of the QDRO provisions, an alternate payee cannot be anyone other than a spouse, former spouse, child, or other dependent of a participant. That leaves out aunts and uncles, cousins, and siblings unless something in the question indicates that they are dependents of the plan participant.

   LO 18.f

Knowledge Check 18.5

1. **B** The Section 404(c) safe harbor places limits on the responsibility of certain plan fiduciaries when the required conditions are met. There is no standard of investment performance. Plan participants must have the ability to make investment decisions in their account (control). There must be at least three different types of investments to choose from (selection). Certain information, such as accessibility to participant accounts by phone or online, is also a requirement.

   LO 18.g

2. **A** Be careful. There is a difference between a prohibited transaction (the subject of this question) and a prohibited investment. Self-dealing by the plan fiduciary, such as buying securities from or selling securities to the plan, is a prohibited transaction. The other choices here represent investments that are prohibited. Normally, the decision of the plan fiduciary to own company stock in the company's ERISA qualified plan is limited to 10% of the plan's total assets.

   LO 18.g

Knowledge Check 18.6

1. **A** Contributions to 529 savings plans are not federally tax deductible. Some states do offer a deduction or a tax credit for investing in the state's plan.

   LO 18.h

2. **D** The Coverdell ESA begins to limit the amount of contribution once earnings reach $190,000 (filing jointly; half of that for a single filer). On the other hand, contributions to a Section 529 plan may be without limitation on the donor's income. The other choices are all reversed. That is, the 529 plan is limited to tuition (up to $10,000) as a K–12 expense, and the federal limit on an ESA is $2,000 annually with a requirement that the funds be used by age 30 (excluding special-needs beneficiaries).

   LO 18.h

Knowledge Check 18.7

1. **D** The UTMA account has far greater investment flexibility than the UGMA. Included would be various real estate investments that could not be made in a UGMA. The JTWROS account cannot be opened with a minor, and the Coverdell is for education savings.

   LO 18.i

2. **B** One of the disqualifiers from HSA eligibility is having Medicare coverage. It would not be unusual for this individual to have taken out Medicare coverage when first eligible. Being claimed as a dependent on someone else's tax return is also a disqualifier. It is possible but unlikely that anyone working a 40-hour week could be claimed as a dependent by their grandchild. On the exam, do not choose the answer that "stretches the imagination." Age has nothing to do with eligibility, and the HDHP is a requirement.

   LO 18.j