

RETIREMENT ISSUES

11



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Please Note. Corrections for all chapters and the *2005 National Income Tax Workbook Update* are available at <http://www.taxworkbook.com> (User Name: class2005 Password: class2005).

ISSUE 1: CREDIT FOR RETIREMENT SAVINGS This issue explains the individual income tax credit for qualified retirement savings contributions, including the qualifications for it and its calculation.

The I.R.C. §25B credit for qualified retirement savings contributions was enacted to encourage lower income taxpayers to save for their retirement through contributions made to either employer plans or individual retirement accounts (IRAs). The credit is a percentage of qualified contributions, based on adjusted gross income (AGI) and filing status. In theory, the

credit can be as much as \$1,000 for single filers and \$2,000 for a married couple filing jointly. Specific qualifications must be met, and the amount of contributions eligible for the credit is reduced by certain distributions. The maximum contribution eligible for this credit is \$2,000 per person.

What Is a Qualified Contribution?

The first step toward the credit is making an eligible contribution to a retirement plan. This can be either a direct contribution to a traditional or Roth IRA, or an elective deferral to an employer plan. Eligible plans are I.R.C. §401(k) plans, I.R.C. §403(b) annuities, I.R.C. §457 governmental plans, SIMPLE IRAs, salary reduction SEPs (SARSEPs), and the federal employees' Thrift Savings Plan. Contributions to 501(c)(18) plans are also qualified, as are voluntary after-tax contributions to employer plans. A contribution is voluntary if it not required as a condition of employment (Announcement 2001-106, 2001-2 CB 416).

Testing Period

Because the goal is long-term savings, distributions taken from retirement plans during the testing period reduce the contributory amount that is eligible for the credit. The testing period covers the tax year for which the credit is claimed, plus periods before and after it. It begins 2 years before the credit year, and it ends on the due date of the return, including extensions, for the year of the credit.

Example 11.1 Testing Period Dates

Roberta and Jim timely filed a 2005 joint federal income tax return by the due date without an extension. On November 30, 2005, Roberta made a \$2,000 contribution to her IRA. Her testing period for the retirement savings credit begins on January 1, 2003, and ends April 17, 2006. (If they obtained the automatic 6-month extension of time to file, until October 16, 2006, her testing period would not end until October 16.)

Distributions

Distributions received during the testing period generally offset a qualified contribution, whether or not the distribution is taxable. If a joint return is filed for both the credit and distribution years, distributions taken by either spouse during the testing period will offset allowable contributions by both spouses when calculating the credit.

Certain types of distributions are disregarded and do not reduce the eligible contribution. They are

- Trustee-to-trustee transfers or rollover distributions that are not included in income
- Withdrawals of current year contribution (plus any earnings) before the due date of the return, including extensions, for which no deduction is taken
- Employer plan loans treated as distributions
- Distributions of excess contributions and deferrals, including the income attributed to them
- Distributions of dividends on stock held by an employee stock ownership plan (ESOP)

Example 11.2 Effect of Spouse's Distribution

Jim, from Example 11.1, withdrew \$800 from his IRA in May 2004, and he did not contribute to his IRA in 2005. Roberta did not take any distributions from her account. Because they file a joint return, Jim's \$800 distribution reduces Roberta's eligible contribution from \$2,000 to \$1,200.

Example 11.3 Distributions Exceeding Contributions

Roger contributed \$2,000 to his IRA in 2005. In February 2003, he bought his first house and used \$8,000 from his IRA for a down payment and closing costs. Although the 2003 distribution was not subject to the early distribution penalty, it was still taxable and was taken during the testing period for a 2005 credit. Because the 2003 distribution exceeds his 2005 contribution, Roger does not have an eligible contribution in 2005. The 2003 withdrawal is not included in the testing period for 2006, so his IRA contribution for 2006 may be eligible for the credit.

Who Is an Eligible Taxpayer?

A taxpayer's eligibility for the credit is based upon a combination of filing status and modified adjusted gross income (AGI). Modified AGI is AGI increased by any exclusion or deduction

claimed for foreign earned income, foreign housing costs, income for bona fide residents of American Samoa, and income from Puerto Rico. For most taxpayers, the amount shown on their individual income tax returns as AGI is the correct figure.

AGI Limits

The AGI limit is \$50,000 for a married couple filing jointly, \$37,500 for a head of household, and \$25,000 for a taxpayer who is single, married filing separately, or a qualifying widow(er). A taxpayer with modified AGI exceeding these amounts does not qualify for the credit.



Observation—Married Filing Separately. In contrast to many personal credits, the retirement savings credit is available to married persons filing separate returns.

Automatic Disqualifiers

Three categories of people are automatically disqualified and cannot claim the retirement savings credit:

- Anyone who is not 18 by the end of the tax year
- Full-time students (for some part of at least 5 months during the year)
- Anyone claimed as a dependent on another person's return

How Is the Credit Figured?

Form 8880, Credit for Qualified Retirement Savings Contributions, is used to calculate the credit. The credit percentage is 10%, 20%, or 50%, based on a combination of filing status and income, as shown in Figure 11.1.

FIGURE 11.1 Retirement Savings Credit Rates

Credit Rate	MFJ Income	HoH Income	Single/MFS Income
50%	Up to \$30,000	Up to \$22,500	Up to \$15,000
20%	Over \$30,000–\$32,500	Over \$22,500–\$24,375	Over \$15,000–\$16,250
10%	Over \$32,500–\$50,000	Over \$24,370–\$37,500	Over \$16,250–\$25,000
0%	Over \$50,000	Over \$37,500	Over \$25,000

Example 11.4 Figuring the Credit

Matthew, age 21, and Laura, age 22, file a joint return with an AGI of \$30,000. Neither of them is a full-time student. Matthew contributed \$500 to his employer's retirement plan, and Laura contributed \$300 to hers, for a total contribution of \$800. This was their first year of participation in an eligible plan, so they have no distributions. They are entitled to the full 50% credit based on their contributions, which totals \$400. If their AGI had been \$1 more, their credit would have dropped to \$160 (20% of \$800).

Nonrefundable Credit

The tax benefit of the retirement savings credit is further limited by tax liability because it is not a refundable credit. Other credits taken for foreign taxes, child and dependent care expenses, the elderly and disabled, and education expenses reduce the tax liability before the retirement savings credit is applied.

Example 11.5 Credit Limited to Tax

Bonnie has tax-exempt military pay because she was stationed in Iraq and a \$9,500 AGI. She contributed \$2,000 to the Federal Thrift Savings Plan. After she subtracts her \$5,000 standard deduction for a single person and her \$3,200 personal exemption deduction, her taxable income is \$1,300, and her tax is \$131. Her tenta-

tive retirement savings credit is \$1,000 (50% of her \$2,000 contribution), but she can use it only to offset the \$131 tax.

Questions and Answers

Question 1. How does the credit affect the deductibility of the contribution?

Answer 1. A double benefit is allowed. Deductible contributions are still deductible, and elective deferrals are still not reported in income, even if the credit is taken. For example, if an unmarried taxpayer whose only income is \$20,000 of wages contributes \$3,000 to a traditional IRA, he or she is entitled to a \$200 credit (10% of the \$2,000 limit for the credit), and will still get a \$3,000 deduction from gross income. The IRA contribution reduces AGI, potentially allowing a larger amount of credit. In essence, the contribution counts twice, both for the deduction and for the credit.

Question 2. How many taxpayers actually qualify for the maximum \$1,000 credit for singles or \$2,000 for married filing jointly?

Answer 2. None. Because of the tax liability limitation, it is mathematically impossible to get the full credit. The following illustrations utilize the 2005 tax tables.

- If a married couple has a \$30,000 AGI and makes the maximum \$4,000 contribution, their tentative credit is \$2,000 (50% of the \$4,000). They will have a taxable income of \$13,600 (after subtracting \$6,400 for two exemptions and \$10,000 for the standard deduction). Their tax will be \$1,363, so the maximum credit allowed is \$1,363.
- The credit for a person filing as head of household with an AGI of \$22,500 (the maximum for the 50% credit) and not claiming any dependents is limited to the potential maximum tax liability of \$1,281 (based on taxable income of \$12,000, after subtracting \$3,200 for one exemption and \$7,300 for the standard deduction).
- The credit for a single filer with an AGI of \$15,000 (the maximum for the 50% credit) is limited to the potential maximum tax liability of \$683 (based on taxable income of \$6,800, after subtracting \$3,200 for one exemption and \$5,000 for the standard deduction).

ISSUE 2: TAXATION OF DISTRIBUTIONS This issue explains the rules for determining the taxation of a distribution from retirement plans, including employer plans and IRAs.

At some point, distributions must be made from a retirement plan. Whether the distributions are taxable depends upon the type of account and on the amount of any after-tax contributions made by the owner or employee.

Distributions made before age 59½ are considered early distributions that are potentially subject to a 10% penalty tax. Exceptions to the penalty are **not** exceptions to taxability of the distribution.

Distributions may be fully or partially nontaxable to the extent that they represent contributions for which no previous tax benefit was received. This can include distributions from Roth IRAs, nondeductible traditional IRAs, and

employer plans that contain after-tax contributions.

Early Distributions

The definition of early is uncomplicated—it is a withdrawal from a retirement plan before the employee (or IRA owner) has reached age 59½. The I.R.C. §72(t) penalty tax for an early distribution is 10% of the taxable amount of the distribution. Different exceptions to the penalty tax apply to employer plans and IRAs.

Employer Plans

For employer plans, the 10% penalty tax does not apply to distributions made in the following instances:

- Because of the death or disability of the participant
- As part of a series of substantially equal periodic payments
- After employment ends, if the participant was at least 55 years of age in the year of separation
- To an alternate payee if required by a qualified domestic relations order (QDRO)
- To the extent that the participant incurred deductible medical expenses exceeding 7.5% of AGI, regardless of whether the participant actually itemizes deductions on Schedule A (Form 1040)
- Dividends distributed from employee stock ownership plans (ESOPs)
- Because of an IRS levy on the plan

IRAs

For IRAs, the 10% penalty tax does not apply to distributions made in the following instances:

- Because of the death or disability of the owner
- As part of a series of substantially equal periodic payments
- To the extent that the participant incurs deductible medical expenses (applying the same rules as for employer plans)
- To cover the cost of medical insurance while unemployed (see Practitioner Note later)
- To the extent of qualified higher education expenses incurred for the owner, spouse, children, or grandchildren
- To buy, build, or remodel a first home for the owner, spouse, children, grandchildren, parents, or grandparents, within the \$10,000 lifetime limit (a first-time homebuyer is defined as someone who had no present home ownership interest within a 2-year period prior to the new acquisition)
- Because of an IRS levy against the IRA



Practitioner Note—Unemployment Restrictions. The IRA owner must be unemployed and have received 12 consecutive weeks of unemployment compensation, the distribution must be made in the year of unemployment compensation or the following year, and the distribution must be received no later than 60 days after the owner is reemployed. A self-employed person may qualify if ineligibility for unemployment compensation was solely because the person had been self-employed.

Example 11.6 Early Distribution Penalty

Marilyn, age 50, is married to Matt, age 52. After 25 years of living in apartments, they have decided to buy their first home. Marilyn has \$100,000 in an IRA that has no tax basis, and Matt's 401(k) account is currently valued at \$125,000. The new house will cost \$125,000, and they are considering taking half of the cost from each retirement plan to avoid having a mortgage.

