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New Retirement Account Rules May Impact Special-Needs Planning

By Ed Slott, CPA

In the past, there were plenty of good reasons not to make a family member with special needs the beneficiary of a retirement account such as an IRA or a 401(k), starting with the simple fact that receiving a distribution from the account directly could result in the loss of critical government benefits.

Individuals with special needs often rely on Supplemental Security Income (SSI), Medicaid, and other government programs for which eligibility depends on meeting a means or resource test. To help keep a disabled person's income or net worth within the eligibility limits, assets can be placed in a special-needs (or supplemental) trust, from which a trustee has the discretion to pay for "amenities" (other than food or shelter) that enhance the life of the beneficiary, such as gifts, education, vacations, and other extras.

Navigating the rules for both inherited retirement accounts and special-needs trusts has always been complicated. However, changes introduced in the Setting Every Community Up for Retirement Enhancement (SECURE) Act may affect the beneficiary designations and estate plans of account owners who want to provide for heirs with special needs.

Stretch IRA Exception

As of January 2020, most nonspouse beneficiaries (including children and grandchildren) who inherit

It's still important to consider carefully whether a large traditional IRA or 401(k) is the best way to fund a special-needs trust.



IRA or employer plan assets can no longer "stretch" distributions over their lifetimes. They are required to liquidate inherited accounts within 10 years of the account owner's death, which may generate large tax bills. However, there are key exceptions for those known as eligible designated beneficiaries — a surviving spouse; a minor child of the account owner (until he or she reaches the age of the majority); those who are not more than 10 years younger than the decedent (such as a close-in-age sibling or other relative); and disabled and chronically ill individuals, as defined by the IRS. These eligible designated beneficiaries can still take smaller required minimum distributions (RMDs) based on their life expectancies.

The SECURE Act also created a new type of trust called an applicable multi-beneficiary trust (AMBT), which can be used when there are one or more designated beneficiaries (all living individuals with a life expectancy) and at least one of them is disabled or chronically ill. If an AMBT is named as the beneficiary

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If you have any questions about the topics in this newsletter or about your financial future, call us.
We are available to help.

PRACTICAL INSIGHTS FOR YOUR FINANCIAL GOALS

401(k) and IRA: A Combined Savings Strategy

Contributing to an employer-sponsored retirement plan or an IRA is a big step on the road to retirement, but contributing to both can significantly boost your retirement assets. A recent study found that, on average, individuals who owned both a 401(k) and an IRA at some point during the six-year period of the study had combined balances about 2.5 times higher than those who owned only a 401(k) or an IRA. And people who owned both types of accounts consistently over the period had even higher balances.¹

Here is how the two types of plans can work together in your retirement savings strategy.

Convenience vs. Control

Employer-sponsored plans such as 401(k), 403(b), and 457(b) plans offer a convenient way to save through pre-tax salary deferrals, and contribution limits are high: \$19,500 in 2021 (\$20,500 in 2022) and an additional \$6,500 if age 50 or older. Although the costs for investments offered in the plan may be lower than those offered in an IRA, these plans typically offer limited investment choices and have restrictions on control over the account.

IRA contribution limits are much lower: \$6,000 in 2021 and 2022 (\$7,000 if age 50 or older). But you can usually choose from a wide variety of investments, and the account is yours to control and keep regardless of your employment situation. If you leave your job, you can roll any assets in your employer plan into your IRA.² Whereas contributions to an employer plan generally must be made by December 31, you can contribute to an IRA up to the April tax filing deadline.

Matching and Diversification

Many employer plans match a percentage of your contributions. If your employer offers this program, it would be wise to contribute at least enough to receive the full match. Contributing more would be better, but

you also might consider funding your IRA, especially if the contributions are deductible (see below).

Along with the flexibility and control offered by the IRA, holding assets in both types of accounts, with different underlying investments, could help diversify your portfolio. Diversification is a method used to help manage investment risk; it does not guarantee a profit or protect against investment loss.

Rules and Limits

Although annual contribution limits for employer plans and IRAs are separate, your ability to deduct traditional IRA contributions phases out at higher income levels if you are covered by a workplace plan: modified adjusted gross income (MAGI) of \$66,000 to \$76,000 for single filers and \$105,000 to \$125,000 for joint filers in 2021 (\$68,000 to \$78,000 and \$109,000 to \$129,000 in 2022).³ You can make nondeductible contributions to a traditional IRA regardless of income.

Eligibility to contribute to a Roth IRA phases out at higher income levels regardless of coverage by a workplace plan: MAGI of \$125,000 to \$140,000 for single filers and \$198,000 to \$208,000 for joint filers in 2021 (\$129,000 to \$144,000 and \$204,000 to \$214,000 in 2022).

Contributions to employer-sponsored plans and traditional IRAs are generally made on a pre-tax or tax-deductible basis and accumulate tax deferred. Distributions are taxed as ordinary income and may be subject to a 10% federal income tax penalty if withdrawn prior to age 59½ (with certain exceptions). Nondeductible contributions to a traditional IRA are not taxable when withdrawn, but any earnings are subject to ordinary income tax. Required minimum distributions (RMDs) from employer-sponsored plans and traditional IRAs must begin for the year you reach age 72 (70½ if you were born before July 1, 1949). However, you are generally not required to take distributions from an employer plan as long as you still work for that employer.

Roth IRA contributions are not deductible, but they can be withdrawn at any time without penalty or taxes. To qualify for the tax-free and penalty-free withdrawal of earnings, Roth IRA distributions must meet a five-year holding requirement and take place after age 59½ (with certain exceptions). Original owners of Roth IRAs are exempt from RMDs. Beneficiaries of all IRAs and employer plans must take RMDs based on their age and relationship to the original owner.

