



Grace Global Alliance

An Independent Association of Christian Churches & Ministers

403(b) Retirement Plans An Overview Tax Year 2017

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Grace Global Alliance
Ministers & Churches

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Making the Most of Your Retirement Plan

Defined Contribution Retirement Plans

Many employers offer some form of defined contribution retirement plan. Although the name may vary (401(k), 403(b), 457(b))¹, on a basic level they all function in much the same way. During your working years money is automatically deducted from your paycheck and contributed to the plan. The accumulated funds are ultimately used to help pay for your retirement.

Why Participate?

The answer to this is simple: you'll likely need the money. With people living longer, more money is needed to pay for retirement. And two of the traditional financial pillars of retirement, defined benefit pension plans (providing a known benefit) and Social Security are playing a smaller role in meeting this increased need for retirement income.

- Over the past several decades many employers have changed from defined benefit to defined contribution plans. From 1985 to 2000, for example, the rate of participation in defined benefit plans by full-time employees of medium and large private firms dropped from 80% to 36%.² A survey by the Bureau of Labor Statistics, published in 2014, found that only 25% of civilian workers in the U.S. participated in defined benefit pension plans.³

Social Security also faces problems. As the baby boom generation enters retirement (the so-called "silver tsunami"), the number of individuals remaining in the workforce to support these retirees grows smaller. Although politically unpleasant, harsh fiscal realities may force increased payroll taxes, reductions in benefits, or both.

What to Do?

Today, more than ever before, you're on your own. One starting point is to take a more active role in your employer's defined contribution plan:

¹ These refer to the sections of the Internal Revenue Code which authorize the different types of retirement plans.

² See, "Employee Participation in Defined Benefit and Defined Contribution Plans, 1985-2000." U.S. Bureau of Labor Statistics, updated June 16, 2004.

³ National Compensation Survey: Employee Benefits in the United States, March 2014, Table 2.

Making the Most of Your Retirement Plan

- **Investment options:** Or, where do I invest my money? This will depend on a number of factors, including the plan's available options, the amount of your retirement income goal, the number of years until retirement begins, and your tolerance for risk.
- **Contribution rate:** A 3% rate may be the default, but is that enough to meet your needs? Another factor to consider is whether there is an employer match for part of your contributions. At the least you should contribute to the level which will maximize the employer match. Otherwise, you're walking away from "free money."
- **Annual checkup:** Everyone's situation changes over time. Make sure you thoroughly review your retirement plan at least once a year. Are you saving enough? Are your investments still appropriate?

Seek Professional Guidance

Successful long-term investing requires discipline and patience. The guidance of a financial professional is highly recommended.

403(b) Salary Deferral Plan

Tax-Sheltered Annuities

Eligible Employers

Religious, charitable, educational, scientific, and literary organizations described in IRC Sec. 501(c)(3), certain governmental employers and public school systems may establish 403(b) plans for their employees.¹



Who Contributes To The Plan?

While employer contributions are allowed, typically it is the employee who makes the contributions by agreeing to have his or her salary reduced by the contribution amount. If the employer contributes its own funds, the arrangement is subject to many of the same federal tax and labor laws that govern regular qualified plans, such as 401(k) plans. Certain 403(b) plans must satisfy non-discrimination tests. For example, if a non-governmental employer provides a matching contribution, the plan must meet the same Average Contribution Percentage test required of 401(k) plans. The 403(b) plan may be exempt from this test if it provides a “safe harbor” contribution similar to those applicable to 401(k) plans.

Contribution Limits

For 2017, the total of employer contributions and employee deferrals added to a participant’s account generally may not exceed the lesser of 100% of compensation² (limited to a maximum of \$270,000), or \$54,000 per year. An employee’s elective contributions are generally limited to \$18,000 annually. Total elective deferrals for employees of qualifying organizations with 15 years of service may be up to \$21,000. For those age 50 or older, additional “catch-up” contributions of \$6,000 may be made.

Employer Obligations

In 2007, the IRS issued new 403(b) regulations, generally effective January 1, 2009. These regulations impose specific responsibilities on the employer to ensure the plan operates in accordance with IRS rules. These requirements include:

¹ The discussion here concerns federal income tax law. State or local income tax law may vary.

² The term “compensation” includes deferrals to 403(b) plans as well as deferrals made to IRC Sec. 125 and IRC Sec. 457 plans.

403(b) Salary Deferral Plan

- **Written plan document:** The plan must have a written plan document adopted by the employer. This document must include eligibility, contribution, distribution, loan and hardship provisions and list the funding vehicles offered. The employer must operate the plan in accordance with these written plan provisions.
- **Ongoing administrative responsibility:** The employer must be responsible for the plan's administrative functions. While many functions may be outsourced to the plan providers, the employer is responsible for the coordination of these functions.
- **Employer as fiduciary:** The employer has a fiduciary duty to ensure the plan operates in the best interests of plan participants by selecting and monitoring service and fund providers and investment options, as well as the fees charged for these services.
- **Expanded Form 5500 reporting and independent plan audit:** The new 403(b) regulations expand the information 403(b) sponsors must report to the federal government, on Form 5500. Further, many non-profit organizations with more than 100 eligible participants will be required to hire an accounting firm to prepare an audit of the plan to accompany Form 5500. These requirements do not apply to sponsors exempt from ERISA, such as governmental organizations and churches.
- **Plan must be universally available to employees:** The plan must be “universally available.” If one employee is eligible to make contributions, all employees must be eligible, with limited exceptions.

403(b) plans must meet the same coverage requirements as 401(k) plans. If the employer makes contributions to the plan, these employer contributions must satisfy the same non-discrimination requirements as 401(k) plans. (Governmental entities are exempt from the non-discrimination rules). 403(b) plans are exempt from the Actual Deferral Percentage (ADP) test applicable to 401(k) plans. This is a significant advantage, as highly compensated employees¹ do not have to worry about having excess contributions refunded to them.