This would be a poor financial decision for many reasons:

- Their retirement money would then be tied up in a nonliquid asset.
- If the money is withdrawn, the \$125,000 will be fully taxable.
- The maximum amount that can be taken out of an IRA without penalty for purposes of buying a personal residence is \$10,000, and there is no equivalent exception to the penalty tax for an employer plan distribution.
 - Matt's \$62,500 withdrawal will be subject to the 10% penalty tax.
 - \$52,500 of Marilyn's \$62,500 will be subject to the 10% penalty tax.

If funds are needed for a down payment and closing costs, a \$10,000 distribution from Marilyn's IRA could be taken without penalty. Income tax would be due on only \$10,000.

**Practitioner Note—SIMPLE**

Distributions. A 25% early distribution penalty applies to withdrawals from SIMPLE IRAs during the first 2 years of participation if the account owner is under age 59½. After 2 years, the penalty drops to the same 10% level that is applicable to other plans.

If an early distribution penalty applies, Form 1040, U.S. Individual Income Tax Return, must be filed, instead of one of the shorter forms. Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, also may be required.

Tax Free Distributions

The prevailing rule is that retirement plan distributions are taxable. There are three exceptions to this rule, but those exceptions require additional calculations.

Roth IRA

A *qualified* distribution from a Roth IRA is a tax-free distribution. To be qualified, one must satisfy a 5-year test, and the recipient must meet one of the following criteria:

- Be age 59½ or older
- Be disabled
- Be paying up to \$10,000 in qualified first-time homeowner costs
- Be a beneficiary of a decedent

5-Year Test

A Roth IRA distribution is not a qualified distribution if it is taken before the end of a 5-year nonexclusion period [I.R.C. §408A(d)(2)(B)]. For calendar-year taxpayers, the 5-year period begins January 1 of the first tax year *for* which a contribution is made, and it ends on December 31 of the fourth succeeding year. In reality, it can be less than 4 full years.

Example 11.7 5-Year Nonexclusion Period

Wilma made her first Roth IRA contribution in April 2001, designating it as a contribution for 2000. Her 5-year nonexclusion period ended on December 31, 2004. Any distribution she takes in 2005 or later is totally tax-free, if she is also at least 59½ years of age.

**Practitioner Note—Distributions to**

Beneficiaries. If a Roth IRA owner dies before meeting the 5-year test, a beneficiary can fulfill the 5-year requirement by waiting to take a distribution until the original 5-year nonexclusion period ends. Generally, the entire balance of a Roth IRA must be distributed to a non-spouse beneficiary by the end of the fifth year after the year of death. Waiting until after the decedent's 5-year period is met enables the beneficiary to withdraw the entire balance tax-free.

As with traditional IRAs, being age 59½ automatically qualifies a person to make a penalty-free withdrawal from a Roth IRA. Taxable distributions made to an owner under 59½, however, are subject to the penalty tax if no other exception to the penalty is met.

Ordering Rules

Despite the 5-year test, the basis ordering rules make it possible to withdraw funds from a Roth IRA in an earlier year without owing any tax. Distributions are deemed to be made in a specific sequence: first from regular contributions, then from conversion contributions, and finally from earnings. Until distributions exceed basis (contributions), the 5-year test generally is not applicable.

Example 11.8 Premature Roth Distribution

Cheryl, age 40, opened a Roth IRA in April 2004, designating a \$2,000 contribution for 2003. In December 2004, she contributed another \$2,000 for the 2004 year. At the beginning of 2005, her account balance was \$4,080, including \$80 in earnings. Early in 2005 she withdrew \$1,000 to pay some bills.

Did she meet the 5-year rule? No. Is the distribution taxable? No. Because her distribution was less than her contributions, the distribution

is tax-free, and it does not matter whether she is age 59½ or whether she owned the account for more than 5 years. There is no penalty because there is no taxable income. Her basis in the Roth is reduced to \$3,000.

Conversions

The rules are somewhat different if the client converted a traditional IRA to a Roth IRA. At the time of the conversion, income tax was paid on the converted amount to the extent that it exceeded any basis in the traditional IRA. But the early withdrawal tax did not apply because the funds remained in a retirement account.

To prevent circumvention of the early distribution penalty through a conversion transaction followed by a withdrawal, a separate 5-year non-exclusion period is figured for each conversion solely for purposes of the early distribution penalty tax. This 5-year period begins the year the conversion was actually made. A distribution attributable to the conversion amount is subject to the 10% early withdrawal penalty if it is made during the 5-year period beginning with the conversion year, even though the distribution itself is not included in income.

Example 11.9 Conversion Distributions

Bruce, age 45, converted his traditional IRA to a Roth in 2003. Because he had previously deducted all of his contributions, he paid tax on the full \$52,000 value. He then made \$3,000 contributions to a new Roth account in both 2004 and 2005. In December 2005, he withdrew \$10,000 to purchase a new car. The first \$6,000 reduces the balance of his regular contributions in the new account to zero. The remaining \$4,000 comes out of his conversion amount. None of the distribution is included in income, but because Bruce has not met the 5-year rule and does not meet any exception to the I.R.C. §72(t) tax, he owes the 10% early distribution penalty tax on the \$4,000.

Nondeductible IRAs

A distribution from a traditional IRA is partially nontaxable if the owner ever made a nondeductible contribution. In calculating the tax-free por-

tion, the balances in all traditional IRAs (deductible and nondeductible) are combined. Form 8606, Nondeductible IRAs, is required in the year a nondeductible contribution is made and in the year of a distribution if a nondeductible contribution was ever made.

Steps to Determine Taxable Portion of IRA Distribution

1. Combine all IRA withdrawals from all accounts
2. Calculate the basis (the total amount of nondeductible contributions minus any prior tax-free withdrawals) in all traditional IRAs
3. Add the IRA balances at year end to the amounts withdrawn in the current year
4. Tax-free percentage: Divide Step 2 by Step 3.
5. Tax-free withdrawal: Multiply Step 4 times Step 1
6. Taxable withdrawal: Subtract Step 5 from Step 1

Example 11.10 Determining Partially Tax-Free Withdrawals

Penny withdrew \$8,000 from her IRA in 2005. The account contained \$30,000 in deductible contributions and \$15,000 in nondeductible ones, plus earnings. This was her first distribution. The value of the account at the end of 2005 is \$70,000. Using the steps shown above, the taxable portion of Penny's withdrawal is \$6,462. If Penny is not 59½ or does not meet one of the exceptions, she will also owe a 10% penalty tax of \$646.

1. IRA withdrawal: \$8,000
2. Nondeductible contributions: \$15,000
3. IRA balance plus withdrawal: \$78,000
(\$70,000 plus \$8,000)
4. Tax-free percentage: 19.23%
(\$15,000 divided by \$78,000)
5. Tax-free withdrawal: \$1,538
(\$8,000 times 19.23%)
6. Taxable withdrawal: \$6,462
(\$8,000 minus \$1,538)

Employee Contributions to Employer Plans

Employer retirement plan contributions may be made in several ways. Sometimes all contributions are made by the employer or through salary deferrals, so that all of the distributions are taxable. But if an employee makes after-tax contributions to a plan, he or she has a basis in the plan that can be recovered tax-free over a period of years as distributions are made.

For periodic distributions, the employee must follow the I.R.C. §72(d) rules that are explained in Publication 575, Pension and Annuity Income. Use of the Simplified Method is mandatory for periodic distributions from qualified plans when the participant is under age 75 or is entitled to less than 5 years of guaranteed payments. A worksheet for calculating the tax-

able amount of a distribution can be found in Publication 575 and in the Form 1040 instructions. It must be completed each year to track the cost recovery.

The Simplified Method divides the total after-tax contributions to the plan by a factor based on the participant's age at the time payments begin (or the combined ages of the participant and a survivor, if the survivor will receive a life annuity). It then calculates the taxable amount for the year based on the number of months that year for which payments were received, and the total amount of payments for the year. The required charts are shown in Figure 11.2, and they are also located on the bottom of the worksheet. Table 1 is used if there is no lifetime survivor annuity. Table 2 is used for a joint and survivor annuity.

FIGURE 11.2 Simplified Method Tables

Table 1: For Plans that Do Not Use Table 2		
AND your annuity starting date was—		
IF the age at annuity starting date was	before November 19, 1996, enter on line 3...	after November 18, 1995, enter on line 3...
55 or under	300	360
56–60	260	310
61–65	240	260
66–70	170	210
71 or older	120	160

Table 2: For Plans with a Starting Date after 1997 and Payments Are for the Joint Lives of the Employee and a Beneficiary	
IF the combined ages at annuity starting date were...	THEN enter on line 3...
110 or under	410
111–120	360
121–130	310
131–140	260
141 or older	210

Example 11.11 Simplified Method

Carol, age 66 and single, retired in February 2005 and is receiving a \$1,000 monthly pension from her employer plan. In 2005, her pension payments totaled \$10,000, and her investment in the plan is \$20,000. Because Carol was 66 when she began receiving the pension in 2005, she

uses 210 from the third column of Table 1 as her divisor. Her monthly tax-free cost recovery is \$95.24 ($\$20,000 \div 210$).

Each of Carol's \$1,000 monthly payments thus includes a taxable amount of \$905 and a tax-free cost recovery of \$95. For 2005, Carol must report \$9,050 in taxable income from her

pension. The \$95 monthly exclusion will not change, even if Carol receives a cost-of-living increase in the pension payment amount in future years. Each annual exclusion amount reduces Carol's \$20,000 contribution. If she lives longer than 210 months (17.5 years) after beginning to draw her pension, the distributions will become fully taxable.

If Carol had established a joint and survivor annuity when she retired, she would use Table 2, adding her beneficiary's age to her own, to determine how much of each pension payment is taxable.



Practitioner Note—Nonperiodic

Distributions. If less than the entire balance is withdrawn from a qualified plan in a nonperiodic distribution before the annuity starting date, the tax-free portion of the distribution is determined by dividing the basis by the account balance and multiplying that result by the distribution. If it is taken after the annuity starting date, it is fully taxable unless it reduces subsequent annuity payments.

Other Types of Distributions

Retirement savings can be accessed by means other than just annuities and total distributions. The funds received may or may not be taxable, depending upon the circumstances.

Loans

A fundamental income tax principle is that loans are not income. Borrowing from a retirement plan is an option for only some employer plans. Loans are not permitted from IRAs, including SEP and SIMPLE IRAs. If an employer plan permits loans, the employee needs to be aware that a nontaxable loan can turn into a taxable distribution if it is not handled correctly. At the time a loan is made, it must

1. Require repayment within 5 years, unless it is used to purchase a principal residence

2. Not exceed the lesser of \$50,000 or half the employee's vested benefit, when added to any other plan loans to the employee
3. Require substantially level payments at least quarterly over the life of the loan

Failure to make the required payments results in the outstanding balance of the loan being treated as a distribution.

Example 11.12 Borrowing from an Employer Plan

Dwight, age 55, has worked at XYZ Company for 20 years, and he has \$200,000 in his I.R.C. §401(k) plan. In 2005, he committed to a \$40,000 contribution to his church. Because he is fully vested in the plan, he qualifies to borrow the maximum of \$50,000 to be repaid over a period not exceeding 5 years. If Dwight leaves XYZ before the loan is fully repaid, the remaining balance becomes a taxable distribution to him, subject to the early distribution penalty. However, Dwight would qualify for the penalty exception for an employee severing his employment after age 55.

