

**PRESENT LAW AND BACKGROUND RELATING TO  
TAX-FAVORED RETIREMENT SAVINGS**

Scheduled for a Public Hearing  
Before the  
SENATE COMMITTEE ON FINANCE  
on September 16, 2014

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION AND SUMMARY

The Committee on Finance has scheduled a public hearing on September 16, 2014, entitled “Retirement Savings 2.0: Updating Savings Policy for the Modern Economy.” This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a summary of the present law tax rules applicable to tax-favored retirement savings arrangements, a discussion of economic issues, and data on tax-favored retirement savings.

### Present Law

#### Overview of Compensation and Tax Treatment

Compensation consists of all amounts provided in consideration for services and can take many different forms. An individual may perform services as an employee of an employer or be self-employed, including an independent contractor, a sole proprietor or a partner in a partnership.

Compensation is generally includible in income and taxed as ordinary income when actually or constructively received. However, some forms of compensation are excluded from income, either for employees or also for self-employed individuals. Alternatively, a comparable tax benefit, such as a deduction, may be provided to self-employed individuals. Compensation is generally subject to tax under the Federal Insurance Contributions Act, in the case of employees, or the Self-Employment Contributions Act, in the case of self-employed individuals. Compensation is generally deductible by the employer or other service recipient.

Compensation may be received currently or may be deferred to a later time. The tax treatment of deferred compensation depends on whether it is qualified (*i.e.*, eligible for tax-favored treatment) or nonqualified and, if nonqualified, whether it is funded or unfunded. Unfunded nonqualified deferred compensation is generally not included in income until actually or constructively received, but special tax provisions may cause it to be included in income when vested. Nonqualified deferred compensation is not deductible by the employer or other service recipient until included in the employee’s or other service provider’s income.

#### Tax-favored Employer-Sponsored Retirement Plans

##### Overview

Whether to offer a tax-favored retirement plan is a voluntary choice by an employer, with various factors entering into the decision. The Code provides for multiple types of tax-favored employer-sponsored retirement plans, including qualified retirement plans and annuities (secs. 401(a) and 403(a)), tax-deferred annuities (sec. 403(b)), governmental eligible deferred

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Tax-Favored Retirement Savings* (JCX-98-14), September 15, 2014. This document can be found on our website at [www.jct.gov](http://www.jct.gov). All section references in this document are to the Internal Revenue Code of 1986 unless otherwise specified.

compensation plans (sec. 457(b)), SIMPLE (savings incentive match plan for employees) IRAs (sec. 408(p)), and simplified employee pensions (“SEPs”) (sec. 408(k)). These plans afford employers flexibility in the design and structure of the retirement plans they adopt, subject to the requirements applicable to each type of plan under the Code and, in some cases, under the Employee Retirement Income Security Act of 1974 (“ERISA”).

### Qualified retirement plans

Qualified retirement plans (and other tax-favored employer-sponsored retirement plans) are accorded special tax treatment under present law. Most contributions, earnings on contributions, and benefits are not included in gross income until amounts are distributed, even though the arrangement is funded and even if benefits are vested. Additionally, many distributions can be rolled over to another plan for further deferral of income inclusion. In the case of a taxable employer, the employer is entitled to a current deduction (within certain limits) for contributions even though the contributions are not currently included in an employee’s income. Contributions and earnings are held in a tax-exempt trust, which enables the assets to grow on a tax-free basis.

Qualified retirement plans are subject to various requirements to receive tax-favored treatment. Some of these requirements define participant rights and provide participant protections, such as minimum participation, vesting, exclusive benefit and minimum funding requirements. These requirements generally have parallels under ERISA. Some qualified plan requirements limit tax benefits, such as the limit on compensation taken into account under a plan and limits on contributions and benefits. Minimum coverage and nondiscrimination requirements are intended to ensure that qualified retirement plans achieve the goal of retirement security for both lower-paid and higher-paid employees.

Enforcement of the qualified retirement plan requirements depends on the source of the requirements. Failure to meet a qualification requirement may mean the loss of tax-favored status; however, in practice, the Internal Revenue Service (“IRS”) rarely disqualifies a plan. Certain requirements are enforced through an excise tax rather than through disqualification of the plan.

Qualified annuity plans are similar to qualified retirement plans in treatment, but plan assets are invested in annuity contracts rather than held in a trust or custodial account.

### Types of qualified retirement plans

Qualified retirement plans are of two general types: defined benefit plans, under which benefits are determined under a plan formula and paid from general plan assets, rather than individual accounts; and defined contribution plans, under which benefits are based on a separate account for each participant, to which are allocated contributions, earnings and losses. Defined benefit plans generally are subject to minimum funding requirements and benefits are guaranteed, within limits, by the Pension Benefit Guaranty Corporation (“PBGC”). Some qualified retirement plans are referred to as hybrid plans because they have features of both a defined benefit plan and a defined contribution plan; for example, cash balance plans are defined benefit plans, but plan benefits are defined by reference to a hypothetical account balance.