The IRS will treat two or more non-profit entities as a single employer if there is at least 80% overlap of directors or trustees (a controlled group). This means that such commonly controlled entities will have to meet the IRS coverage and availability rules for all involved entities. Special rules apply to churches and qualified church-controlled organizations.

¹ “Highly compensated” employees generally include 5% or more owners and those earning more than \$120,000 (2017 value) in the prior year.

403(b) Salary Deferral Plan

Fee Disclosure Requirements

Effective July 1, 2012, if a plan gives participants the right to direct any investments, plan sponsors must provide participants with expanded, standardized investment fee and performance information. This additional information is intended to aid plan participants in making better-informed investment choices. The failure by a plan sponsor to meet these ERISA requirements may result in a breach of fiduciary duty to plan participants and the loss of ERISA Section 404(c) protection (meaning the plan fiduciaries may be held responsible for the results of the participants' own investment choices).

Other 403(b) Plan Features

- **Roth 403(b) contributions:** If the employer permits, and the written plan so provides, plan participants may choose to have some or all of their salary deferral contributions treated as contributions to a designated Roth account, commonly referred to as a “Roth 403(b).” Unlike normal 403(b) contributions, which are made before-tax, Roth 403(b) contributions are made on an after-tax basis. If certain requirements are met, distributions from the Roth 403(b) are received income tax-free. Contributions to a Roth 403(b) account are subject to the same employee elective deferral limits as the 403(b) plan itself.
- **When to setup a 403(b):** A 403(b) plan may be setup at any time during the year. However, salary-reduction agreements must be entered into before the reduced salary amounts are available to the employee. An employee can later modify the deferral amount, but only with respect to future income.
- **Investment options:** 403(b) plans may offer investments in annuities (fixed or variable and individual or group)¹ or custodial accounts invested in mutual funds.

Withdrawing 403(b) Funds

- **When withdrawals are permitted:** Distributions from 403(b) plans are typically limited and cannot be paid until separation from service, death, disability, termination of the plan, or attainment of age 59½. Some plans may permit hardship distributions. Some 403(b) annuity contracts may have different withdrawal provisions.

¹ Under IRS final regulations, life insurance was permitted only if the policy was issued before Sept 24, 2007.

403(b) Salary Deferral Plan

- **Distributions taxed as ordinary income:** Distributions are generally taxed as ordinary income. Distributions may be eligible for 10-year income averaging¹ or, at retirement from the current employer, rolled over to a Traditional or a Roth IRA, or to another employer plan if that plan will accept such a rollover.
- **Early withdrawal penalties:** Taxable distributions from the plan before a participant reaches age 59½ are subject to a 10% federal tax penalty for “early” withdrawal. The 10% penalty may not apply if one of a number of exceptions applies (See IRC Sec. 72(t)). All taxable distributions are included in the participant’s gross income in the year of distribution from the plan.
- **Required minimum distributions (RMDs):** Plan assets are usually withdrawn at retirement. To avoid income-tax penalties, distributions must begin by April 1 of the later of (a) the year following the year the participant reaches age 70½, or (b) the year following the year the participant retires.²
- **Participant loans:** Participants can borrow funds from their 403(b) and later repay the loan without incurring a tax if certain requirements are met regarding maximum loan amount, amortization requirements, time period for repayments, etc.
- **Financial Hardship:** The salary-reduction amount (but not the earnings) is available for financial hardship; e.g., an immediate and heavy financial need which cannot be met with other sources. Hardship distributions are included in the participant’s taxable income in the year of distribution.

The Death of a 403(b) Participant

When a participant dies, 403(b) proceeds become part of his or her taxable estate for federal estate tax purposes. For federal income tax purposes, plan proceeds are generally treated as ordinary income to the beneficiary, except for any “pure” insurance proceeds provided by a 403(b) life insurance contract.³

Changing from One 403(b) to Another, Rolling Over to IRA

The transfer of funds from one 403(b) investment to another will not be considered a taxable distribution if the funds remain subject to the same distribution restrictions as on the prior

¹ Those born before 1936 may be able to elect 10-year income averaging or capital gain treatment.

² If the first distribution is delayed until April 1 of the following year, two distributions will be required in that year.

³ For insurance policies purchased prior to September 24, 2007.

403(b) Salary Deferral Plan

investment, and the employer has an agreement in place with the new investment provider to permit the new investment. If proceeds from a 403(b) are rolled directly into a traditional IRA, it will defer taxation. A rollover to a Roth IRA is a taxable event. If a distribution is paid directly to the participant first, it will be subject to the mandatory 20% income tax withholding rule.

Federal Bankruptcy Impact

Federal bankruptcy law provides significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans.

Counting Deferred Amounts as Current Compensation

Deferred amounts can be counted as current compensation in computing benefits under a separate qualified pension plan, if the qualified plan so provides.