Hardship Distributions

Although hardship distributions are permitted by law, not all employer plans offer them. To qualify, the employee must have an *immediate and dire financial need*. A hardship option must be the employee's final option for withdrawing the funds, after first taking any other distributions or nontaxable loans that the plan offers. Only the employee's elective contributions may be withdrawn; any earnings in the account are not accessible through a hardship distribution.

New final regulations (T.D. 9169) expanded the list of expenses that may qualify for a hardship distribution. Such expenses now include medical expenses for the employee, spouse, and dependents, the cost of purchasing a principal residence (not mortgage payments), postsecondary education expenses, payments to prevent eviction from or foreclosure on a principal residence, burial or funeral expenses for a parent, spouse, child, or dependent, and costs of repairing casualty loss damage to a principal residence [Treas. Reg. §1.401(k)-1(d)(3)].



Planning Pointer—Hardship Distributions are Taxable. Hardship distributions are taxable and subject to the early distribution penalty. When calculating the amount to be withdrawn, federal, state, and local income and penalty taxes can be included in the distribution.

Even if a hardship distribution could be replaced within 60 days, it cannot be rolled over into another type of retirement plan. Any employee receiving a hardship distribution also is penalized by not being allowed to make elective or after-tax contributions to the retirement plan for 6 months after the distribution.

Example 11.13 Hardship Distribution

Rodney's daughter Alexa needed a liver transplant, and Rodney (age 42) qualified to take a \$100,000 hardship distribution from his I.R.C. §401(k) plan in February 2005. In March 2005, he won the state lottery, which more than covered all the medical expenses. Rodney cannot roll over the \$100,000 (as discussed in the next section) to reduce his tax. He owes income taxes and the early distribution penalty, because with the lottery winnings, the medical expense does not exceed 7.5% of his gross income.



Observation—Last Resort. Given the extremely negative consequences of hardship distributions, they should be used only as a last resort.

Rollovers

Rollovers can generally be made from one type of tax-deferred retirement account to another without any tax consequence. A direct rollover between trustees requires no withholding and incurs no tax. If a qualifying distribution is received by the taxpayer, there is a 60-day period

for completing a personal rollover by making a contribution to the other plan.

If a distribution that qualifies for rollover is made from an employer plan, 20% federal income tax withholding is required. To avoid having a taxable transaction, the participant must replace the 20% withholding when completing the rollover. The tax that is withheld is reported on Form 1099-R, and it can be claimed as a credit when the participant's federal income tax return is filed.



Practitioner Note—Roth IRA Exception. Because of the difference in treatment of distributions, rollovers to Roth IRAs are restricted to amounts withdrawn from other Roth IRAs. Traditional IRAs can be converted to Roth IRAs, but this is a taxable transaction. Distributions from other types of plans cannot be rolled over to Roth IRAs.

Example 11.14 Rollover as a Loan

Irene, age 58, needs a short-term loan for \$10,000. She decides to withdraw funds from her IRA, use the money for 60 days, and then deposit it into a new IRA account. The 20% withholding does not apply to distributions from IRAs, and she elects not to have the 10% withholding that is offered. If she is unable to redeposit the full \$10,000 within the 60-day window, she will owe both income tax and the 10% early distribution penalty on the amount that is not rolled over.



Practitioner Note—Waiver of 60-Day Deadline. IRS can extend the 60-day period for a rollover if the failure to complete it timely was due to casualty, disaster, or other events beyond the taxpayer's reasonable control [I.R.C. §402(c)(3)]. This requires a private letter ruling request, to which fees apply.

ISSUE 3: REQUIRED MINIMUM DISTRIBUTIONS This issue reviews the timing and calculations for required minimum distributions from tax-deferred retirement accounts.

Most individuals are concerned about having enough financial resources to support their ideal retirement lifestyle, but sometimes there is a retirement account that isn't needed currently for day-to-day living expenses. Can the money remain where it is, untouched, until it is needed, or until it is passed to beneficiaries after the account owner's death? The answer to that question is age-dependent.

First Required Minimum Distribution

Account owners can generally wait until they turn age 70½ to take any money out of their tax deferred retirement accounts. But at that point, a required minimum distribution (RMD) is required to be distributed for each tax year under I.R.C. §§401(a)(9), 403(b)(10), 408(a)(6), 408(b)(3), or 457(d)(2), depending on the type of plan. If a required distribution is not taken, a 50% penalty tax is imposed by I.R.C. §4974.

However, in three circumstances, reaching age 70½ does not trigger an RMD:

- Distributions are not required from a Roth IRA during the owner's lifetime.
- An employee who is still working does not have to begin distributions from his or her current employer's plan until retirement, unless the employee is a 5% owner.
- An individual who is already receiving regular payments from all retirement plans based upon his or her life expectancy is already meeting the RMD requirement.



Practitioner Note—5% Ownership. A 5% owner is an employee who owns (or is considered to own under I.R.C. §318) more than 5% of the employer's stock (by value or voting power) or more than 5% of the capital or profits interest in an unincorporated employer. See Related-Party Issues (Chapter 2) in this book for the attribution rules.

Example 11.15 IRA Requirements

Susan turned 70½ on August 30, 2005. She is still employed by a small business, which does not offer a retirement plan. Her retirement account is a traditional IRA. Susan plans to continue to work for another 5 years. Can she wait until she retires to begin her RMD?

No, Susan must begin taking distributions by her required beginning date, discussed later in this issue. The fact that she is still working relieves her of the RMD requirement for her employer's qualified plan, if one existed, but not from an IRA.



Practitioner Note—SEP and SIMPLE IRAs. Clients whose retirement savings are in either a SEP or a SIMPLE IRA are treated in the same manner as those with traditional IRAs. They must start distributions for the year they turn 70½, even if they continue to work for the employer sponsoring the plan.

Calculation of Required Minimum Distribution

To calculate an RMD for the current year, three pieces of information are required:

- The value of the retirement account as of December 31 of the prior year
- The taxpayer's age as of December 31 of the current year
- The life expectancy tables, included in Appendix C of Publication 590, Individual Retirement Arrangements. The Uniform Lifetime Table III is shown in Figure 11.3

If a spouse is an account beneficiary, the spouse's age as of December 31 of the current year is also needed.

The year-end value of an IRA is reported annually in box 5 of Form 5498.

The distribution periods in the Uniform Lifetime Table are used each year to calculate the amount of the distribution. They decrease with age, so that as a client ages, the RMD may increase if the investment is doing well.

The Uniform Lifetime Table uses the life expectancy of two individuals, with a 10-year age difference. The actual age of the beneficiary, or even whether there is a named beneficiary does not matter. The only exception is when the beneficiary is the owner's spouse, and the spouse is more than 10 years younger than the owner. In that case, the Joint Life and Last Survivor Expectancy Table may be used. It is also in Appendix C of Publication 590.

FIGURE 11.3 Uniform Lifetime Table III

Age	Distribution Period	Age	Distribution Period
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115 and older	1.9

To calculate an RMD for 2005, find the distribution period in the table for the taxpayer's age as of December 31, 2005. Divide the value of the retirement account as of December 31, 2004, by the distribution period. The result is the RMD.

Example 11.16 Calculating the Distribution

Michael reached age 70½ in November 2005. He has three traditional IRA accounts. His wife, who is 67, is the beneficiary of one account, his son, who is 35, is the beneficiary of the second, and his granddaughter, who is 2, is the beneficiary of the third. At the end of 2004 their individual values were: \$125,000, \$98,000, and \$35,000, respectively. What is his required distribution?

Generally, a required distribution must be figured separately for each account. However, because his wife is not more than 10 years younger than Michael, the same distribution period applies for all accounts. Because Michael may take an aggregate distribution from any of his IRAs, he will achieve the same result by computing an aggregate RMD.

1. The total value of the three accounts is \$258,000.
2. Michael will not be 71 until May 2006, so he uses age 70 to determine the distribution period from the uniform table.
3. The distribution period is 27.4.
4. Dividing \$258,000 by 27.4 results in a \$9,416 RMD. The distribution can be divided among the IRAs or taken from just one, as Michael chooses. This is true even though each trustee also supplies Michael with an RMD calculation.

Timing of First Distribution

The year an individual reaches the age of 70½ is the year for which the first RMD becomes due. However, the first RMD can be postponed until April 1 of the following year. Because the first distribution is the only one that can be delayed until the subsequent year, an individual who takes advantage of the first-year delay then must pay tax on two distributions in the next year.

The required amount may be taken in a lump sum or in periodic payments.

Example 11.17 Subsequent Year Calculation

Assume that Michael, in Example 11.16, has other taxable income totaling \$20,000 in both 2005 and 2006. Michael and his wife Elizabeth also receive \$23,000 in social security benefits each year. Without the distribution, their social security benefits are not taxable.

Option 1

If Michael opts to take the \$9,416 IRA distribution in 2005, the additional income will result in \$4,458 of his social security benefits becoming taxable, giving him an includible gross income of \$33,874. Figure 11.4 shows his social security benefit tax worksheet.

FIGURE 11.4 2005 Distribution

1	Total Social Sec	\$23,000
2	1/2 SS	\$11,500
3	Other Income (\$20,000 + \$9,416)	\$29,416
4	Tax Exempt	\$ -
5	Total lines 2, 3, 4	\$40,916
6	Adjustments	\$ -
7	Subtract 6 from 5	\$40,916
8	Less \$32,000 (MFJ)	\$32,000
9	Subtract 8 from 7	\$ 8,916
10	Less \$12,000 (MFJ)	\$12,000
11	Subtract 10 from 9	\$ -
12	Smaller of 9 or 10	\$ 8,916
13	1/2 line 12	\$ 4,458
14	Smaller of 2 or 13	\$ 4,458
15	Line 11 × 85%	\$ -
16	Add 14 and 15	\$ 4,458
17	Line 1 × 85%	\$19,550
18	Smaller of 16 or 17	\$ 4,458

Option 2

If Michael waits until 2006 to take the 2005 RMD, he will also have to take another RMD before the end of 2006. Assume that, after the

distribution for 2005, earnings restored the overall value of the accounts to the same amount as at the end of 2004. Because he is a year older, his factor from the Uniform Lifetime Table changes, and his 2006 required distribution amount is \$9,736 (\$258,000 divided by 26.5). This will make his gross income \$39,152 (\$20,000 + \$9,416 + \$9,736), and his taxable social security benefit will be \$11,654, for total income of \$50,806. Figure 11.5 shows his 2006 social security benefits worksheet.

Assume that Michael and Elizabeth take the standard deduction, including the additional deduction for both of them being over age 65. Figure 11.6 compares the tax consequences of each situation. The 2006 deduction and tax amounts are estimated using 2005 figures. Their tax for 2005 will increase by \$1,430 (\$1,591 minus \$161) if they take the distribution in 2005, and they would expect a similar tax in 2006, for a 2-year total tax of \$3,182. Delaying the 2005 RMD until 2006, and taking two distributions that year, will increase the 2-year total tax to \$4,295, an increase of \$1,113 (\$161 + \$4,134) – (\$1,591 + \$1,591)].