Qualified retirement plans are also categorized by the number of employers that maintain the plan and the type of employees covered by the plan. A single-employer plan is a plan maintained by one employer (treating members of controlled groups and affiliated service groups as one employer) and may cover collectively bargained employees (employees covered by a collective bargaining agreement), noncollectively bargained employees or both. A multiple-employer plan is a single plan in which two or more unrelated employers (not members of the same controlled group or affiliated service group) participate. Some qualification requirements apply to a multiple-employer plan on a plan-wide basis; others apply on an employer-by-employer basis. Multiemployer plans (also known as “Taft-Hartley” plans) are maintained pursuant to one or more collective bargaining agreements with two or more unrelated employers; the collective bargaining agreements require the employers to contribute to the plan.

#### Prohibited transactions

The Code generally prohibits certain transactions between qualified retirement plans and a disqualified person, including a fiduciary. The Code requirements apply also to individual retirement arrangements (“IRAs”) and certain other tax-favored savings arrangements. Under ERISA, similar prohibited transaction rules apply to employer-sponsored retirement plans and welfare benefit plans. Violation of the Code requirements may result in the imposition of an excise tax.

#### Taxation of distributions

Distributions from tax-favored employer-sponsored plans are generally includible in income, except to the extent a portion of the distribution is treated as a recovery of the employee’s basis (if any). Subject to certain limitations, distributions from a plan may generally be rolled over to another tax-free retirement plan with a deferral of income inclusion. A distribution may be rolled over directly to another plan or may be paid to the participant who may roll it over to another plan within 60 days. A distribution that is eligible for rollover is subject to income tax withholding at a 20-percent rate unless rolled over directly to another plan.

#### IRS administrative programs

The IRS has established various administrative programs for qualified retirement plans. Under the preapproved plan program, a service provider can obtain advance IRS approval of standardized plan documents that can be adopted by various employers, along with plan-related services from the service provider, which helps to make adopting and maintaining a plan more affordable for employers. Assets of plans maintained by various employers can be pooled and held in a group trust, providing economies of scale for investment purposes. As an alternative to plan disqualification, the consequences of which would fall most heavily on plan participants, the Employee Plans Compliance Resolution System permits employers to correct qualification compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis.

#### Owner-employees

Qualified retirement plans are required to be maintained for the exclusive benefit of employees. Business owners may be employees (in the case of corporations, including an S

corporation) or self-employed (in the case of a sole proprietorship or partnership). However, for qualified retirement plan purposes, self-employed individuals are treated as employees. Although the qualified retirement plan rules generally apply to self-employed individuals in the same manner as to employees, special rules apply in determining the compensation of a self-employed individual and the deduction for plan contributions to provide the self-employed individual with contributions or benefits under the plan. Top-heavy rules apply to limit the extent to which accumulated benefits or account balances under a qualified retirement plan can be concentrated with key employees. If a plan is top-heavy, minimum contributions or benefits for nonkey employees and, in some cases, faster vesting is required. Because a plan of a large business with many employees is unlikely to be top-heavy, the top-heavy requirements are generally viewed as primarily affecting plans of smaller employers in which the owners participate.

#### Tax credit for small employer pension plan start-up costs

A small employer that adopts a new qualified defined benefit or defined contribution plan, SIMPLE IRA plan, or SEP may receive a nonrefundable income tax credit for expenses related to the establishment or administration. The credit is the lesser of \$500 per year or 50 percent of qualified expenses and applies for up to three years.

#### Defined Contribution Plans

##### In general

Defined contribution plans may provide for nonelective contributions and matching contributions by employers and pretax (that is, contributions are either excluded from income or deductible) or after-tax contributions by employees. Total contributions made to an employee's account for a year cannot exceed the lesser of \$52,000 (for 2014) or the employee's compensation. The deduction for employer contributions to a defined contribution plan for a year is generally limited to 25 percent of the participants' compensation. A participant must at all times be fully vested in his or her own contributions to a defined contribution plan and must vest in employer contributions under three-year cliff vesting or two-to-six-year graduated vesting.

In the case of a defined contribution plan, nondiscrimination testing is generally based on the amount of employer nonelective contributions allocated to participants' accounts ("allocations"). Three general approaches to nondiscrimination testing are available: (1) design-based safe harbors; (2) a general test comparing allocation rates for highly and nonhighly compensated employees under the plan; and (3) cross-testing, which involves converting allocations to actuarially equivalent annuity accruals and comparing the equivalent accrual rates for highly and nonhighly compensated employees. Special nondiscrimination tests apply to section 401(k) plans.

Defined contribution plans often provide for loans to participants and generally provide for distributions on severance from employment and, depending on the type of plan, may provide for in-service distributions. Defined contribution plans may provide for distributions to be made

in a lump sum or installments; defined contribution plans may offer annuity distributions, but most are not required to offer annuities.

### General types of defined contribution plans

Defined contribution plans may themselves be of different types, specifically, profit-sharing plans, stock bonus plans, or money purchase plans, and may include special features, such as a qualified cash or deferred arrangement (sec. 401(k)) or an employee stock ownership plan (“ESOP”). Rules requiring annuity benefits for surviving spouses and spousal consent to certain distributions apply to money purchase plans and, in some cases, other defined contribution plans offering annuities. However, most defined contribution plans are exempt from these requirements as long as they provide that a participant’s account balance will be paid to the participant’s surviving spouse (unless the spouse consents to a different beneficiary).