End Result

Contributing to a 403(b) plan has several significant benefits:

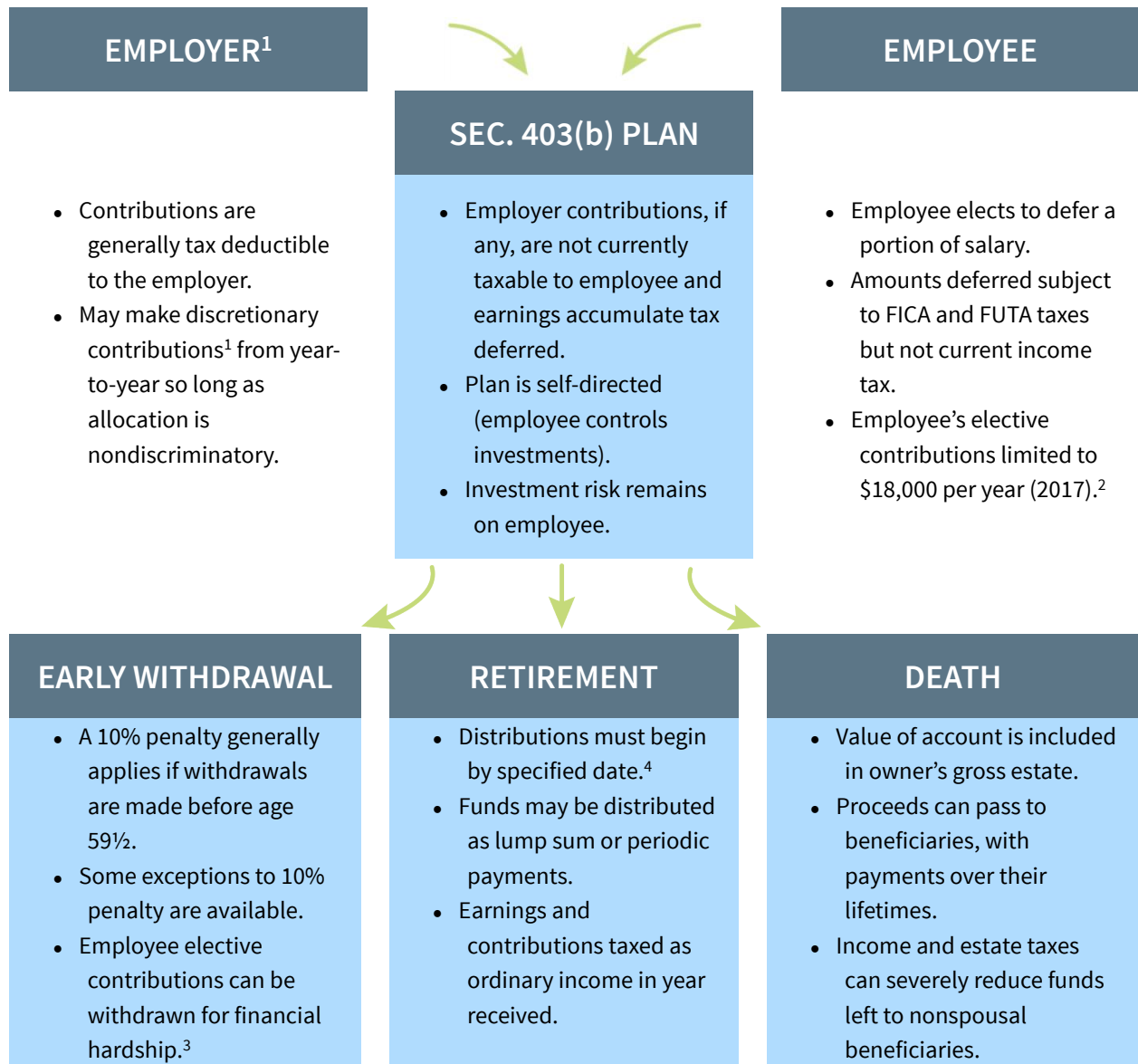
- Except for payroll taxes (e.g., FICA, Medicare), the employee avoids current income taxation on the deferred amount.
- The earnings on the accumulating funds are not taxed until they are distributed, usually at retirement.

Comparison of Federal Income Tax Payable¹

Without 403(b) Plan		With 403(b) Plan		Benefit
Taxable Income Before \$5,000 Salary Reduction	Tax Due Without Annuity	Taxable Income After Reduction	Tax Due with Annuity	Current Income Tax Reduction
\$25,000	\$2,818	\$20,000	\$2,068	\$750
35,000	4,318	30,000	3,568	750
45,000	5,818	40,000	5,068	750
55,000	7,318	50,000	6,568	750
85,000	12,728	80,000	11,478	1,250

¹ Based on 2017 federal income tax rates and married filing jointly.

How a 403(b) Salary Deferral Plan Works



¹ If there are employer contributions, the arrangement must generally satisfy the minimum participation requirements as well as the nondiscrimination rules applicable to employer-sponsored qualified plans.

² For those age 50 and older, additional "catch-up" contributions of \$6,000 may be made.

³ If provided for by the plan. Under Treasury regulations, financial hardship is defined as "immediate and heavy financial need where funds are not reasonably available from other sources."

⁴ Distributions must begin by April 1 of the later of (a) the year following the year in which the participant reaches age 70½, or (b) the year following the year in which the participant retires.

Annuities in Retirement Income Planning

For much of the recent past, individuals entering retirement could look to a number of potential sources for the steady income needed to maintain a decent standard of living:

- **Defined benefit (DB) employer pensions:** In these plans the employer promises to pay a specified monthly amount for the life of the retiree and/or spouse.
- **Social Security:** Designed to replace only a part of an individual's working income, Social Security provides a known benefit for the life of a retiree and his or her spouse.
- **Defined contribution (DC) plans:** Such as 401(k), 403(b), or 457¹ plans, which allow for contributions from the employee (in some cases from the employer as well) to a retirement account. The funds in the account, whatever they amount to at retirement, provide retirement income.
- **Individual retirement plans:** Such as Traditional IRAs or Roth IRAs. These are "individual" versions of employer-sponsored DC plans. The funds in the IRA at retirement, whatever the amount, are used to provide retirement income.