FIGURE 11.5 Delay Until 2006

1 Total Social Sec	\$23,000
2 1/2 SS	\$ 11,500
3 Other Income	\$ 39,152
4 Tax Exempt	\$ –
5 Total lines 2, 3, 4	\$ 50,652
6 Adjustments	\$ –
7 Subtract 6 from 5	\$ 50,652
8 Less \$32,000 (MFJ)	\$ 32,000
9 Subtract 8 from 7	\$ 18,652
10 Less \$12,000 (MFJ)	\$ 12,000
11 Subtract 10 from 9	\$ 6,652
12 Smaller of 9 or 10	\$ 12,000
13 1/2 line 12	\$ 6,000
14 Smaller of 2 or 13	\$ 6,000
15 Line 11 × 85%	\$ 5,654
16 Add 14 and 15	\$ 11,654
17 Line 1 × 85%	\$ 19,550
18 Smaller of 16 or 17	\$ 11,654

FIGURE 11.6 Comparison of Tax

	No Distribution in First Year (2005)	One Distribution in Each Year (2005, 2006)	Two Distributions in Second Year (2006)
Other Income	\$20,000	\$20,000	\$20,000
Distribution	\$ –	\$ 9,416	\$19,152
Taxable SS	\$ –	\$ 4,458	\$11,654
Gross Income	\$20,000	\$33,874	\$50,806
Standard Ded	\$12,000	\$12,000	\$12,000
Exemptions	\$ 6,400	\$ 6,400	\$ 6,400
Taxable Income	\$ 1,600	\$15,474	\$32,406
Tax	\$ 161	\$ 1,591	\$ 4,134



Observation—Employer Plans. The same rules apply in calculating an RMD for a defined-contribution employer plan (explained in the next issue in this chapter). Generally, the trustee of the plan will make the calculation after the employee chooses a distribution method. A separate RMD must be taken from each employer plan.

IRA Information

Ultimately the taxpayer is responsible for taking a required distribution, but Treas. Reg. §1.408-8, Q&A 10, requires IRA trustees to provide RMD information. Box 11 on Form 5498, IRA Contribution Information, must be checked if an RMD is required for the following year. In addition, Notice 2003-3, 2003-1 CB 258, provides that by January 31 each year, the trustee must either

- Furnish a statement to the IRA owner indicating the RMD amount for the IRA and the date by which it must be distributed, or
- Furnish a statement showing that an RMD is required and the date by which it must be distributed and including an offer to calculate, upon request, the RMD amount.

Inherited Retirement Accounts

The balance in either an employer plan or an IRA can be passed to a beneficiary after the death of the owner/employee. How quickly the account must be liquidated depends upon the relationship of the decedent and the beneficiary.

Individual Beneficiary Other than Spouse

An individual beneficiary generally is allowed to take distributions over his or her own life expectancy, using the Single Life Expectancy Table in Publication 590, beginning in the year after the owner's death. The account remains tax-deferred, and the distributions are taxable to the beneficiary when they are received. The table factor for the initial year is based on the beneficiary's age at the end of the year after the year

the account owner died. The factor for succeeding years is reduced by one each year.



Practitioner Note—Beneficiary Older Than Owner. If the owner dies on or after the required beginning date, and the beneficiary is older than the owner, the beneficiary may take distributions over a single-life period based on the owner's age at the time of death.

Example 11.18 Non-Spouse Individual Beneficiary

Mel died the day after his 75th birthday in 2005. The beneficiary of his traditional IRA is his daughter Beckie, who will be 42 by the end of 2006. The RMD for 2005 is based on Mel's age of 75 and the Uniform Life Table III, Appendix C of Publication 590, even if he did not take it before his death. (If it is paid out after his death, it is income to Beckie, who, as the beneficiary, receives it.) Beckie will start taking her own distributions in 2006, using the Single Life Expectancy Table I, Appendix C of Publication 590 to determine her first-year divisor of 41.7. The value of the IRA on December 31, 2005 is \$275,000, so Beckie's RMD is \$6,595 (\$275,000 divided by 41.7). In 2007, she will subtract one from the table factor and divide by 40.7; in subsequent years, she will continue subtracting one each year (39.7, 38.7, 37.7, and so on). Beckie can always choose to take out more than the minimum amount each year, but she cannot take out less, nor can she opt to leave the money in the account untouched.

If Mel was only 65 at the time of his death (he died before his required beginning date), the rules for Beckie's distributions would be the same. Her first required distribution is for 2006 and it must be taken by December 31, 2006.

Multiple Beneficiaries

If a retirement account distribution is to be divided among several beneficiaries, the oldest beneficiary's age is used to determine the factor from the Single Life Expectancy Table, unless that beneficiary is older than the decedent. In that case, the deceased person's age is used.

Surviving Spouse

A surviving spouse who inherits the entire account can transfer ownership to his or her own name. If the ownership is transferred, and the surviving spouse is under age 70½, distributions are not required until the survivor reaches the age of 70½.

The survivor also may opt to leave the account in the decedent's name and not take any distributions from it until the year the deceased spouse would have turned 70½. This can defer taxation for a longer period if the surviving spouse is older than the deceased spouse. It also may be advisable if the surviving spouse is under age 59½, because distributions from the decedent's account could be taken without imposition of the early distribution penalty tax.

Example 11.19 Spouse as Beneficiary

Bob, age 65, is the sole beneficiary of an IRA established by his deceased wife, Barbara, who died in 2005 at age 62. Bob can choose to withdraw all of Barbara's IRA money now and pay the tax; he can transfer it tax-free from her name to his own and begin distributions for the year he reaches age 70½; or he can leave it in her account until 2012, the year Barbara would have been 70½, and then start taking taxable required distributions. Bob can also opt to begin receiving distributions now over his remaining life expectancy. Because he is already over age 59½, but under age 70½, he doesn't have to worry about any kind of penalty in 2005, no matter which option he selects.

Other Beneficiary

If the owner fails to identify a beneficiary, or if the beneficiary is the decedent's estate, a trust, or a charity, the required distribution period depends upon whether the owner died before or after the required beginning date. The required beginning date is April 1 of the year following the year the individual reached age 70½.

The beneficiaries of trusts can be treated as IRA beneficiaries for this rule if the following four requirements are met [Treas. Reg. §1.401(a)(9)-4 Q/A-5(b)]:

1. The trust is a valid trust under state law, or would be but for the fact that there is no corpus.
2. The trust is irrevocable, or will, by its terms, become irrevocable upon the death of the employee.
3. The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable from the trust instrument.
4. Required documentation has been provided to the plan administrator.

Death after Required Beginning Date

If an individual dies after the required beginning date for distributions, and the beneficiary is not an individual, a distribution period is calculated based on his or her age as of the year of death birthday. The Single Life Expectancy Table assumes that an individual will live for a certain number of years. The remaining term of years, reduced by one each year, can be used by a non-individual beneficiary to take annual distributions.

Death before Required Beginning Date

All of the money in the account must be withdrawn within a 5-year period beginning the year after death if the beneficiary is not an individual. There is no option for extended distributions, although the money can be withdrawn in annual amounts over the 5 or 6 years, or in a lump sum at any point.

The 5-year option may be chosen by any beneficiary. A beneficiary who has failed to take required distributions over a life expectancy and who would be subject to the excess accumulation tax, discussed later, may void the penalty by using the 5-year rule.



Practitioner Note—Plan May Require

Shorter Period. As a practical matter, some plans may require that all of the money be withdrawn in 5 years, regardless of who is the beneficiary. In those cases, the plan provision takes precedence. In any event, each withdrawal is taxable to the beneficiary as income in respect of the decedent. If the decedent had a basis in the plan, the beneficiary succeeds to that basis.

Questions and Answers

Question 1. What happens if a client fails to take a required distribution?

Answer 1. A penalty equal to 50% of the amount that should have been withdrawn is imposed by I.R.C. §4974. Because of the reporting requirements for trustees, the IRS is becoming more aware of when distributions are required, and imposition of the penalty is more likely. The penalty is reported on Form 5329. The IRS can consider extenuating circumstances and excuse the penalty if the excess accumula-

tion was due to reasonable error, and the client has taken, or is taking, steps to remedy the insufficient distribution.

Question 2. If the required distributions total \$9,000 for three separate IRAs, how should the client actually take the distribution?

Answer 2. This is a personal choice. It can all be taken from one account, or divided among the three, as long as all three are IRAs (including SEP and SIMPLE IRAs, but not Roth IRAs). The final amount distributed must equal the required amount for the year.

ISSUE 4: CHOICE OF RETIREMENT PLANS This issue includes a brief description of selected types of retirement plans, including their characteristics and requirements, plus examples and figures that illustrate the strengths and weaknesses of each plan.

In 2004, about half of all U.S. workers were covered by some type of employer retirement plan. For medium and large employers (those with 100 or more employees), the participation rate was 67%. But only 37% of the employees of small businesses (those with fewer than 100 employees) were covered, the Bureau of Labor Statistics found during its March 2004 National Compensation Survey.

Owners of small companies that do not have a retirement plan often are not aware of the tax incentives and credits available when a plan is implemented. A comparison of alternatives can assist practitioners in helping their clients choose a retirement plan that will provide targeted retirement benefits at an acceptable cost.

A *qualified plan* is a plan established under the Internal Revenue Code by an employer to provide retirement income for employees. The plan must meet minimum vesting rules, minimum coverage and participation rules, nondiscrimination rules, contribution and benefit limitations, top-heavy rules, and distribution rules in order to be afforded special tax-favored treatment.

A *non-qualified deferred compensation* arrangement is a method for deferring taxation of compensation that is owed to employees or to independent contractors until payment is actually made, so as to avoid the constructive receipt rules. A nonqualified deferred compensation arrangement does not have to meet the strict rules that apply to qualified plans. However, changes contained in the American Jobs Creation Act of 2004 (2004 Jobs Act) placed additional restrictions on non-qualified deferred compensation plans.

Employer-sponsored retirement plans fall into four general categories, ranging from simple to very complex.

Types of Retirement Plans

Qualified retirement plans can provide

- An employer deduction for plan contributions
- A tax-free buildup of plan investments
- Deferral of income tax to the employees until the funds are distributed

IRAs, SEP IRAs, and SIMPLE IRAs

Individual retirement account (IRA) based plans utilize individual bank or custodial accounts for

receiving and investing contributions. These plans are always 100% vested. While they are tax-favored, they are not qualified plans, and they are subject to different rules that generally are simpler. The employer generally may deduct contributions when they are made to the plan.

Defined-Contribution Plans

These plans provide each participant with an account to which contributions, earnings, and forfeitures are credited. Benefits at retirement are based on the amount accumulated in the participant's account. Defined-contribution plans include profit-sharing and money purchase plans. The employer generally may deduct contributions when they are made to the plan.

Defined-Benefit Plans

These plans provide a specified benefit at retirement, based on a formula set forth in the plan document. Factors such as age, years of service, and compensation are taken into account in computing the benefit amount. This type of plan includes pension and cash balance plans. The employer generally may deduct contributions when they are made to the plan.

Nonqualified Deferred Compensation Plans

These plans provide deferral of income for the participant, but the business may not take a deduction until the income is taxable to the participant (I.R.C. §404). Nonqualified plans may set aside funds to accumulate benefits (funded plans), or wait and pay benefits from current assets when they are payable (unfunded plans). Several tax rules affect the timing of the income inclusion for nonqualified plans:

- An employee's rights under a deferred compensation plan are taxable under the *economic benefit doctrine* when the rights are *nonforfeitable* and secured (Treas. Reg. §1.83-1).
- An employee's deferred compensation is taxable under the *constructive receipt doctrine* before it is actually received if the compensation is made available to the employee.
- An arrangement to defer compensation generally is effective to defer tax only if the arrangement is made before the compensation is made available (Rev. Rul. 60-31, 1960-1 CB 174).