### Section 401(k) plans

Under a section 401(k) plan, an employee may elect to have contributions (elective deferrals) made to the plan, rather than receive the same amount in cash. For 2014, elective deferrals of up to \$17,500 may be made, plus, for employees aged 50 or older, up to \$5,500 in catch-up contributions. Elective deferrals generally cannot be distributed from the plan before the employee’s severance from employment, death, disability or attainment of age 59½ or in the case of hardship or plan termination.

Elective deferrals are generally made on a pretax basis. However, a section 401(k) plan may include a qualified Roth contribution program under which elective deferrals are made on an after-tax basis (designated Roth contributions), and certain distributions (“qualified distributions”) are excluded from income. Many section 401(k) plans provide for matching contributions and may also provide for employer nonelective contributions and after-tax employee contributions.

Section 401(k) plans may be designed so that elective deferrals are made only if the employee affirmatively elects them. However, a section 401(k) plan may provide for “automatic enrollment,” under which elective deferrals are made at a specified rate unless the employee affirmatively elects not to make contributions or to make contributions at a different rate. Various rules have been developed to provide favorable treatment for plans that provide for automatic enrollment, subject to certain notice requirements.

Elective deferrals under a section 401(k) plan are subject to a special nondiscrimination test, called the actual deferral percentage test or “ADP” test, which compares the average deferral rates for highly compensated employees and nonhighly compensated employees. A similar test, the actual contribution percentage test or “ACP” test, applies to employer matching contributions and after-tax employee contributions. Designed-based safe harbors are also available for satisfying the special nondiscrimination requirements.



## ESOPs

An ESOP is a stock bonus plan that is designated as an ESOP and is designed to invest primarily in employer stock. An ESOP can be an entire plan or it can be a portion of a defined contribution plan.

ESOPs are subject to additional requirements that do not apply to other plans that hold employer stock. However, certain benefits are available to ESOPs that are not available to other types of qualified retirement plans, including an exception to the prohibited transaction rules for certain loans and, in the case of a C corporation, higher deduction limits. ESOPs maintained by S corporations are subject to special rules, including some restrictions on the grant of stock options (or the provision of other “synthetic equity”) by the S corporation.

A taxpayer may elect to defer the recognition of long-term capital gain on the sale of employer stock to an ESOP maintained by a C corporation if the taxpayer purchases qualified replacement property within a certain period and other requirements are met.

## Diversification of employer stock

If employer stock is allocated to participants’ accounts under a defined contribution, participants generally must be given diversification rights, that is, the right to have the participant’s account invested in assets other than employer securities. In the case of an ESOP, a participant age 55 or older with at least 10 years of participation generally must be permitted to diversify up to 25 percent of his account each year in a six-year-period (50 percent in the sixth year), reduced by the portion of the account diversified in prior years. In general, in the case of a defined contribution plan that holds publicly traded employer stock and is not an ESOP (or is an ESOP that is a section 401(k) plan), a participant must be permitted to diversify amounts attributable to elective deferrals and employee contributions. In the case of amounts attributable to nonelective employer contributions and employer matching contributions, a participant with three years of service must be permitted to diversify.

## Special types of plans for governmental and tax-exempt employers

Tax-exempt charitable organizations (sec. 501(c)(3)) and educational institutions of State or local governments may offer their employees a section 403(b) plan. State and local government employers may offer their employees a section 457(b) plan. Section 403(b) plans and governmental section 457(b) plans are similar to section 401(k) plans.

## Plan loans and hardship distributions

A defined contribution plan may provide for loans to participants, subject to certain conditions on the amount of the loan and repayment terms. A loan that does not meet these conditions is a deemed distribution. If a loan meets the required conditions, but the participant’s account balance is later reduced (offset) to repay the loan, a distribution occurs in the amount of the plan loan offset.

Despite general restrictions on in-service distributions of elective deferrals, defined contribution plans and section 403(b) plans may offer hardship distributions. Section 457 plans

may provide for distributions in the case of an unforeseeable emergency, a similar, but narrower, concept than hardship.

### Lifetime income under defined contribution plans

Although pension plans are required to offer annuity forms of distribution, most defined contribution plans are not required to offer annuities. Instead, a participant's benefit consists of an account balance, which can be depleted during the participant's lifetime. The increase in the number of employees who are covered only by defined contribution plans has increased concern that participants will outlive their account balances. Similar concerns arise with respect to IRA owners.

These concerns have been a focus of an initiative by the Department of the Treasury and the IRS in collaboration with DOL to expand the availability of lifetime income options under defined contribution plans and IRAs. As part of this initiative, the IRS recently amended the regulations governing required minimum distributions to accommodate the holding, in a defined contribution plan or IRA, of an annuity contract under which payments are scheduled to begin at an advanced age, such as age 80 or 85. Other guidance clarifies the application of certain spousal protection requirements when a deferred annuity contract is offered as an investment option under a profit-sharing plan.

### Saver's credit

Taxpayers with AGI below certain thresholds who make contributions to a qualified retirement plan, a section 403(b) plan, a governmental section 457 plan, or an IRA are generally eligible for a nonrefundable tax credit. The credit is a percentage of the taxpayer's contributions up to \$2,000, with the credit percentage varying from 10 percent to 50 percent, depending on the taxpayer's adjusted gross income ("AGI").

### Defined Benefit Plans

Under a defined benefit plan, benefits are determined under a plan formula, rather than based on actual accounts or plan assets. Traditionally, a defined benefit plan formula has determined benefits as a life annuity commencing at normal retirement age, based on compensation and years of service. However, hybrid defined benefit plans, such as cash balance plans, under which a participant's benefit is expressed as a hypothetical account balance, are also common.