The Changing Face of Retirement

The saying that “life is what happens when you’re making other plans” is particularly true when it comes to retirement income planning, for several key reasons:

- **Fewer employer pensions:** Over the past several decades, many employers have changed from defined benefit to defined contribution plans. From 1985 to 2000, for example, the rate of participation in defined benefit plans by full-time employees of medium and large private firms dropped from 80% to 36%.² A survey by the Bureau of Labor Statistics, published in 2013, found that only 26% of civilian workers in the U.S. participated in defined benefit pension plans.³

¹ These refer to the sections of the Internal Revenue Code which authorize these different types of retirement plans.

² See, “Employee Participation in Defined Benefit and Defined Contribution Plans, 1985-2000.” U.S. Bureau of Labor Statistics, updated June 16, 2004.

³ National Compensation Survey: Employee Benefits in the United States, March 2013, Table 2.

Annuities in Retirement Income Planning

- **Social Security:** Social Security is a “pay-as-you-go” system, with current workers supporting those already receiving benefits. As the baby boom generation begins to retire, the number of individuals remaining in the workforce to support them grows smaller. Although politically unpleasant, fiscal reality may force higher payroll taxes, reductions in benefits, or both.
- **We’re living longer:** A child born in 1940 had an average life expectancy of 62.9 years. For a child born in 2010, however, average life expectancy had increased to 78.7 years.¹

With the stable, lifetime income stream from employer pensions and Social Security playing an ever shrinking role, retirement income planning demands that each individual accept a higher degree of personal responsibility for both accumulating and managing the assets needed to pay for retirement. And managing these assets has to be done in a world where constant inflation, fluctuating interest rates, and sometimes volatile financial markets are a fact of life.

Extended life spans mean that the money has to last longer, although exactly how long is unknown.

One Possible Answer – Immediate Annuities

Life insurance is designed to help solve the problems created when someone dies prematurely. An annuity, on the other hand, is designed to protect against the possibility of living too long. An “immediate” annuity is a contract between an individual and an insurance company. In exchange for a single, lump-sum premium, the insurance company agrees to begin paying a regular income to the purchaser for a period of years or for life. The periodic payment amount depends on a number of factors:

- **Premium paid:** Generally the larger the payment, the larger the income stream.
- **Age:** Older individuals typically receive larger periodic payments.
- **Payout period selected:** A shorter payout period usually results in a larger payment.
- **Underlying investment medium:** Generally, either a fixed or a variable annuity.

¹ Source: National Center for Health Statistics: Deaths: National Vital Statistics Reports, Volume 61, Number 4. Deaths: Final Data for 2010. May 8, 2013.

Annuities in Retirement Income Planning

FIXED ANNUITY

A fixed annuity pays a fixed rate of return. The insurance company invests in a portfolio of debt securities such as mortgages or bonds and pays out a fixed rate of return. Generally, this rate of return is guaranteed for a certain period of time after which a new rate is calculated. Most insurance companies offer a guaranteed minimum rate throughout the life of the contract. Such guarantees are based upon the claims-paying ability of the issuing insurance company.

VARIABLE ANNUITY

A variable annuity offers the potential for higher returns in exchange for assuming a higher level of risk. You can choose from among several types of investment portfolios, such as stocks or bonds. The amount of each annuity payment will fluctuate depending on the performance of the underlying investments. Variable annuities are long-term investments designed for retirement purposes. They have certain limitations, exclusions, charges, termination provisions, and terms for keeping them in force, and are sold by prospectus only.¹

Annuities are not insured by the FDIC or any government agency. Since an annuity may be payable far into the future, dealing with a financially solid insurer is essential. Credit rating companies such as A.M. Best, Standard and Poor's, or Moody's can provide an objective measure of a firm's financial stability.

Seek Professional Guidance

For many individuals, an immediate annuity can form an important part of their retirement income planning. Because an immediate annuity is a complex product, the advice and guidance of a trained financial professional is highly recommended.

¹ The prospectus for a variable annuity contains complete information including investment objectives, risk factors, fees, surrender charges, and any other applicable costs.

Deferred Annuities

What Is a Deferred Annuity?

Life insurance is used to create an estate for an individual if he or she dies too soon. A deferred annuity, however, can provide protection against the possibility that an individual will live too long and outlive his or her accumulated assets.



The term “annuity” derives from a Latin term meaning “annual” and generally refers to any circumstance where principal and interest are liquidated through a series of regular payments made over a period of time. A “deferred” annuity is an annuity in which both the income, and any taxes due on growth inside the contract, are pushed into the future, until they are actually received by the owner.¹

A commercial² deferred annuity is a special type of policy issued by an insurance company. In a typical situation, the policyowner contributes funds to the annuity. The money put into the policy is then allowed to grow for a period of time. At a future date, the policy may be “annuitized” and the accumulated funds paid out, generally through periodic payments made over either a specified period of time, or the life of an individual, or the joint lives of a couple.

Parties to an Annuity

There are four parties involved in a typical annuity:

- **Insurance company:** This is the issuer of the annuity.
- **Policyowner:** This is the individual or entity that contributes the funds. The policyowner typically has the right to terminate the annuity, to gift it to someone else, to withdraw funds from it, and to change the annuitant or beneficiary. Depending on the type of annuity, a policyowner may have other rights as well.

¹ Under federal law, the deferral of income tax on growth inside the policy is available only to natural persons; the tax-deferral is generally not permitted if the annuity owner is a non-natural person such as a trust or corporation.

² A private annuity is an agreement between individuals, usually exchanging a valuable asset (such as a business) for a lifetime income. The party promising to pay the annuity is someone who is not in the business of issuing annuities.

Deferred Annuities

- **Annuitant:** This is the individual whose life is used to determine the payments during annuitization. An annuity will remain in force unless terminated by the owner, or as a result of the death of the owner, or the annuitant dies.
- **Beneficiary:** This is the individual or entity that receives any proceeds payable on the death of the annuitant or the policyowner, depending on whether the annuity is “annuitant driven” or “owner driven.”