- Amounts placed in an escrow account with a depository, or in a revocable trust in which the beneficiary's interest is forfeitable and not transferable, are not taxable until received or otherwise made available.
- Amounts placed in an irrevocable trust that is subject to the employer's general creditors, i.e., a *rabbi trust*, also are not taxable until received or made available [Rev. Proc. 92-64, 1992-2 CB 422].



Law Change—I.R.C. §409A Imposes Restrictions.

The 2004 Jobs Act codified in new I.R.C. §409A several operating rules for nonqualified deferred compensation plans. It defines *substantial risk of forfeiture* under the I.R.C. §83 rules and imposes restrictions on elections, accelerations of benefits, and distributions. See the Prior Legislation chapter in this book for additional information.

Decision-Making Factors

Retirement plan options provide a wide range of benefits, limitations, and requirements. No one plan will be the best in all situations. Each company's situation, goals, and objectives are unique, and they must be considered in determining the preferred plan. No single plan is likely to capture all of the advantages and none of the disadvantages for a specific client. In reality, business owners must choose a plan that meets most of their goals and objectives, while limiting any negative impact. Figure 11.10 on pages 312–313 of this chapter compares the features of several types of plans.

IRA-Based Plans

Traditional IRAs

An IRA is a trust or custodial account created or organized in the U.S. for the exclusive benefit of an individual or his beneficiaries (I.R.C. §408). An annuity or endowment contract also may qualify as an IRA. An employer may contribute directly to an employee's IRA or agree to make

payroll deductions for employee contributions. In either case, the contribution is not excluded from the employee's wages. If the employee qualifies for a deductible IRA contribution, the deduction is taken as an adjustment to income on the employee's individual income tax return.

Employer Pros/Cons

The only responsibility or cost to the employer is to handle the payroll deduction and forward the deducted amounts to the employees' IRA accounts.

Employee Pros/Cons

Many individuals who are eligible to contribute to an IRA do not do so. They wait until the end of the year only to decide that they don't have sufficient funds. Payroll deductions allow individuals to plan ahead and save smaller amounts each pay period. Payroll deduction contributions are tax-deductible by an individual to the same extent as other traditional IRA contributions. If there is no employer plan (and the employee's spouse is not covered by an employer plan), the contributions will be deductible.



Planning Pointer—Deemed IRAs. Since 2003, qualified plans may provide deemed IRA accounts to hold voluntary employee contributions. Contributions to deemed IRA accounts are treated just like contributions to other IRAs [Treas. Reg. §1.408(q)-1].

Simplified Employee Pension (SEP) IRAs

An SEP is an employer plan in which pretax contributions are made to individual retirement accounts or to individual retirement annuities [I.R.C. §408(k)]. The contributions are not included in employee wages; they are not income until the employee withdraws them from the SEP-IRA.

Contributions may be made until the extended due date of the employer's tax return. They are immediately vested, and the employer has no further responsibility for an employee's account. That is handed over to the IRA trustee, and the SEP is treated as an IRA for all other purposes, including distributions.

Employer Pros/Cons

SEPs are easy to set up and maintain, with no government filings required of the employer, and low administrative expenses. Also, SEPs allow the flexibility to vary annual contributions that is needed for businesses with unpredictable cash flow. However, employers must cover all qualifying employees and, in a year when contributions are made, they must be nondiscriminatory. The ease of administering these plans and the discretion permitted to the employer in deciding whether or not to make an annual contribution are features that are especially attractive.

Employee Pros/Cons

SEPs allow immediate ownership. Employees are 100% vested in the plan immediately, and they can make their own investment decisions. However, employees cannot make salary reduction contributions to a new SEP. Before 1997, an employer could establish a salary-reduction SEP (SARSEP). Existing plans are grandfathered, but new ones cannot be set up. Elective deferrals for existing SARSEPs cannot exceed \$14,000 for 2005.

SIMPLE IRAs

SIMPLE IRA plans, which are limited to small employers, replaced the SARSEP option. These accounts are funded primarily through employee salary reduction arrangements.

Employer Pros/Cons

A SIMPLE IRA is easy to establish, has a relatively low cost for the employer, has few administrative requirements, and is not subject to complex nondiscrimination and top-heavy rules. A SIMPLE IRA plan is preferred if the employer wants to share the cost of funding the plan with employees and maintain some flexibility in making employer contributions.

Employee Pros/Cons

Employees can save for retirement through convenient payroll deduction, while reducing their current income tax and benefiting from tax-deferred compounding of earnings. Employer contributions are nonforfeitable when made, so employees are 100% vested. Employees can make investment decisions, and they keep their accounts when they change jobs. A SIMPLE

may offer the largest deferral potential for an employee under age 50 with compensation not exceeding \$45,450.



Practitioner Note—Two Types of SIMPLE Plans. An eligible employer may offer either a SIMPLE IRA or a SIMPLE I.R.C. §401(k) plan. SIMPLE IRA matching contributions can be reduced to as little as 1% of compensation in 2 of 5 years, with advance notice to the employees. An employer with a SIMPLE I.R.C. §401(k) that elects to make matching contributions must use the 3% match in all years. Notice 98-4, 1998-1 CB 269, provides question and answer style guidance on SIMPLE plans.

Qualified Retirement Plans

Qualified retirement plans may be defined-contribution plans, which include profit-sharing and money-purchase plans, or defined-benefit plans. An I.R.C. §401(k) plan is usually a profit-sharing plan.

Defined-Contribution Plans

A defined-contribution plan provides an individual account for each participant, with benefits based solely upon the balance in the account. This amount comes from contributions to the account, plus any income, expenses, gains, and losses realized on the investments, and any allocated forfeitures from other participants' accounts.

Profit-Sharing Plans

A profit-sharing plan allows an employer to make discretionary contributions that could be keyed to the company's profits. Current or accumulated profits are not required for the company to make a contribution, but a contribution formula based on profits may be used by employers to encourage productivity. The plan document governs, and it must define *profits* to be used for contributions. A profit-sharing plan also can be written to allow employers flexibility in making contributions. A plan that allows discretionary contributions enables the employer to decide on a year-to-year basis whether to con-

tribute to the plan and the amount that will be contributed.

Employer Pros/Cons

Profit-sharing plans allow employers to create strong employee incentives to increase profitability, and to reward long-term employees based on the financial growth and success of the business. Employer contributions can be based on a flexible formula determined annually for businesses with variable cash flow and profits. Plans must be non-discriminatory, but they can be customized to limit participants to employees who are age 21 or over and who have completed 1 year of service. However, the administrative complexity of complying with nondiscrimination and reporting rules may require the use of professional services.

Employee Pros/Cons

Employees share in the profitability and success of the business. Employees do not contribute unless the plan includes an I.R.C. §401(k) provision (discussed next). Contributions are not immediately vested; an employer may select an allowable vesting schedule. If a considerable part of the plan assets are company stock, given recent economic and market events, employee retirement assets are at risk if the company fails.

I.R.C. §401(k) Plans

An I.R.C. §401(k) plan is a profit-sharing or stock bonus plan with an elective deferral feature. Employees may elect to receive their pay currently in cash or to defer receipt of part of it on a pretax basis until retirement. These plans are frequently referred to as CODAs (cash or deferred arrangements).

Employer Pros/Cons

Responsibility for funding the plan generally is shared between the employer and employees. Employer contributions are discretionary, and they can be varied from year to year. They can be made on a matching basis only, or made for all eligible employees. Employers can limit participation to employees who are age 21 and who worked at least 1,000 hours the previous year. Administrative expenses are moderate to high, but they are decreasing due to competition among firms offering plan administration. In

general a company with 25 or more employees could offer an I.R.C. §401(k) plan at a reasonable cost. Several plan providers now offer one-participant plans.

Employee Pros/Cons

Employees can contribute through convenient payroll deductions. The maximum deferral is greater than it is for a SIMPLE plan if the employee's compensation is greater than \$45,450. Employee contributions are 100% vested, whereas employer contributions vest according to the plan. Employees can make investment decisions and tailor portfolios to meet individual objectives.

Roth 401(k) Plans

For tax years beginning after 2005, I.R.C. §401(k) plans may offer a Roth contribution option (I.R.C. §402A). The contribution limit is the same as for an elective deferral contribution to an I.R.C. §401(k) plan (\$15,000 for 2006), but the contribution is made on an after-tax basis. Although the employee contributions are not excluded from income, they count as an elective deferral for employees who are making elective deferrals to more than one plan. They do not reduce the limit for a Roth IRA contribution.

Tax-deferred employer-matching contributions cannot be made to a Roth account, but they can be made to other parts of the retirement plan.

A separate account and recordkeeping are required [Prop. Reg. §1.401(k)-1(f)]. Distributions of both employee contributions and earnings will be nontaxable under the same rules that apply to Roth IRAs, including a 5-year nonexclusion period for each plan. Rollovers may be made to Roth IRAs.

Higher income taxpayers who cannot contribute to a Roth IRA because of the AGI limit would benefit from this plan. In general, after-tax retirement contributions are appropriate for taxpayers who expect to be in a higher tax bracket in retirement. Workers who expect to be in the same or a lower tax bracket in retirement may want to continue making elective deferrals to existing I.R.C. §401(k) plans. The impact of tax deferral on total savings is discussed in Issue 5, in this chapter.

Money Purchase Pension Plans

A money purchase pension plan is a defined-contribution plan with a fixed contribution formula. These contributions must be made annually; they are not subject to the discretion of the employer.



Law Change—Money Purchase Plans Outdated. Before 2002, money purchase pension plans allowed a larger amount of retirement savings than profit-sharing plans, and the two plans were often used in combination to reach the maximum contribution percentage of 25%. Because a 25% of compensation deduction is now allowed for profit-sharing plans, the need for a money purchase pension plan is virtually eliminated.

Defined-Benefit Plans

A defined-benefit plan provides determinable benefits to the employer's employees over a period of years, usually for life, after retirement. Any plan that is not a defined-contribution plan is a defined-benefit plan.

- Retirement benefits are measured by and based on factors such as the employee's years of service and compensation.
- Contributions to the plan to fund the benefits are not dependent upon the employer's profits. They are determined actuarially, and the assistance of an actuary is needed in making this calculation.
- Contributions may be small for a young employee because investments are expected to develop sufficient funds to provide the benefits promised by the plan.
- Common types of defined-benefit plans are fixed-benefit, flat-benefit, and unit-credit plans. A fixed benefit is a specific dollar amount. Flat-benefit plans generally provide the same percentage of final compensation to all employees who have satisfied the service requirement. Unit-credit plans pay an increment (percentage of compensation or dollar amount) based on each year of service.

Employer Pros/Cons

Employers can establish substantial retirement benefits based on actuarial formulas. Annual contributions are required, and they may increase if plan earnings don't meet expectations. Consistent cash flow and profits are necessary to make the required contributions. Plans may permit or require employee contributions. The administrative complexity requires professional actuarial assistance that can drive up costs.

Employee Pros/Cons

Retirement payments are guaranteed based on age, compensation, and years of service. The plans are ideal for older employees who have a short time to save for retirement. Employees have no control over investment options. Vesting is determined by the plan, and it usually requires years.



Planning Pointer—Credit for Establishing Plan. I.R.C. §45E provides a tax credit for small employers who establish a SEP, SIMPLE, or qualified plan. The credit equals 50% of the costs of setting up and administering the plan, and educating employees about the plan, for the first 3 years of the plan. Up to \$1,000 of costs are eligible each year, for a \$500 maximum credit per year. A small employer is defined as having 100 or fewer employees who were each paid at least \$5,000 in the preceding year.