Defined benefit plans are generally funded by employer contributions, but some also provide for employee contributions, particularly governmental plans. Private defined benefit plans are subject to minimum funding requirements and benefits under most private plans are guaranteed, within limits, by the PBGC. Employer contributions to defined benefit plans are currently deductible, within limits.

Defined benefit plans are generally subject to the same qualification requirements as defined contribution plans, including the nondiscrimination requirements and vesting requirements. A participant must at all times be vested in the portion of the accrued benefit attributable to his or her own contributions, if any. With respect to the employer-provided

portion of the accrued benefit under a defined benefit plan using a traditional benefit formula, minimum vesting must occur under one of two vesting schedules: 100 percent vesting after five years of service, or 20 percent, 40 percent, 60 percent, 80 percent, and 100 percent, respectively, over the period of three to seven years of service. Under a hybrid plan, full vesting must occur after three years of service. In addition, benefits must accrue in a one of three permissible patterns over a participant's period of service in order to prevent significant accruals to be delayed until later years of service.

Defined benefit plans are generally subject to spousal protections, under which the default form of retirement benefit for a married participant must provide annuity benefits for a surviving spouse and annuity benefits must also be provided to a surviving spouse if a participant dies before receiving benefits. Various forms of benefits under a defined benefit plan (referred to as optional forms of benefit) must generally be actuarially equivalent to the normal retirement benefit, and, once earned, benefits may not be reduced or optional forms of benefit be eliminated. Defined benefit plans must provide benefits in the form of an annuity and generally cannot make in-service distributions before age 62.

Annuity distributions from a defined benefit plan for a year generally cannot exceed the lesser of \$210,000 (for 2014) or the employee's high-three-year average compensation. The dollar limit is generally reduced if distributions begin before age 62 and increased if distributions begin after age 65, and an actuarially adjusted limit applies to benefits paid in other forms, such as lump sums.

#### Individual Retirement Arrangements

There are two basic types of IRAs: traditional IRAs, to which deductible or nondeductible contributions can be made, and Roth IRAs, contributions to which are not deductible. The total contributions made to all IRAs for a year cannot exceed \$5,500 (for 2014), plus an additional \$1,000 (not indexed) in catch-up contributions for individuals age 50 or older. Certain individuals are not permitted to make deductible contributions to a traditional IRA or to make contributions to a Roth IRA, depending on their income.

Distributions from traditional IRAs are generally includible in income, except to the extent a portion of the distribution is treated as a recovery of the individual's basis (if any). Qualified distributions from a Roth IRA are excluded from income; other distributions from a Roth IRA are includible in income to the extent of earnings. IRA distributions generally can be rolled over to another IRA or qualified retirement plan; however, a distribution from a Roth IRA generally can be rolled over only to another Roth IRA or a designated Roth account.

SIMPLE IRAs and SEPs are special types of employer-sponsored retirement plans under which the employer makes contributions to IRAs established for each of its employees in accordance with the Code requirements for each type of plan. Deemed IRAs are permitted to be provided in conjunction with a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan. An employer may also establish a payroll deduction IRA program, under which employees can elect to have amounts withheld from their pay and contributed to an IRA opened by the employee.

An IRA can be an annuity contract issued by a State-licensed insurance company or a trust or custodial account with a trustee or custodian that is a Federal- or State-regulated bank or an IRS-approved nonbank trustee. IRA assets are not permitted to be invested in certain assets, such as life insurance contracts or collectibles (for example, art, gems, stamps or most coins). Impermissible investments and certain transactions involving an IRA may result in loss of IRA treatment and/or a deemed distribution of some or all of IRA assets.

#### Early Distributions and Required Minimum Distributions

Distributions before age 59½ that are includible in income are also subject to an additional 10-percent early withdrawal tax unless an exception applies.

Under the minimum distribution requirements, distributions from a qualified retirement plan are required to begin within a certain period after a participant attains age 70½ or, in certain circumstances, after a participant retires, if later, and distributions must be taken over the life or life expectancy of the participant (or the participant and a beneficiary). Minimum distribution requirements also apply after a participant's death. An excise tax may apply if required minimum distributions are not made.

#### Other Tax-Favored Individual Savings Arrangements for Specific Purposes

Besides employer-sponsored plans and IRAs, the Code provides tax-favored treatment for qualified tuition programs and Coverdell education savings accounts, to save for education, and health savings account and Archer medical savings accounts, to save for health expenses.

#### **Economic Issues Relating to Retirement Plans**

Qualified retirement plans, IRAs, and other tax-favored forms of saving modify the tax treatment of saving that would apply in a pure income tax. By permitting taxpayers to defer income tax on income that is saved indirectly, this system achieves substantially similar economic effects as a cash-flow consumption tax.

From a practical standpoint, economists disagree whether these tax-favored saving vehicles increase the level of national saving; empirical investigations of this question often yield conflicting results, partially due to underlying assumptions about behavioral responses to such policies.