A single individual may be the policyowner, annuitant, and the beneficiary, although this is not usually recommended. More commonly, these roles are held by different individuals or entities.

Types of Deferred Annuities

There are many different ways to classify deferred annuities:

- **Method of purchase:** Annuities can be purchased with a single lump-sum of cash; such annuities are often referred to as single premium annuities. They may also be purchased with installment payments over time, either of a fixed dollar amount on a regular basis or with flexible payments.
- **When annuity payments begin:** Payments under a deferred annuity typically begin at some future time. In comparison, an "immediate" annuity, is purchased with a single premium, with annuity payments beginning one payment period (monthly, annual, etc.) later.
- **Investment options:** During the period before a policy is annuitized or completely liquidated, the funds invested by the policyowner are put to work. Depending on the type of annuity, the underlying investment vehicle will vary.
- **Fixed annuity:** In a fixed annuity, the issuing life insurance company will guarantee a certain rate of interest, for a specified period of time, typically 1-10 years. Such annuities are useful for conservative, risk-averse individuals. The investment risk rests on the insurance company and any annuity payments are relatively predictable.

Deferred Annuities

- **Variable annuity:** A buyer of a variable annuity has the option of placing the funds in the policy in a variety of investment options. The investment risk rests largely on the policyowner. Annuity payments are linked to the value of the underlying investments, which can fluctuate up or down.
- **Indexed annuity:** An indexed annuity is a type of fixed-rate annuity which combines a guaranteed minimum interest rate with a potential for greater growth, with returns being based on a formula related to a specific market index such as the Standard & Poor's 500 index. If the chosen index rises sufficiently during a specific period, a greater rate is credited to the policyowner's account for that period. Unlike variable annuities, where poor market performance can lead to decreased policy values, indexed annuities are structured to not lose value due to a declining stock market. However, because of surrender charges, an investor may lose principal value if an indexed annuity is surrendered early.

Payments from an Annuity

There are a number of ways that money may be withdrawn or received from a deferred annuity:

- **Lump-sum withdrawal:** A policyowner can withdraw all of the funds in an annuity in a single lump sum. Such a withdrawal is considered a surrender of the policy and the annuity ends. Depending on the policy and the length of time it has been in force, the insurance company may impose surrender charges, generally expressed as a percentage of the balance.
- **Partial withdrawal:** Many annuity policies allow an owner to withdraw a certain portion of the balance each year (usually 10% - 15%), without a surrender charge.
- **Partial annuitization:** Beginning in 2011, federal income tax law allows a portion of a nonqualified annuity contract, endowment, or life insurance contract to be annuitized while the balance is not annuitized, provided that the annuitization period is for 10 years or more, or is for the lives of one or more individuals.
- **Life only annuity:** Regular payments are made for as long as the annuitant lives. When the annuitant dies, payments cease and no refund is made, even if the policyowner has not recovered the initial investment.

Deferred Annuities

- **Life with term certain:** Regular payments are made for the life of the annuitant, or a specified number of years. If the annuitant dies before the specified term has passed, annuity payments continue to a beneficiary for the remainder of the term.
- **Joint and survivor:** Regular payments are made over the lives of two individuals. When one dies, annuity payments (or a specified portion) continue to the survivor.
- **Refund options:** Regular payments are made over the life of the annuitant. However, if the annuitant dies before the policyowner's investment has been recovered, the balance is refunded to a named beneficiary through either a lump-sum payment or continued annuity payments.
- **Specified period:** Regular payments are made for a pre-selected number of years. If the annuitant dies before the specified period has expired, payments are continued to a named beneficiary for the remaining term.
- **Specified amount:** Payments of a set amount are paid out regularly as long as there is money in the account.

Taxation of Annuity Payments

The tax treatment of payments made from a deferred annuity will vary, depending on whether the funds used to purchase the annuity have been taxed or not,¹ and on where in the life cycle of the annuity the payments are made. In general, the following rules apply:²

- **Before annuitization:** Funds withdrawn from an annuity prior to annuitization are considered to be made first from interest or other growth.³ These earnings are taxable as ordinary income. If the annuity owner is under age 59½ at the time a withdrawal is made, the earnings are also subject to a 10% federal tax penalty, unless an exception applies. If earnings are completely withdrawn and payments are then made from the owner's initial investment, the payment is treated as a tax-free recovery of basis.

¹ "Qualified" annuities are annuities purchased inside of a retirement plan such as a 401(k) or IRA, generally with pre-tax funds. "Nonqualified" annuities are purchased outside of an IRA or retirement plan, with money that has already been taxed. The taxation discussion here concerns nonqualified annuities.

² This information is based on federal law. State law may vary.

³ Withdrawals from annuity policies entered into before August 14, 1982 were treated as first coming from principal, to the extent of premiums contributed before August 14, 1982.

Deferred Annuities

- **After annuitization:** Regular annuity payments are treated as being composed of part earnings and part return of investment. The earnings portion is taxable as ordinary income. Once the owner has completely recovered his or her investment, all remaining payments are fully taxable as ordinary income. In some situations, if the owner is under age 59½ when payments are received, a 10% federal penalty tax may apply.
- **Estate taxes:** Any amount payable to a beneficiary under an annuity by reason of an owner's death is includible in the owner's gross estate. If an annuitant/owner receiving payments under a life-only annuity dies, no further payments are due and nothing is includible in his or her estate.