Comparison of Plans

Example 11.20 Self-Employed Individual

Roberta, a self-employed consultant, is 53 years old and single. Her business has a net profit of \$75,870 in 2005, and she expects her income to exceed \$200,000 in the near future. She would like to contribute the maximum amount to a retirement plan. How much can Roberta contribute to alternative plans at different income levels? Figure 11.7 shows the calculations of her maximum contributions if her Schedule C (Form 1040) profit is \$100,000. Because she is over age 50, catch-up contributions are included. Figure 11.8 shows her maximum contributions for three levels of Schedule C (Form 1040) profits.

FIGURE 11.7 Calculation of Maximum Contributions for \$100,000 Income

Roberta's SIMPLE IRA Contribution		
Self-Employment Income		\$ 100,000
Less: Self-Employment Income Times ½ of Self-Employment Income Tax Rate ¹		(7,650)
Equals		<u>\$ 92,350</u>
Times Match Rate 3%		× .03
Equals	Matching Contribution	\$ 2,771
Plus	Employee Basic Contribution	10,000
	Employee Catch-up Contribution	<u>2,000</u>
	Total Contribution	<u>\$ 14,771</u>
Roberta's SEP IRA or Profit-Sharing Contribution		
Income		\$ 100,000
	Less ½ of Self-employment Tax ²	(6,919)
Equals		<u>\$ 93,081</u>
	Times Contribution Rate .25/1.25 =	× .20
Equals	Total Contribution	<u>\$ 18,616</u>
Roberta's I.R.C. §401(k) Contribution		
Income		\$ 100,000
	Less ½ of Self-Employment Tax ²	6,919
Equals		<u>\$ 93,081</u>
	Times Contribution Rate .25/1.25 =	× .20
Equals	Employer Contribution	<u>\$ 18,616</u>
Plus	Employee Basic Contribution	14,000
	Employee Catch-up Contribution	<u>4,000</u>
	Total Contribution	<u>\$ 36,616</u>

¹I.R.C. §408 (p)(6)(A)(ii) and 1402(a)(12)
²I.R.C. §401(c)(A)(vi)

FIGURE 11.8 Maximum Contributions

Income	\$75,870	\$100,000	\$210,000
SIMPLE IRA ¹	\$14,102	\$14,771	\$17,818
SEP IRA ²	\$14,102	\$18,616	\$40,322
Profit Sharing ²	\$14,102	\$18,616	\$40,322
I.R.C. 401(k) Plan ²	\$32,102	\$36,616	\$46,000

¹Based on income from line 3 of Schedule C (Form 1040) multiplied by (1 – 7.65%).

²Based on income from line 3 of Schedule C (Form 1040) reduced by the I.R.C. §164(f) deduction.

Question 1. If Roberta wants to contribute the maximum amount to her retirement plan, which plan should she choose?

Answer 1. Roberta should choose an individual I.R.C. §401(k) plan. Her allowable employer contributions to either a SEP IRA or a profit-sharing plan would be equal, but the I.R.C. §401(k) plan permits an additional salary deferral contribution.

Question 2. If the cost of establishing a qualified plan will limit Roberta's choice to either a SIMPLE IRA or a SEP IRA, which plan would allow a larger contribution?

Answer 2. It depends on the level of Roberta's income. Because of the SIMPLE catch-up contribution provision, if Roberta's income is below \$75,870, the SIMPLE IRA contribution is greater. If her income is above that level, the SEP IRA allows a larger contribution. If Roberta expects her future income to remain below about \$75,000, a SIMPLE retirement plan would allow the largest contribution.

Question 3. Will the income break-even point for SEP and SIMPLE contributions continue to increase as the SIMPLE contribution limit increases?

Answer 3. Yes. The SIMPLE contribution limit has been increasing each year since 2002. In 2006, the \$10,000 contribution limit will be indexed for inflation, rounded down to the near-

est \$500 increment. As the maximum SIMPLE contribution increases, more self-employed individuals can maximize their retirement contribution by choosing a SIMPLE retirement plan.

If net self-employment income is below the break-even amount shown in Figure 11.9, self-employed individuals can make a SIMPLE contribution that is larger than the contribution allowed under a SEP IRA with no elective deferral.

Question 4. Is it possible for Roberta to contribute even more to a retirement plan?

Answer 4. Only a defined-benefit plan that allows an actuarially determined contribution based on Roberta's age and a defined retirement benefit could allow a larger contribution.

Question 5. Is Roberta also eligible to contribute \$4,500 to a Roth IRA in addition to her 401(k) plan?

Answer 5. Possibly, depending on her other income. If she cannot contribute to a Roth IRA because of the AGI limitation, she could make a nondeductible contribution to a traditional IRA. Her retirement plan contribution does reduce her AGI, so even with some other income, she might be below the \$95,000 threshold where the Roth contribution phaseout begins.

Figure 11.10 on pages 312–313 of this chapter compares the features of several types of retirement plans.

FIGURE 11.9 Breakeven Self-Employment Income for Equal Contributions to SIMPLE and SEP for Individual Eligible to Make Catch-Up Contributions

Year	2002	2003	2004	2005
SIMPLE Contribution Limit	\$ 7,000	\$ 8,000	\$ 9,000	\$10,000
Catch Up Contribution (Age 50)	500	1000	1500	2000
Total Contribution	<u>\$ 7,500</u>	<u>\$ 9,000</u>	<u>\$10,500</u>	<u>\$12,000</u>
Breakeven SE Income	\$47,418	\$56,900	\$66,385	\$75,870
Simple IRA	\$ 8,814	\$10,576	\$12,339	\$14,102
SEP IRA	\$ 8,814	\$10,576	\$12,339	\$14,102
Profit-sharing w/o Elective Deferral	\$ 8,814	\$10,576	\$12,339	\$14,102
401(k) + Elective Deferral	\$20,814	\$24,576	\$28,339	\$32,102

ISSUE 5: IMPACT OF TAX DEFERRAL ON SAVINGS This issue compares tax-deferred and after-tax savings and investments, considering the 2003 tax law changes that reduced the maximum tax rate on qualifying dividends and long-term capital gains to 15%.

Since tax-deferred savings opportunities became available to individuals in the late 1970s, financial advisors and individuals have computed, compared, and discussed the consequences of tax-deferred savings versus investments using after-tax dollars.

Tax-deferred savings opportunities include IRAs and employer retirement plans. After-tax investments often yield similar rates of return, but they suffer the disadvantage of upfront taxation of the initial investment amount, plus current taxation of the earnings. Variations include tax-free investments such as municipal bonds and investments made with after-tax dollars that yield earnings that are deferred until withdrawn.

Variables important to the analysis include the planning horizon, assumed investment returns, risk tolerance, and the individual's ordinary income and capital gain tax rates in both the contribution and the distribution periods.

Pre-Tax Investment Is Best

One possible reaction to the reduced dividend and capital gains tax rates is shifting savings from tax-deferred accounts to after-tax investments that generate earnings taxable at the lower rates. Although investors surely welcome lower tax rates on dividend and capital gains, those lower rates may not overcome the inherent advantage of tax-deferred growth, as shown in Example 11.22.

Example 11.21 Investment of Year-End Bonus

Jane Perkins, age 54, expects to qualify for a \$15,000 bonus. She can receive the bonus as

wages, pay the tax, and invest the after-tax proceeds, or, before the bonus is available, she can instruct her employer to contribute it on her behalf to a retirement plan. In either case, assume that the investment's value will triple by the time Jane retires. Assume also that Jane will have a combined federal and state tax rate of 30% on ordinary income and 20% on capital gains, both now and in retirement.

Question 1. What is the after-tax net value if she makes an after-tax investment in a capital asset?

Answer 1. Jane's initial investment amount is \$10,500 ($\$15,000 - 4,500$), and if it triples, it will increase to \$31,500. Her basis is \$10,500 and the resulting \$21,000 gain is subject to Jane's 20% capital gain rate, for a tax of \$4,200. Her after-tax net value is \$27,300 ($\$31,500 - \$4,200$).

Question 2. What is the after-tax net value of the tax-deferred investment?

Answer 2. The initial \$15,000 can be invested free of tax, and it will grow to \$45,000 if it triples. When Jane withdraws it after age 59½, the full amount is subject to tax at her 30% ordinary income tax rate, for a tax of \$13,500. Her after-tax net value is \$31,500 ($\$45,000 - \$13,500$). Although Jane pays a seemingly large amount of ordinary income tax, her after-tax net value from the tax deferred investment exceeds the after-tax investment by \$4,200. Even with lower state and federal capital gains rates, the tax-deferred investment yields greater after-tax net values. See Figure 11.11 on page 314.

FIGURE 11.10 Comparison of Plan Characteristics and Decision Factors
RETIREMENT PLAN COMPARISON (Reprinted with permission of A.G. Edwards)

Plan Type	SEP IRA <i>(Simplified Employee Pension)</i>	Profit Sharing <i>(Defined Contribution)</i>	Age-Weighted/Cross-Tested Profit Sharing <i>(Defined Contribution)</i>	Money Purchase <i>(Defined Contribution)</i>
Who may use	Any business entity (corporation, partnership, self-employed, S corporation, nonprofit, government entities and LLC).	Any business entity (corporation, partnership, self-employed, S corporation, nonprofit, government entities and LLC).	Any business entity (corporation, partnership, self-employed, S corporation, nonprofit, government entities and LLC).	Any business entity (corporation, partnership, self-employed, S corporation, nonprofit, government entities and LLC).
Client profile	Best-suited for business owners who want simplicity. Ideally suited for companies with more volatile profits and low employee turnover. Must be willing to contribute to part-time employees.	Best-suited for companies with more volatile profits where employee turnover may be a problem or where part-time employees are excluded.	The Age-Weighted profit sharing plan is best-suited for companies that want to favor older employees. The Cross-Tested (new comparability) plan is best-suited for companies that want to favor particular groups of employees who are, on average, older employees.	Best-suited for companies with stable yearly profits and who want an annual fixed-contribution commitment.
Deadline for establishing	Employer's tax filing due date, including extensions.	Last day of plan year.	Last day of plan year.	Last day of plan year.
Deadline for employer contributions	Due date of employer's tax return, including extensions.	Due date of employer's tax return, including extensions.	Due date of employer's tax return, including extensions.	Due date of employer's tax return, including extensions, or 8½ months after the end of the plan year, whichever is earlier.
Who must be included	Any employee who is aged 21 or older and has worked for the employer for any part of three of the last five years. May exclude employees earning less than \$450 (indexed for cost of living).	Any employee who is aged 21 or older with 1,000 hours of service in two 12-month periods. Can exclude certain employees based on plan document.	Any employee who is aged 21 or older with 1,000 hours of service in two 12-month periods. Can exclude certain employees based on plan document.	Any employee who is aged 21 or older with 1,000 hours of service in two 12-month periods. Can exclude certain employees based on plan document.
Obligation to contribute¹	Employer makes discretionary contributions and can change or discontinue them each year.	Unless fixed as a percentage of compensation or profits, contributions are at the discretion of the employer and are not dependent on profits.	Unless fixed as a percentage of compensation or profits, contributions are at the discretion of the employer and are not dependent on profits.	Employer is required to make contributions as elected in adoption agreement at plan establishment.
Maximum annual employer deduction limit	25% of total eligible payroll (maximum eligible pay per employee is \$210,000).	25% of total eligible payroll (maximum eligible pay per employee is \$210,000).	25% of total eligible payroll (maximum eligible pay per employee is \$210,000).	25% of total eligible payroll (maximum eligible pay per employee is \$210,000).
Maximum annual allocation² to employee's account	25% of employee's eligible pay or \$42,000, whichever is less.	100% of employee's eligible pay or \$42,000, whichever is less.	100% of employee's eligible pay or \$42,000, whichever is less.	100% of employee's eligible pay or \$42,000, whichever is less.
Maximum annual employee contribution	No employee elective contributions allowed, except in grandfathered SARSEPs.	No employee contributions allowed.	No employee contributions allowed.	No employee contributions allowed.
Catch-up contributions	N/A, except grandfathered SARSEPs (\$4,000 limit).	N/A	N/A	N/A
Vesting	Immediate 100% vesting.	Vesting schedules available when using a maximum of one year of service for eligibility requirements.	Vesting schedules available when using a maximum of one year of service for eligibility requirements.	Vesting schedule available when using a maximum of one year of service for eligibility requirements.
Reporting and disclosure	When plan is established, employer completes the SEP IRA agreement and gives a copy to the employee when the employee becomes eligible. No additional annual reporting is required.	Full ERISA requirements. IRS Forms 5500 or 5500-EZ and applicable schedules must be filed annually.	Full ERISA requirements. IRS Forms 5500 or 5500-EZ and applicable schedules must be filed annually.	Full ERISA requirements. IRS Forms 5500 or 5500-EZ and applicable schedules must be filed annually.