#### **Data Relating to Retirement Savings**

Data show that, in 2014, 65 percent of private-sector workers had access to a qualified retirement plan and 48 percent of those with access participated. Over the period 1975-2011, the number of participants in private single-employer defined contribution plans has steadily increased while participation in private single-employer defined benefit plans and multiemployer defined contribution and defined benefit plans has remained steady. Among private defined benefit plan participants, a steadily decreasing portion consists of active participants and a steadily increasing portion consists of inactive. Within the private sector, rates of access to and participation in qualified retirement plans vary between full-time and part-time workers and between union and non-union workers. Rates of access to and participation in qualified

retirement plans also vary between workers in the private sector and in State and local government.

Data show that married households are more likely to have savings in tax-favored retirement arrangements than single households. Older households are more likely than younger households to have defined benefit plan pensions and younger households are more likely than older to have defined contribution plan accounts.

In 2013, assets in private defined benefit plans totaled about \$3.1 trillion; assets in private defined contribution plans totaled about \$4.9 trillion; and assets in IRAs totaled about \$6.5 trillion. The investment composition of total assets held in private defined benefit plans, private defined contribution plans and IRAs varies among the types of arrangements.

## I. PRESENT LAW

### A. Overview of Compensation and Tax Treatment

#### 1. In general

Compensation consists of all amounts provided in consideration for services. Compensation can take many different forms, including cash, noncash benefits, property or other economic benefit. Retirement plans are another form of compensation. Subject to certain limits and mandates under Federal and State law, and to the collective bargaining process, if applicable, service providers and service recipients have a great deal of flexibility in how they structure their compensation packages.

An individual may perform services as an employee of an employer, which may be an individual (including a sole proprietorship), a business (a partnership or corporation), or a tax-exempt organization. An individual may also perform services as an independent contractor, in which case the individual is self-employed for tax purposes. Sole proprietors and partners performing services for the businesses they own are also self-employed.

Compensation is generally includible in gross income and taxed as ordinary income. Compensation is also generally taxed on a cash basis (rather than an accrual basis), *i.e.*, compensation is taxed when it is actually or constructively received. Constructive receipt occurs when income has been credited to the individual's account, set apart for the individual, or otherwise made available to the individual without substantial limitation or restriction, so that the individual can draw on it at any time.

Compensation costs are generally deductible as business expenses in accordance with the employer's (or other service recipient's) method of accounting as modified by special rules under the Code (including special rules for deferred compensation). In the case of a self-employed individual, compensation for services is reduced by any deductions for related expenses, and the net amount is includible in gross income.

Certain types of employee compensation are excludible from gross income - and thus not taxable - for example, employer-paid health insurance premiums<sup>2</sup> and reimbursements for medical care,<sup>3</sup> employer-provided dependent care assistance up to \$5,000 a year,<sup>4</sup> and certain fringe benefits such as qualified transportation fringes.<sup>5</sup> These exclusions do not apply to self-employed individuals unless specifically provided for. For example, for purposes of the exclusion for dependent care assistance, a self-employed individual is treated as an employee. In some cases, a comparable alternative tax benefit may be provided to a self-employed individual,

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<sup>2</sup> Sec. 106.

<sup>3</sup> Sec. 105(b).

<sup>4</sup> Sec. 129.

<sup>5</sup> Sec. 132.

for example, the above-the-line deduction for health insurance premiums paid by a self-employed individual.<sup>6</sup>

Subject to certain exceptions, employee compensation is subject to tax under the Federal Insurance Contributions Act (“FICA”) (consisting of Social Security tax and Medicare tax, employer and employee shares),<sup>7</sup> as well as income tax withholding.<sup>8</sup> Net compensation of a self-employed individual is subject to tax under the Self-Employment Contributions Act (“SECA”).<sup>9</sup>

## 2. Deferred compensation

Compensation may be received currently, *i.e.*, within or shortly after the end of the taxable year in which the compensation is earned, or receipt may be deferred to a later time. For this purpose, compensation is generally not considered earned until the individual’s right to the compensation is vested, *i.e.*, not subject to a substantial risk of forfeiture. Compensation is subject to a substantial risk of forfeiture, and thus not vested, if the individual’s right to the compensation is conditioned on the future performance of substantial additional services.

Current compensation is includible in income when actually or constructively received. The tax treatment of deferred compensation depends on whether it is qualified (*i.e.*, eligible for tax-favored treatment) or nonqualified and, if nonqualified, whether it is funded or unfunded. Tax-favored deferred compensation arrangements include a qualified retirement plan or annuity, a tax-sheltered annuity plan (referred to as a “section 403(b)” plan), and an eligible deferred compensation plan of a State or local government employer (referred to as a governmental “section 457(b)” plan). As discussed below in Part I.B.1, under tax-favored employer-sponsored retirement plans, employees do not include employer contributions, earnings on contributions, or benefits in gross income until amounts are distributed, even though the arrangement is funded and even if benefits are vested. In contrast to the rules for nonqualified deferred compensation under which, as discussed below, an employer’s deduction is not allowable before employees include the nonqualified deferred compensation in gross income, in the case of a taxable employer, the employer is entitled to a current deduction (within limits) for its contributions to tax-favored retirement plans even though the contributions are not currently included in an employee’s income.

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<sup>6</sup> Sec. 162(l).

<sup>7</sup> Secs. 3101-3128.

<sup>8</sup> Secs. 3401-3404.

<sup>9</sup> Secs. 1401-1403.