Other Common Annuity Provisions

There are several standard provisions commonly found in annuity policies:

- **Bailout provision:** The bailout provision applies only to fixed annuity policies. In a fixed annuity, an insurer will typically offer a guaranteed rate of interest for a specified period of time. For any subsequent time periods, a different rate of interest will usually be offered. Under the bailout provision, generally, if a renewal interest rate is more than 1% less than that offered in the previous period, the policy owner has the option of terminating the policy without paying any insurance company surrender charges. Interest or other growth withdrawn will generally be subject to current income tax and may also be subject to the 10% penalty tax if taken before age 59½.
- **Surrender charges:** Most commercial annuities do not charge a commission when an annuity is purchased. Many, however, impose a surrender charge if withdrawals in excess of a certain amount are made, or if the policy is surrendered completely. Surrender charges can range from 0% to 10% and typically decline over time.
- **Prospectus:** Variable annuities are considered by the Securities and Exchange Commission (SEC) to be a security. The SEC requires that the purchaser of a variable annuity be given a prospectus, which provides detailed information on how the annuity works, the investment options available, the risks involved, and any expenses or charges. The SEC also requires individuals selling variable annuities to be licensed to sell securities.

Deferred Annuities

Certain optional provisions may be available by paying an additional charge:

- **Guaranteed death benefit:** The guaranteed death benefit provision applies only to variable annuities. If an annuitant or owner in some contracts dies before annuity payments begin, the policy will pay the named beneficiary the greater of the investment in the policy (less any withdrawals) or the policy value on the date of death.
- **Enhanced death benefit:** Some variable annuities offer an enhanced death benefit option. This feature provides that upon the death of the annuitant or owner in some contracts, the beneficiary will receive the greater of the policy's value on the date of death, or the original principal (plus any additions) compounded at 5% per year. Other enhanced death benefits include percentage increases and highest anniversary valuation.

Seek Professional Guidance

Deferred annuities are primarily intended to be long-term investments. Because of this, and because of the complexity of many annuity policies, an individual considering the purchase of a deferred annuity should carefully consider all aspects. The guidance of appropriate tax, legal, and other advisors is highly recommended.

Indexed Annuities

The term “annuity” derives from a Latin term meaning “annual” and generally refers to any circumstance where principal and interest are liquidated through a series of regular payments made over a period of time. A tax-deferred annuity is an annuity in which taxation of interest or other growth is deferred until it is actually paid.¹



A commercial² tax-deferred annuity is a contract between an insurance company and a contract owner. In a typical situation, the contract owner contributes funds to the annuity. The money put into the contract is then allowed to grow for a period of time. At a future date, the contract may be “annuitized,” when the accumulated funds are paid out, generally through periodic payments made over either a specified period of time or the life of an individual or the joint lives of a couple.

An indexed annuity is a type of annuity that grows at the greater of an annual, guaranteed minimum rate or the return based on a formula related to a specific market index. Annuity contract guarantees are based on the claims-paying ability of the issuing insurance company.

Fixed vs. Indexed Annuities

Two primary annuity types are the fixed and variable annuities. (An indexed annuity is a type of fixed-rated annuity.) Although these annuities share many features in common, the primary difference between them is in the mechanism used to credit earnings to the annuity:

- **Fixed annuities:** Fixed annuities are characterized by a minimum interest rate guaranteed by the issuing insurance company. Typically, a minimum annuity benefit is also guaranteed. With a fixed annuity, the focus is on safety of principal and stable investment returns.

¹ Under federal law, the deferral of income tax on growth inside the contract is available only to natural persons; the tax deferral is generally not permitted if the annuity owner is a non-natural person such as a trust or corporation, unless the owner is an agent for a natural person.

² In comparison, a private annuity is an agreement between individuals, usually exchanging a valuable asset (such as a business) for a lifetime income. The party promising to pay the annuity is someone who is not in the business of issuing annuities.

Indexed Annuities

- **Indexed annuities:** In contrast, indexed annuities (IA) are characterized by a contract return that is the greater of an annual minimum rate (typically 3%) or the return based on a formula related to a specific market index, such as the Standard & Poor's 500 index, reduced by certain expenses. If the chosen index rises sufficiently during a specific period, a greater return is credited to the contract owner's account for that period. If the market index does not rise sufficiently, or even declines, the lower minimum rate is credited. An owner is guaranteed to receive back at least all principal, if an IA contract is held for a minimum period of time, known as the penalty period. The penalty period for some indexed annuity contracts can be quite lengthy.

Understanding Indexed Annuities

Although all indexed annuities share the same objective, contracts can vary greatly. The specific structure of a contract will affect the amount and timing of growth in the contract, as well as its liquidity. Below are definitions of some common IA terminology:

- **Term:** This is the length of time the penalty period lasts and/or the time when the investor has the option to renew. The period is commonly three to seven years.
- **Participation rate:** Also known as the "index rate," the "participation rate" is the percentage increase in the index by which a contract will grow. For example, "75% of the S&P's increase for the calendar year" means that if the S&P 500 index increases 10% for the year, the contract would be credited with 7.5%. This rate is usually less than 100%. The participation rate is subject to change by the insurance company.
- **Administrative fee:** This is also known as an annual fee, spread yield, or expense load. It is a fixed charge subtracted annually by the insurer. This fee ranges from 1.0% to 2.25%.
- **Cap rate:** This is the annual maximum percentage increase allowed. For example, if the chosen market index increases 35%, a contract with a 9.0% cap rate will limit the client's increase to 9.0%. The cap rate is subject to change by the insurance company. Some contracts do not have a cap rate.
- **Floor:** This is the minimum guaranteed amount credited to the contract, typically in the three to four percent range. The investor will receive this minimum amount only if the IA is held for a specified, minimum period of time.