¹ Top-heavy minimums may apply when more than 60% of account balances/accrued benefits are attributable to key employees (or for SEP IRAs, 60% of aggregate contribution for key employees).

² Allocation refers to the total of employer contributions, forfeitures, and any employee salary deferral or voluntary after-tax contribution.

³ Compensation is the amount shown on W-2 (wages, salaries, bonuses, etc.) and self-employed earned income, or as defined within the plan document.

⁴ Safe Harbor 401(k) plans must be established on or before the effective date and must exist for at least three months. Employees must receive notice prior to establishment; then 30 days prior to each plan year thereafter.

FIGURE 11.10 Comparison of Plan Characteristics and Decision Factors (Continued)

Defined Benefit Pension Plan <i>(Defined Benefit)</i>	SIMPLE IRA <i>(Savings Incentive Match Plan for Employees)</i>	401(k) Profit Sharing & Safe Harbor 401(k) <i>(Defined Contribution)</i>	403(b)	457(b) Plans <i>(Nonqualified Deferred Compensation)</i>
Any business entity (corporation, partnership, self-employed, S corporation, nonprofit, government entities and LLC).	Corporation, partnership, self-employed, S corporation, nonprofit, government entities and LLC. Maximum 100 employees with \$5,000 in compensation and business cannot fund any other plan in current year.	Corporation, partnership, self-employed, S corporation, nonprofit and LLC (excluding government entities).	Organizations qualified under IRC section 501(c)(3), such as schools, churches and hospitals.	State and local governments and nonprofit organizations, such as universities and hospitals. Does not include churches and qualified church-controlled organizations.
Best-suited for established companies with consistent profits. Benefits companies with key employees who are 10 to 15 years from retirement.	Best-suited for employers that want to encourage employee retirement savings and avoid costly administration. Employer obligation to contribute is relatively small compared with other choices. Must be willing to contribute to part-time employees.	Best-suited for employers that want to minimize employer contributions and encourage employee savings.	Best-suited for employers that want to minimize employer contributions and encourage employee savings, particularly plans that will be employee-funded only (non-ERISA).	Best-suited for employers that want to minimize employer contributions and encourage employee savings.
Last day of plan year.	Oct. 1 for contributions in current calendar year. (Plan year must be calendar.)	Last day of plan year, but no later than commencement of employee contributions. ⁴	Can be established any time during calendar year.	Can be established any time during calendar year.
Due date of employer's tax return, including extensions, or 8½ months after the end of the plan year, whichever is earlier.	Due date of employer's tax return, including extensions. Employee deferrals must be deposited as soon as reasonably possible but no later than 30 days following month of payroll.	Due date of employer's tax return, including extensions. Deferrals must be deposited as soon as reasonably possible, not to exceed 15 days following the end of the month.	Due date of employer's information return, including extensions.	Due date of employer's information return, including extensions.
Any employee who is aged 21 or older with 1,000 hours of service in two 12-month periods. Can exclude certain employees based on plan document.	Any employee who earned \$5,000 or more during any two preceding years and is expected to earn \$5,000 or more in the current year.	Any employee who is aged 21 or older with 1,000 hours of service within 12 months. Can exclude certain employees.	All employees of qualified organizations; some exclusions may be allowed if ERISA.	All employees of qualified organizations; some exclusions may be allowed.
Employer must make contributions dictated by the benefit formula and calculated annually by an actuary.	Requires one of the following employer contributions: • Dollar-for-dollar matching contribution up to 3% of employee's compensation • Nonmatching contribution of 2% of compensation for all eligible employees	Employer contributions are discretionary unless the plan is top-heavy. ⁵ Safe Harbor Requires one of the following employer contributions: • Basic match — Dollar-for-dollar on first 3% of compensation; 50 cents on next 2% of compensation • Enhanced match ⁷ — Nonmatching contribution of 3% of compensation for all eligible employees	Contributions typically come from employee salary reduction (non-ERISA). Employer contributions are permitted but may subject the plan to additional reporting/discrimination requirement (ERISA).	Contributions typically come from employee salary reduction. Employer contributions are permitted if the plan document provides.
Contribution is not limited (maximum pay per employee to determine benefits is \$210,000). Note: Annual benefit from the plan may not exceed the lesser of 100% of participant's compensation or \$170,000.	Match — \$10,000 maximum match up to 3% of pay, assuming a salary of \$333,333. Catch-up contributions, if any, must be matched. Nonelective — \$4,200 employer contribution maximum eligible pay per employee is \$210,000.	25% of total eligible payroll (maximum eligible pay per employee is \$210,000).	100% of employee's eligible pay (maximum eligible pay per employee is \$210,000).	Contributions limited to 100% of includable compensation with a maximum of \$14,000.
No individual accounts.	Match — \$20,000 (\$10,000 maximum match up to 3% of pay plus \$10,000 salary deferral, which does not include catch-up contributions) assuming an annual salary of \$333,333. \$24,000 limit if employee is aged 50 or older. Nonelective — \$14,200 (\$4,200 employer contribution plus \$10,000 salary deferral, which does not include catch-up contributions); maximum eligible pay per employee is \$210,000. \$16,200 limit if employee is aged 50 or older.	100% of employee's eligible pay or \$42,000 (\$46,000 if employee is aged 50 or older), whichever is less (including employee salary deferral).	100% of employee's eligible pay or \$42,000, whichever is less.	\$14,000. ⁵
No employee contributions allowed.	\$10,000 not to exceed 100% of compensation. ³	Up to 100% of compensation, ³ not to exceed \$14,000. ⁵	Up to 100% of includable compensation, ³ not to exceed \$14,000. ^{5,6} No longer subject to MEA calculation.	Up to 100% of includable compensation, ³ not to exceed \$14,000. ^{5,6}
N/A	\$2,000	\$4,000	\$4,000 ⁶	\$4,000 ⁶
Vesting schedules available when using a maximum of one year of service for eligibility requirements.	Immediate 100% vesting.	Employee contributions: Immediate 100% vesting. Safe Harbor employer contributions: Immediate 100% vesting. Non-Safe Harbor employer contributions: Vesting schedules available.	Employee contributions: Immediate 100% vesting. Employer contributions: Vesting schedules available.	Employee contributions: Immediate 100% vesting. Employer contributions: Vesting schedules available.
Full ERISA requirements. IRS Forms 5500 or 5500-EZ and applicable schedules must be filed annually.	Employer must give employees Summary Plan Description and Contribution Notice no later than Nov. 2 each year. No additional annual reporting is required.	Full ERISA requirements. IRS Forms 5500 and 5500-EZ applicable schedules must be filed annually. Discrimination test applies to deferrals for non-safe harbor plans.	If employer makes contributions (ERISA), IRS Forms 5500 may have to be filed annually.	Under some circumstances, may require full ERISA reporting.

³ Individual employer plans may limit deferrals. Refer to plan administrator for individual employee limitations.

⁶ Additional catch-up provisions may apply to certain individuals.

⁷ Enhanced match must be at least as good as the basic match but can be based on an amount up to 6% of compensation.

FIGURE 11.11 Bonus Invested in Tax-Deferred or After-Tax Account

Description	Tax Deferred Investment	After-Tax Investment
Bonus Amount	\$ 15,000	\$ 15,000
Initial Tax Liability	0	(4,500)
Initial Investment	\$ 15,000	\$ 10,500
Investment Growth	30,000	21,000
Total Available to Withdraw	\$45,000	\$ 31,500
Basis	(0)	(10,500)
Amount Subject to Tax	\$ 45,000	\$ 21,000
Tax Rate	× .30	× .20
Tax Liability	13,500	4,200
After-Tax Net Value (withdrawal minus tax liability)	\$31,500	\$ 27,300
Difference		\$4,200

Question 3. Is it a coincidence that the \$4,200 advantage of tax deferred over after-tax investment is equal to the \$4,200 of capital gains tax due when the after-tax investment is withdrawn?

Answer 3. No. Tax-deferred savings effectively allow investment earnings to be accumulated and distributed at a zero tax rate. The difference between tax-deferred and after-tax savings will always be the amount of taxes paid on the after-tax investment earnings. The above statement depends on the assumption that ordinary income tax rates are the same throughout the accumulation and distribution years.

Question 4. Because Jane does not understand or believe the answer, is there another way to explain these surprising results?

Answer 4. When Jane defers ordinary income into a tax-deferred savings vehicle, she can think of it as creating a partnership or joint venture with the IRS. Jane is contributing the sum that she would net if the whole ordinary income amount were subject to current taxation; the government is contributing the sum that would be paid in taxes if there were no deferral.

The \$15,000 retirement plan contribution represents an investment partnership of which \$10,500 has been funded by Jane, and \$4,500 has been funded by the IRS. With a three-fold

investment growth, the \$15,000 grows to \$45,000; the individual's \$10,500 share grows to \$31,500, while the IRS's \$4,500 share grows to \$13,500.

What happens when the retirement plan accumulation is paid out is surprisingly simple, but extremely important: The \$13,500 of taxes payable on the \$45,000 distribution represents a redemption of the IRS's 30% share of the investment partnership. Jane keeps \$31,500, which is her entire 70% of the partnership; in essence, she pays not one penny of taxes on the \$21,000 of growth on her initial \$10,500 share. In effect, her \$10,500 share of the initial \$15,000 deferral receives the same zero-tax treatment as a \$10,500 Roth IRA contribution would receive.

Roth Account in I.R.C. §401(k) Plan

I.R.C. §401(k) plans can add a Roth option in 2006, as explained in Issue 4. Taxpayers who cannot contribute to a Roth IRA because of income limits would benefit from this plan. Workers who do not expect their tax bracket to increase after retirement may want to continue tax-deferred contributions to existing I.R.C. §401(k) plans. An employee contribution to a

Roth account within an I.R.C. §401 plan reduces the allowable salary deferral dollar for dollar, even though the Roth contribution is made on an after-tax basis.