### 3. Tax treatment of nonqualified deferred compensation<sup>10</sup>

Funded nonqualified deferred compensation is included in income when vested, even if the individual does not have the right to receive the compensation currently. Nonqualified deferred compensation is considered funded if it is held in a trust or account that is set aside from claims of the employer's (or other service recipient's) creditors, if it is provided under a nonqualified annuity contract, or if it is otherwise secured, such as by a letter of credit.<sup>11</sup> The amount included in income results in "basis," and later payments of the deferred compensation are taxed as an annuity, *i.e.*, part nontaxable basis recovery and part income.<sup>12</sup> However, in the case of nonqualified deferred compensation funded by a trust that fails to meet certain nondiscrimination requirements applicable to qualified retirement plans, a highly compensated employee must include in income each year any increase in the employee's vested interest in the trust for that year.

Unfunded deferred compensation consists of a mere promise to pay compensation in the future and may be payable through a trust or account, provided that the assets of the trust or account are subject to claims of the employer's (or other service recipient's) creditors. Unfunded nonqualified deferred compensation is generally includible in income when actually or constructively received. However, earlier income inclusion (and taxes in addition to regular income tax) may result from a violation of certain rules as to the timing of elections to defer compensation and the time when deferred compensation can be paid.<sup>13</sup> In addition, nonqualified deferred compensation for services performed for a tax-exempt or State or local government employer or certain other entities may be included in income on vesting, even if unfunded.<sup>14</sup>

A trust or account that holds assets related to nonqualified deferred compensation is not tax-exempt. The trust may be a separate taxable entity, or the earnings of the trust or account may be income of the employer (or other service recipient).

Nonqualified deferred compensation is not deductible by the employer (or other service recipient) until includible in the individual's income.<sup>15</sup>

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<sup>10</sup> The Employee Retirement Income Security Act of 1974 ("ERISA") limits the extent to which nongovernmental employers (other than churches) can maintain a nonqualified deferred compensation arrangement without satisfying various ERISA requirements, such as the vesting and funding requirements. Such an arrangement is generally permitted only with respect to a select group of management or highly compensated employees.

<sup>11</sup> Secs. 83, 402(b), and 403(c).

<sup>12</sup> Sec. 72.

<sup>13</sup> Sec. 409A.

<sup>14</sup> Secs. 457(f) and 457A.

<sup>15</sup> Sec. 404.



## **B. Tax-Favored Employer-Sponsored Retirement Plans**

### **1. Overview of employer-sponsored tax-favored retirement plans**

Whether to offer a tax-favored retirement plan to employees is a voluntary choice by an employer. As with other components of a compensation package, an employer may have a variety of motivations in deciding whether to offer a retirement plan. The motivations to offer a plan may be different for a large public company that is broadly owned by its stockholders than for an owner-operated company where the plan is providing retirement benefits for both the owners and their employees. For a large public company that is competing for employees with other employers that offer retirement plans, the motivation may be primarily recruitment and retention of employees. For an owner-operated company, providing for the owner's retirement may play a larger role, with providing benefits also to employees as a further consideration. For some employers, the decision to offer a plan may be subject to collective bargaining negotiations.

A key element in an employer's decision is the value that employees place on being provided benefits under a retirement plan versus receiving current compensation. A basic reason for employees to value being provided benefits under an employer-sponsored retirement plan as a portion of their total compensation is the tax deferral and savings opportunity inherent in these plans. For example, the amount of elective deferrals an employee can make to an employer-sponsored retirement plan is greater than the contributions an individual can make to an IRA. In addition, the employer may separately make nonelective or matching contributions.

For employers that decide to offer a tax-favored retirement plan, the Code provides rules as to the amount of benefits, the timing of benefit distributions, and the deductibility of contributions. The Code also imposes protections for employees to ensure that they receive the benefits promised under the plan, for example, by requiring defined benefit plans to be adequately funded and protecting the integrity of individual accounts under defined contribution plans by making sure account assets are not misused or diverted; parallel rules generally apply under ERISA. However, subject to these rules, an employer has a great deal of flexibility in deciding the structure of its retirement plan and the level of benefits, as permitted under the various types of plans available.

One element in a plan's structure is whether the employer offers retirement benefits as a unilateral benefit that the employee accepts implicitly by accepting employment with, or remaining employed by, the employer. Alternatively, within limits, the employer may allow a year-by-year choice by the employee whether to accept current compensation or make contributions to the plan. Employers may structure a retirement plan in part as a retention tool so that only employees who work for a certain number of years become vested in the benefits accrued under the plan (within limits as discussed below).

The most common type of tax-favored plan is a qualified retirement plan,<sup>16</sup> which may be a defined benefit plan or a defined contribution plan. A defined contribution plan may include a

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<sup>16</sup> Sec. 401(a).

qualified cash or deferred arrangement,<sup>17</sup> which offers an employer great flexibility in designing a retirement program for its employees. Another option is a qualified annuity plan,<sup>18</sup> which is similar to and subject to requirements similar to those applicable to qualified retirement plans.

Additional options are available to certain tax-exempt or governmental employers, including tax-deferred annuities<sup>19</sup> and eligible deferred compensation plans,<sup>20</sup> which are sometimes offered in lieu of a section 401(k) plan. Certain small employers have the option of maintaining a SIMPLE IRA plan<sup>21</sup> or a simplified employee pension (“SEP”),<sup>22</sup> as discussed in Part I.E.3, which are funded through direct contributions by the employer to an IRA established for each employee.