Indexed Annuities

- **Reference (contract) value:** This is the amount the investor is entitled to, i.e., the greater of the current account value less any remaining surrender charges.
- **Anniversary date:** This is the beginning of the term used to measure the growth in a contract.
- **Index credit period:** Amounts are credited to a contract at specific points in time. The three most common period methodologies used to determine the credited amount are as follows.
 - **Annual reset:** This measures the change in the market index over a one-year period.
 - **Point-to-point:** While similar to annual reset, the period used is usually five years.
 - **Annual high watermark with look back:** While similar to point-to point, the highest annual anniversary value¹ is used to determine the gain instead, i.e., the largest number at the end of any of the five years.
- **Averaging:** Some indexed annuities will determine any increased contract value based on an average of the monthly changes in the market index, measured over a specified period.

Other Issues

Other issues to keep in mind include the following:

- **Guaranteed death benefit:** Some contracts offer, as an optional feature, a guaranteed death benefit. If an annuitant dies before annuity payments begin, the contract will pay the named beneficiary the greater of the investment in the contract (less any withdrawals) or the contract value on the date of death.
- **Contract fees and charges:** Although there is typically no commission charged when an indexed annuity is purchased, these contracts are subject to a number of fees and charges. These include administrative and mortality risk charges to cover the insurer's basic expenses as well as the cost of any guaranteed death benefit provisions. Surrender charges may also be imposed if withdrawals in excess of a certain amount are made or if the contract is surrendered. Surrender charges can range from 0 to 15% and typically decline over time. Payment of a surrender charge may result in a redemption less than the principal amount invested.

¹ For example, the credited amount might be the largest number at the end of any of the five years.

Taxation of Annuity Payments

The tax treatment of payments made from an annuity will vary, depending on where in the life cycle of the annuity the payments are made. In general, the following rules apply:¹

- **Before annuitization:** Funds withdrawn from an annuity contract prior to annuitization (i.e., the beginning of regular payments) are considered to be made first from interest or other growth.² These earnings are taxable as ordinary income. If the annuity owner is under age 59½ at the time a withdrawal is made, the earnings are also generally subject to a 10% federal tax penalty.³ If earnings are completely withdrawn and payments are then made from the owner's initial investment, the withdrawal is treated as a tax-free recovery of capital.

Changes to the annuity contract, including loans, collateral assignments, and ownership changes may also result in income tax consequences.

- **After annuitization:** Regular annuity payments are treated as being composed of part earnings and part return of capital. The earnings portion is taxable as ordinary income. Once the owner has completely recovered his or her investment in the contract, all remaining payments are fully taxable as ordinary income. Income amounts paid before the owner attains the age 59½ are generally subject to a 10% federal tax penalty, unless the annuitization is made for the owner's life or life expectancy.
- **Estate taxes:** Any amount payable to a beneficiary under an annuity contract by reason of an owner's death is includable in the owner's gross estate. If an annuitant/owner receiving payments under a life-only annuity contract dies, no further payments are due and nothing is includable in his or her estate.
- **Income in respect of a decedent:** Payments are still subject to income tax when received by the beneficiary. However, the beneficiary may also be eligible for a federal income tax deduction for a portion of the estate tax paid.

¹ Based on federal law. State law may vary.

² Withdrawals from annuity contracts entered into before August 14, 1982 were treated as first coming from principal, to the extent of premiums contributed before August 14, 1982.

³ Two exceptions to the 10% penalty involve the death or disability of the contract owner.

Seek Professional Guidance

Tax-deferred annuities are primarily intended to be long-term investments. Because of this and the complexity of many annuity contracts, an individual considering the purchase of a tax-deferred annuity should carefully consider all aspects before entering into the contract. The guidance of appropriate tax, legal, and other financial professionals is highly recommended.

Mutual Funds

Individuals with excess dollars to put to work in some form of investment have an often-bewildering range of choices. An investor may decide to tackle the financial markets alone, and buy and sell investments directly, in his or her own name. A second option is to invest indirectly, using an investment medium known as a mutual fund.



What Is a Mutual Fund?

A mutual fund is an organization designed to pool the assets of many investors, to achieve a common purpose. The money raised is then invested in accordance with pre-defined goals. This mutual effort of a number of investors provides benefits that an individual, working alone, might not be able to receive.

- **Professional management:** Trained, experienced investment professionals provide the research, selection and monitoring skills needed to manage an investment portfolio.
- **Diversification:** Owning shares in a mutual fund allows an investor to participate in a diversified portfolio. Instead of placing all the eggs in one basket, diversification spreads the risk over many different securities.
- **Convenience:** Mutual funds offer many conveniences. Investment programs can be started with relatively small amounts of money. Dividends and other gains can be automatically reinvested. Many funds offer features to automate both contributions and withdrawals. Regular fund statements ease bookkeeping by tracking an investor's purchases, withdrawals and reinvestments, as well as providing tax information.

Types of Mutual Funds

Mutual funds are classified according to their structure and investment objectives:

- **Open-end mutual funds:** Mutual funds that issue as many shares as the public wishes to buy are called open-end mutual funds. When a shareholder wants to sell, open-end funds redeem all shares tendered.

- **Closed-end mutual funds:** Closed-end mutual funds are funds that have a fixed number of shares. Unlike shares in an open-end fund, where the fund itself sells and redeems all shares, the shares in a closed-end fund are traded on public exchanges.
- **Investment objective:** Mutual funds are also classified according to the investment objective of the fund. Examples of mutual fund investment goals include:
 - **Money market funds:** These funds invest in a variety of short-term, money market debt, such as Treasury bills or commercial paper.
 - **Growth funds:** Have an emphasis on long-term capital growth, usually through investment in common stock.
 - **Income funds:** Focus on providing high, current income, using bonds and other income producing securities.
 - **Balanced funds:** Strive to provide income and long-term capital gain. Both stocks and bonds are used.