Example 11.22 Tax-Deferred versus Roth Investment

Assume the same facts as in Example 11.21, except that Jane's bonus choice must be made at the beginning of 2006. She can ask her employer to contribute the \$15,000 bonus to a qualified retirement plan or elect a \$10,500 after-tax contribution to a Roth account in the I.R.C. §401(k).

Question 1. Which investment yields the most after-tax funds?

Answer 1. The computational results are the same as in Figure 11.11, except that no tax is paid upon a qualified distribution from the Roth account. Both investments would yield the same \$31,500 after-tax proceeds if Jane's ordinary income tax rate remains the same through the contribution and distribution period.

Question 2. Is it ever possible for after-tax investments to yield the same or greater results than tax-deferred investments?

Answer 2. There are three possible scenarios:

1. If all federal and state taxes on investment returns are eliminated through a Roth account, or if future tax changes result in a broad consumption or value-added tax, then Example 11.21 shows that after-tax yields will equal tax-deferred investments.
2. If an individual's after-tax savings are put into investments that generate no current taxable income and are held until death, the basis step-up at death (basis carryover plus elected increase for deaths in 2010) will eliminate the capital gains tax exposure.
3. If an individual's tax rate on withdrawals from a tax-deferred account is higher than his or her marginal tax bracket during the working and accumulation years, an after-tax investment could yield greater returns than tax-deferred savings.

Comparisons of Options

Example 11.23 Investments Producing Ordinary Income and Capital Gain

John, age 55, is the sole shareholder and employee of Johnco, a C corporation that sponsors a SIMPLE retirement plan. John's financial situation permits him to either make a salary deferral or receive income as taxable salary, pay the tax, and invest the after-tax proceeds. John plans to continue working and receiving a salary from his company for the next 15 years, until age 70. His combined federal and state tax rate on ordinary income is 30%, and he expects that rate to be the same when he starts retirement distributions. His combined federal and state tax rate on long-term capital gains is 20%, which he also expects to stay the same in both the accumulation and distribution or retirement period. John expects his investments to return 6% annually.

Question 1. Should John elect to defer income into the SIMPLE retirement plan, or should he pay the tax and invest in after-tax investments that produce similar returns? He has four investment choices:

- The SIMPLE plan
- An after-tax investment that produces currently taxable ordinary income
- An after-tax investment that produces currently taxable qualified dividends
- An after-tax investment that produces capital gain that is deferred until retirement

Figure 11.12 shows the total return on each dollar invested per year for 15 years in each investment. Figure 11.13 (shown with Example 11.24) displays the annual earnings.

Answer 1

- John's \$1 annual tax-deferred investment grows to \$24.67 over 15 years. Assuming that he withdraws the entire amount and pays ordinary income tax, the tax-deferred investment yields \$17.27 after tax.
- An after-tax investment that produces currently taxable ordinary income yields only \$14.82 after-tax income.

- The same \$1 invested each year in an after-tax investment that produces currently taxable qualified dividends yields \$15.59 after tax income.
- The same \$1 invested each year in an after-tax investment that produces capital gain at the end of the 15 years would yield an after-tax return of \$15.92. It would grow to the

\$17.27 amount that is the net return on the tax-deferred investment, but after subtracting the capital gains tax of \$1.35, his after-tax yield is \$1.35 less. Although that may seem insignificant in this simple example, the tax-deferred investment provides 8.5% more after-tax income than an after-tax investment that produces capital gain.

FIGURE 11.12 Total Investment Return Per \$1

Description	Tax Deferred Investment	After-Tax Investment Earnings (ordinary income)	After-Tax Investment Earnings (currently taxable qualified dividends)	After-Tax Investment Earnings (deferred taxable capital gains)
Investment Amount	\$ 15.00	\$ 10.50	\$ 10.50	\$ 10.50
Investment Growth	9.67	4.32	5.09	6.77
Total Available to Withdraw	\$ 24.67	\$ 14.82	\$ 15.59	\$ 17.27
Tax Liability at Time of Distribution	(7.40)	0	0	(1.35)
Net After-Tax Funds	<u>\$ 17.27</u>	<u>\$ 14.82</u>	<u>\$ 15.59</u>	<u>\$ 15.92</u>

This result depends on the assumption that John's ordinary income tax rate remains constant throughout the contribution and the distribution period. Within the limits of this assumption, the tax-deferred investment will always be better, winning by the amount of the tax paid on the after-tax investment.

Example 11.24 Tax Rate Increase

Assume the same facts as in Example 11.23, except that John's combined state and federal capital gain tax rate increases to 25% in the retirement or distribution period.

Question 1. Does increasing the assumed capital gain rate change the investment results?

Answer 1. Yes. The capital gains tax on the \$6.77 gain increases from \$1.35 to \$1.69, reducing the after-tax funds available for distribution from \$15.92 to \$15.58. A 25% increase in the distribution capital gain rate increases the tax-deferred advantage from 8.5% to 10.8% ($1.35 \div 15.92 = 8.5\%$ and $1.69 \div 15.58 = 10.8\%$). See Figure 11.13. The after-tax investment that produces currently taxable dividends at a combined state and federal rate of 20% yields \$15.59, one cent more than the taxable investment that produces deferred earnings taxed at 25% in the withdrawal period.

FIGURE 11.13 Tax-Deferred versus After-Tax Investments

Tax Deferred Investment		After-Tax Investment— Earnings Currently Taxable— Qualified Dividends Tax Rates				After-Tax Investment— Earnings Tax-Deferred— Capital Gain Rates						
Year	Principal	Earnings	Year End*	Year	Principal	Earnings	Year End*	Year	Principal	Earnings	Year End*	
0	1.00	0.06	1.06	0	0.70	0.03	0.73	0	0.70	0.04	0.74	
1	2.06	0.12	2.18	1	1.43	0.07	1.50	1	1.44	0.09	1.53	
2	3.18	0.19	3.37	2	2.20	0.11	2.31	2	2.23	0.13	2.36	
3	4.37	0.26	4.64	3	3.01	0.14	3.15	3	3.06	0.18	3.25	
4	5.64	0.34	5.98	4	3.85	0.18	4.04	4	3.95	0.24	4.18	
5	6.98	0.42	7.39	5	4.74	0.23	4.96	5	4.88	0.29	5.18	
6	8.39	0.50	8.90	6	5.66	0.27	5.94	6	5.88	0.35	6.23	
7	9.90	0.59	10.49	7	6.64	0.32	6.96	7	6.93	0.42	7.34	
8	11.49	0.69	12.18	8	7.66	0.37	8.02	8	8.04	0.48	8.53	
9	13.18	0.79	13.97	9	8.72	0.42	9.14	9	9.23	0.55	9.78	
10	14.97	0.90	15.87	10	9.84	0.47	10.31	10	10.48	0.63	11.11	
11	16.87	1.01	17.88	11	11.01	0.53	11.54	11	11.81	0.71	12.52	
12	18.88	1.13	20.02	12	12.24	0.59	12.83	12	13.22	0.79	14.01	
13	21.02	1.26	22.28	13	13.53	0.65	14.18	13	14.71	0.88	15.59	
14	23.28	1.40	24.67	14	14.88	0.71	15.59	14	16.29	0.98	17.27	
Tax on Distribution			(7.40)	Basis				10.50	Tax on distribution			(1.69)
Net after tax value			17.27	Net after tax value				15.59	Net After Tax Value			15.58

*The year end figure may not equal the sum of the principal and earnings due to rounding.



Practitioner Note—Higher Rate Offset

Tax Deferral Benefit. The after-tax investment that produces income currently taxed at a 20% combined federal and state rate yields \$15.59. The after-tax investment that produces earnings that are deferred until withdrawal and then are subject to a higher tax rate (25%) yields \$15.58. Thus, the positive impact of deferred earnings was almost identically offset by an increase in the tax rate from 20% to 25%.

Question 2. How much would John’s ordinary income tax rate have to increase to make the after-tax investment more profitable?

Answer 2. An ordinary income tax rate of 36.85% will result in an after-tax return of \$15.58 from both the tax-deferred and the after-tax investment, as shown in Figure 11.14.

FIGURE 11.14 Break-Even Ordinary Income Tax Rate at Retirement

Annual Investment	\$ 1.00		
Planning Horizon	15 years		
Ordinary Income Tax Rate Today	30.00%		
Capital Gains Tax Rate Today	20.00%		
Annual Investment Return	6.00%		
Ordinary Income Tax Rate at Withdrawal	36.85%		
Capital Gains Tax Rate at Withdrawal	25.00%		

Tax Deferred Investment				After-Tax Investment— Earnings Currently Taxable— Qualified Dividends Tax Rates				After-Tax Investment— Earnings Tax-Deferred— Capital Gain Rates			
Year	Principal	Earnings	Year End*	Year	Principal	Earnings	Year End*	Year	Principal	Earnings	Year End*
0	1.00	0.06	1.06	0	0.70	0.03	0.73	0	0.70	0.04	0.74
1	2.06	0.12	2.18	1	1.43	0.07	1.50	1	1.44	0.09	1.53
2	3.18	0.19	3.37	2	2.20	0.11	2.31	2	2.23	0.13	2.36
3	4.37	0.26	4.64	3	3.01	0.14	3.15	3	3.06	0.18	3.25
4	5.64	0.34	5.98	4	3.85	0.18	4.04	4	3.95	0.24	4.18
5	6.98	0.42	7.39	5	4.74	0.23	4.96	5	4.88	0.29	5.18
6	8.39	0.50	8.90	6	5.66	0.27	5.94	6	5.88	0.35	6.23
7	9.90	0.59	10.49	7	6.64	0.32	6.96	7	6.93	0.42	7.34
8	11.49	0.69	12.18	8	7.66	0.37	8.02	8	8.04	0.48	8.53
9	13.18	0.79	13.97	9	8.72	0.42	9.14	9	9.23	0.55	9.78
10	14.97	0.90	15.87	10	9.84	0.47	10.31	10	10.48	0.63	11.11
11	16.87	1.01	17.88	11	11.01	0.53	11.54	11	11.81	0.71	12.52
12	18.88	1.13	20.02	12	12.24	0.59	12.83	12	13.22	0.79	14.01
13	21.02	1.26	22.28	13	13.53	0.65	14.18	13	14.71	0.88	15.59
14	23.28	1.40	24.67	14	14.88	0.71	15.59	14	16.29	0.98	17.27
								Basis			10.50
Tax on Distribution			(9.09)					Tax on distribution			(1.69)
Net after tax value			15.58	Net after tax value			15.59	Net after tax value			15.58

*The year end figure may not equal the sum of the principal and earnings due to rounding.

Example 11.25 Tax Deferred versus After-Tax Investment in a Roth 401(k)

Assume the same facts as Example 11.24, except that John's ordinary income tax rate is 36.85%, and he can choose to defer salary into a SIMPLE plan, or he can contribute an after-tax amount to a Roth account in an I.R.C. §401(k) plan. Which investment yields the most after-tax proceeds?

The after-tax investment in the Roth yields \$17.27 of proceeds, with zero tax liability

(remember this is a Roth account). (This is the same as the tax-deferred after-tax investment shown in Figure 11.13.) Whereas the tax-deferred investment earns \$24.67 (as shown in Figure 11.14), the tax liability of \$9.09 reduces the after-tax yield to \$15.58. The Roth account yields 10.8% ($1.69 \div 15.58$) more after-tax income.