1) Employee Benefit Research Institute, 2020

2) Other options when separating from an employer include leaving the assets in your former employer's plan (if allowed), rolling them into a new employer's plan, or cashing out (usually not wise).

3) If you are not covered by a workplace plan but your spouse is covered, eligibility phases out at MAGI of \$198,000 to \$208,000 for joint filers in 2021 (\$204,000 to \$214,000 in 2022).

Percentage of U.S. households with tax-advantaged retirement savings accounts



Source: Investment Company Institute, 2021

A More Affordable Life Insurance Solution

Many people allow their life insurance policies to expire once their children are grown. This may not be a good idea, especially if you have a mortgage or other substantial expenses and your spouse would need continued financial support. But a new policy can be quite expensive when you are older. Survivorship life insurance may be a more cost-effective solution.

Coverage for Two

Survivorship life insures the lives of two people, typically a married couple, and pays a death benefit after the death of the last-surviving covered person. For this reason, it is sometimes called second-to-die insurance. Because only one death benefit is paid and premiums are based on the life expectancies of both insured individuals, the cost is usually less than premiums for a policy covering either life alone. And it might be possible to obtain coverage for a spouse who has been rejected for an individual policy. Survivorship policies are also used to insure business partners, and options may be available to insure more than two people.

Survivorship policies are typically permanent life insurance, which offers lifetime coverage and stays in force as long as the premiums are paid. The death benefit of a survivorship policy could be used to leave a legacy for your heirs, pay taxes, settle an estate, and pay other end-of-life expenses.

Creating Cash Value

A portion of the premium goes into a cash-value account, which accumulates on a tax-deferred basis throughout the life of the policy. Any cash value accumulated at the time the first spouse dies might be used to help support the surviving spouse. The cash



value could also be tapped through loans or withdrawals while both spouses are alive and used for emergency expenses or to supplement retirement income.

Withdrawals of the accumulated cash value, up to the amount of the premiums paid, are not subject to income tax. Loans are also free of income tax as long as they are repaid. Loans and withdrawals will reduce the policy's cash value and death benefit and could increase the chance that the policy will lapse.

As with most financial decisions, there are expenses associated with the purchase of life insurance. Policies commonly have mortality and expense charges. If a policy is surrendered prematurely, there may be surrender charges and income tax implications. The cost and availability of life insurance depend on factors such as age, health, and the type and amount of insurance purchased. Any guarantees are contingent on the financial strength and claims-paying ability of the issuing insurance company.

Before implementing a strategy involving life insurance, it would be prudent to make sure that you are insurable.

Five Good Reasons

Percentage of consumers who gave these reasons for owning life insurance (multiple responses allowed)





Your Social Security Statement: What's in It for You?

The Social Security Administration (SSA) provides personalized Social Security Statements to help Americans age 18 and older better understand the benefits that Social Security offers. Your Statement contains a detailed record of your earnings and estimates of retirement, disability, and survivor benefits — information that can help you plan for your financial future.

You can view your Social Security Statement online at any time by creating a *my* Social Security account at the SSA's website, ssa.gov/myaccount. If you're not registered for an online account and are not yet receiving benefits, you'll receive a Statement in the mail every year, starting at age 60.

Benefit Estimates

Your Social Security Statement tells you whether you've earned enough credits by working and paying Social Security taxes to qualify for retirement and disability benefits and, if you qualify, how much you might receive. Generally, retirement benefits are projected for up to nine claiming ages, including full (ages 66 to 67), early (age 62), and late (age 70). If you qualify, you can also see the benefit amount your survivors might receive in the event of your death.

The amounts listed are estimates based on your average earnings in the past and a projection of future earnings. Actual benefits you receive may be different if your earnings increase or decrease in the future.

Amounts may also be affected by other factors, including cost-of-living increases and other income you receive, and are based on current law.

Annual Earnings

In addition, your Social Security Statement contains a year-by-year record of your earnings. This record is updated when your employer reports your earnings (or if you're self-employed, when you report your own earnings).

Because Social Security benefits are based on average lifetime earnings, it's important to make sure your earnings have been reported correctly. Compare your earnings record against past tax returns or W-2s. If you find errors, let the Social Security Administration know right away by calling (800) 772-1213.



Ed Slott is a professional speaker and the creator of several public television specials, including "Retire Safe & Secure! with Ed Slott." He is the author of *The Retirement Savings Time Bomb...And How to Defuse It* and many other books about IRA planning.

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of the retirement account, RMDs can be stretched over the lifetime of the disabled beneficiary, and the distributions can be retained in the trust, so they won't jeopardize that person's government benefits.

Trust Tax Dilemma

One potential disadvantage is that the amount of any RMD not distributed to the trust beneficiary is taxed at trust income tax rates, which reach the top 37% tax rate after just \$13,450 of income in 2022. So it's still important to consider carefully whether a large traditional IRA or 401(k) is the best way to fund a special-needs trust. For example, a strategy that involves withdrawing retirement account assets and using the money to purchase life insurance for the trust will trigger current tax bills, but it may be more tax-efficient in the long run. And if you have a special-needs trust that pre-dates the SECURE Act, it may be a good time to revisit your estate plan.

Distributions from traditional IRAs and most employer-sponsored retirement plans are subject to ordinary income tax, and distributions taken prior to age 59½ may be subject to a 10% federal income tax penalty, with certain exceptions. The cost and availability of life insurance depend on factors such as age, health, and the type and amount of insurance purchased. There are costs and ongoing expenses associated with the creation and maintenance of trusts, and their use involves a complex web of tax rules and regulations. You should consider the counsel of experienced legal and tax professionals before implementing a trust strategy.