## **2. Qualified retirement plans and annuities**

### **In general**

A plan of deferred compensation that meets the qualification requirements under the Code (a “qualified retirement plan”) is accorded special tax treatment. Employees do not include employer contributions, earnings on contributions, or benefits in gross income until amounts are distributed, even though the arrangement is funded and even if benefits are vested. Certain distributions (such as lump sums) can be rolled over to another tax-favored plan with further deferral of income inclusion. In the case of a taxable employer, the employer is entitled to a current deduction (within limits) for contributions even though the contributions are not currently included in an employee’s income.<sup>23</sup> Contributions to a qualified retirement plan (other than elective deferrals and after-tax contributions) are exempt from FICA tax, as are plan distributions. Pretax contributions are exempt from income tax withholding, and special withholding rules apply to distributions. Contributions to a qualified retirement plan, and earnings thereon, are held in a tax-exempt trust, which enables the assets to grow on a tax-free basis.

Present law imposes a number of requirements on qualified retirement plans that must be satisfied for favorable tax treatment to apply.<sup>24</sup> Some of these requirements define the rights of

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<sup>17</sup> Sec. 401(k).

<sup>18</sup> Sec. 403(a).

<sup>19</sup> Sec. 403(b).

<sup>20</sup> Sec. 457(b).

<sup>21</sup> Sec. 408(p).

<sup>22</sup> Sec. 408(k).

<sup>23</sup> Sec. 404. Under section 4972, an excise tax may apply if contributions in excess of the deduction limits are made.

<sup>24</sup> In general, for purposes of these requirements, members of controlled groups under section 414(b) or (c) and affiliated service groups under section 414(m) or (o) are treated as a single employer.

plan participants and beneficiaries, such as the minimum participation and vesting requirements. In addition, assets of the plan must be held in a trust or custodial account for the exclusive benefit of plan participants, and prohibited transaction rules (that is, rules prohibiting self-dealing by employers and plan fiduciaries) apply to plan assets.<sup>25</sup> Defined benefit plans and money purchase pension plans (a type of defined contribution plan) are also subject to minimum funding requirements, discussed below.

Under the minimum participation rules, a plan generally cannot delay an employee's participation in the plan beyond the later of completion of one year of service (*i.e.*, a 12-month period with at least 1,000 hours of service) or attainment of age 21.<sup>26</sup> In addition, a plan cannot exclude an employee from participation on the basis of attainment of a specified age. Employees can be excluded from plan participation on other bases, such as job classification, as long as the other basis is not an indirect age or service requirement.

Under the vesting rules, a participant's right to the benefits he or she has accrued under a plan ("accrued benefit") generally must become nonforfeitable after a specified period of service or, if earlier, at attainment of normal retirement age under the plan.<sup>27</sup> Benefits under either a defined benefit plan or a defined contribution plan that are attributable to employee contributions (including elective deferrals) must be fully vested at all times. The period of service after which benefits attributable to employer contributions must be vested depends on the type of plan (defined benefit or defined contribution), as discussed below. A plan may provide for vesting earlier than when required, but not later.

The vesting rules also generally prohibit amendments that reduce previously accrued benefits or eliminate optional forms of benefit with respect to previously accrued benefits. Reductions in an employee's rate of accrual under a defined benefit plan, or rate of allocation under a defined contribution plan, due to increasing age generally are also prohibited.

The vesting rules also prohibit distribution of an employee's accrued benefit without consent (an "involuntary" distribution) before the later of the time the participant has attained normal retirement age under the plan or attained age 62. An exception generally allows an

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<sup>25</sup> Secs. 401(a)(2) and 4975. Under this exclusive benefit requirement, prior to satisfaction of all liabilities under the plan with respect to employees and their beneficiaries, assets are not allowed to be used for or diverted to purposes, other than the exclusive benefit of employee or their beneficiaries. See further discussion below regarding prohibited transactions. Also see section 420 that allows transfer of excess pension assets under a defined benefit plan to retiree health accounts and life insurance accounts under certain circumstance and provides that the plan will not fail the plan qualification requirements (including the exclusive benefit requirement) solely by reason of such transfer.

<sup>26</sup> Sec. 410(a).

<sup>27</sup> Sec. 411. A plan may specify the plan's normal retirement age but may not specify a normal retirement age later than age 65 or, if later, the fifth anniversary of the time the participant commenced plan participation.

involuntary distribution if the present value of the employee's accrued benefit at the time of the distribution is not more than \$5,000 ("mandatory cashout").<sup>28</sup>

Qualified retirement plans are also subject to regulation under ERISA, which generally is under the jurisdiction of the Department of Labor ("DOL").<sup>29</sup> The ERISA rules generally relate to the rights of plan participants and beneficiaries, reporting and disclosure, and the obligations of plan fiduciaries. Some of the provisions of the Code and ERISA that apply to qualified retirement plans are identical or very similar.<sup>30</sup> For example, ERISA includes minimum participation and vesting requirements that parallel those under the Code.

Some qualified retirement plan requirements provide limits on the tax benefits for qualified retirement plans, such as the limit on compensation that may be taken into account for qualified retirement plan purposes (\$260,000 for 2014) and limits on contributions, benefits and deductions.<sup>31</sup> The limits on contributions, benefits and deductions apply separately to defined benefit and defined contribution plans, as discussed below.