Key Mutual Fund Concepts

- **Prospectus:** The Securities and Exchange Commission (SEC) requires that every prospective investor in an open-end mutual fund be provided a document called a prospectus. The prospectus contains valuable information concerning how the fund works, the fund's goals and risks, its history, and any expenses or charges involved. The prospectus is intended to provide the facts necessary for an investor to make an informed investment decision and should be reviewed carefully. For closed-end mutual funds, a prospectus is issued only when shares are first offered to the public.
- **Net asset value:** At the end of each business day, the managers of a fund will add up the market value of all securities held by the fund. The total market value is then divided by the number of outstanding shares in the fund. The result is the Net Asset Value (NAV) per share. For open-end funds, NAV is used to calculate the price per share for both purchases and sales. For closed-end funds, NAV measures only the value of the securities in the fund; the market price of shares in the fund can be higher or lower than NAV.

- **Load vs. no-load:** The term “load” traditionally refers to a commission paid to purchase shares in an open-end mutual fund. Funds which are no load do not charge a commission to purchase their shares. Even though a fund is no load, other fees or expenses may apply. Investors are encouraged to consult a fund’s prospectus for a discussion of the fees and expenses charged by a fund.
- **Offering price:** This is the price charged to purchase shares in an open-end fund. For a load fund, it is the net asset value (NAV) plus the commission charged. For a no-load fund, offering price and NAV are the same.

Possible Risks

The risks involved in owning shares in a mutual fund are the same as those involved in directly owning the underlying securities. However, these risks are generally “spread” by the fund manager over a range of securities, to help minimize the impact of any one risk on the fund’s performance as a whole.

- **Mutual funds holding stock investments.**
 - **Market risk:** The value of stock can fluctuate up and down. If stock purchased at a higher price is sold when the market is down, a loss will result.
- **Mutual funds holding bonds or other debt instruments.**
 - **Market risk:** The value of a bond will fluctuate, usually in response to changes in interest rates. If a bond is sold before it matures, the investor may receive more or less than originally paid.
 - **Default risk:** The possibility that the issuer of a bond or other debt will not pay either principal or interest.
 - **Inflation risk:** As fixed-return investments, bonds are subject to inflation risk; over time, the dollars received have less purchasing power.

Dollar Cost Averaging

Many investors look to the stock market for capital growth, investing in individual stocks or mutual funds. Historically, the stock market has charted a long-term upward trend. In the short run, however, daily fluctuations in prices can make it difficult to decide when to buy.

Rather than trying to time the market, and making a single purchase, many investors use a method called dollar cost averaging. Using dollar cost averaging, an investor buys the same stock or mutual fund at regular intervals; e.g., monthly or quarterly, and with a fixed amount of investment dollars; e.g., \$100 per month.

When the selected stock or mutual fund declines in value, the investor's \$100 will buy a greater number of shares. When the market price increases, the investor's \$100 will buy fewer shares. Over a period of time, as market prices fluctuate, the average cost per share to the investor will be less than the average price per share.

For example, assume that a person invests \$100 per month for 12 months in XYZ mutual fund.

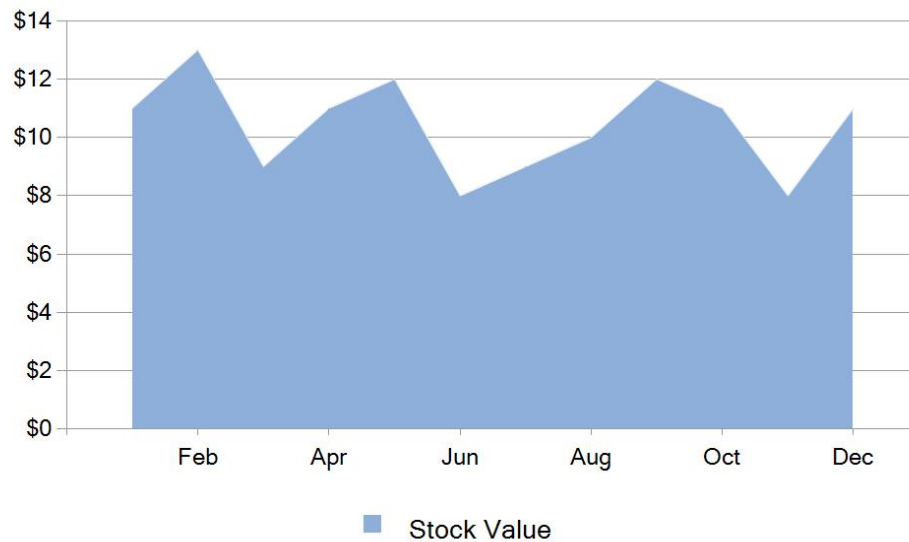
Month	Dollars Invested	Price per Share	Number of Shares Purchased
Jan	\$100	\$11.00	9.09
Feb	\$100	\$13.00	7.69
Mar	\$100	\$9.00	11.11
Apr	\$100	\$11.00	9.09
May	\$100	\$12.00	8.33
Jun	\$100	\$8.00	12.50
July	\$100	\$9.00	11.11
Aug	\$100	\$10.00	10.00
Sept	\$100	\$12.00	8.33
Oct	\$100	\$11.00	9.09
Nov	\$100	\$8.00	12.50
Dec	\$100	\$11.00	9.09
Total	\$1,200	\$125.00	117.94

The average price per share: $(\$125.00 / 12) = \10.42

The average cost per share: $(\$1,200 / 117.94) = \10.17

Dollar Cost Averaging

Graphically, the results of dollar cost averaging in our example would look like this.



Notes:

- Investments must be regular and the same amount each time. If the investor discontinues the plan when the market value is less than the cost of the shares he or she will obviously lose money.
- The investor must be willing and able to invest during the low price levels.
- Dollar cost averaging cannot assure a profit and does not protect the investor in a steadily declining market.

Disclosure Notice

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