### **Minimum coverage and nondiscrimination requirements**

#### In general

A qualified retirement plan is prohibited from discriminating in favor of highly compensated employees, referred to as the nondiscrimination requirements. These requirements are intended to ensure that a qualified retirement plan provides meaningful benefits to an employer's rank-and-file employees as well as highly compensated employees, so that qualified retirement plans achieve the goal of retirement security for both lower-paid and higher-paid employees. The nondiscrimination requirements consist of a minimum coverage requirement and general nondiscrimination requirements.<sup>32</sup> For purposes of these requirements, an employee generally is treated as highly compensated if the employee (1) was a five-percent owner of the

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<sup>28</sup> In determining present value for this purpose, benefits attributable to a rollover to the plan may be disregarded.

<sup>29</sup> Governmental plans and church plans are generally exempt from ERISA and from the Code requirements that correspond to ERISA requirements. The PBGC has jurisdiction over the defined benefit plan insurance program under Title IV of ERISA.

<sup>30</sup> Reorganization No. 4, Pub. L. No. 99-524, divides interpretive jurisdiction between Treasury and the Department of Labor with respect to these provisions so that generally only one agency has interpretative jurisdiction with respect to each provision that is in both the Code and ERISA.

<sup>31</sup> Secs. 401(a)(16) and (17), 404 and 415.

<sup>32</sup> Sections 401(a)(3) and 410(b) deal with the minimum coverage requirement; section 401(a)(4) deals with the general nondiscrimination requirements, with related rules in section 401(a)(5). Detailed regulations implement the statutory requirements. In addition to the minimum coverage and general nondiscrimination requirements, under section 401(a)(26), the group employees who accrue benefits under a defined benefit plan for a year must consist of at least 50 employees, or, if less, 40 percent of the workforce, subject to a minimum of two employees accruing benefits. Governmental plans are not subject to these requirements.

employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of \$115,000 (for 2014).<sup>33</sup>

The minimum coverage and general nondiscrimination requirements apply annually on the basis of the plan year. In applying these requirements, employees of all members of a controlled group or affiliated service group are treated as employed by a single employer. Employees who have not satisfied minimum age and service conditions under the plan, certain nonresident aliens, and employees covered by a collective bargaining agreement are generally disregarded.<sup>34</sup> If a plan does not satisfy the nondiscrimination requirements on its own, it may in some circumstances be aggregated with another plan, and the two plans tested together as a single plan.

#### Minimum coverage requirement

Under the minimum coverage requirement, the plan's coverage of employees must be nondiscriminatory. This is determined by calculating the plan's ratio percentage, that is, the ratio of the percentage of nonhighly compensated employees (of all nonhighly compensated employees in the workforce) covered under the plan over the percentage of highly compensated employees covered. If the plan's ratio percentage is 70 percent or greater, the plan satisfies the minimum coverage requirement. If the plan's ratio percentage is less than 70 percent, a multi-part test applies. First, the plan must cover a group (or "classification") of employees that is reasonable and established under objective business criteria, such as hourly or salaried employees (referred to as a reasonable classification), and the plan's ratio percentage must be at or above a specific level specified in the regulations. In addition, the average benefit percentage test must be satisfied. Under the average benefit percentage test, the average rate of contributions or benefit accruals for all nonhighly compensated employees in the workforce (taking into account all plans of the employer) must be at least 70 percent of the average contribution or accrual rate of all highly compensated employees.

#### General nondiscrimination requirements

##### In general

Under a general nondiscrimination requirement, a qualified retirement plan may not discriminate in favor of highly compensated employees with respect to contributions or benefits. The general nondiscrimination requirements are met if (1) the amount of contributions or benefits provided under the plan are nondiscriminatory, (2) each benefit, right or feature under the plan is available to a nondiscriminatory group of employees, and (3) the timing of plan

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<sup>33</sup> Sec. 414(q). At the election of the employer, employees who are highly compensated based on compensation may be limited to the top 20 percent highest paid employees. A nonhighly compensated employee is an employee other than a highly compensated employee.

<sup>34</sup> A plan or portion of a plan covering collectively bargained employees is generally deemed to satisfy the nondiscrimination requirements. Thus, multiemployer plans, which by definition cover collectively bargained employees are generally deemed to satisfy the nondiscrimination requirements.

amendments does not have the effect of discriminating significantly in favor of highly compensated employees.<sup>35</sup>

As described above, in some circumstances, two or more plans may be aggregated and tested as a single plan for purposes the nondiscrimination requirements. In addition, the regulations implementing the general nondiscrimination requirements, allow a plan to be segmented into multiple plans, referred to as component plans, with each component plan tested separately. For example, a defined benefit plan may cover different divisions, with different benefit formulas for the employees of each division. For purposes of applying the general nondiscrimination requirements, the plan could be segmented into components, based on the portions of the plan covering employees of each division, and the requirements applied separately with respect to each component.

#### Nondiscrimination in the amount of contributions or benefits

There are three general approaches to testing the amount of contributions benefits under a qualified retirement plan: (1) design-based safe harbors under which the benefit formula under a defined benefit plan, or the formula for allocating employer nonelective contributions under a defined contribution plan to participants' accounts, satisfies certain uniformity standards;<sup>36</sup> (2) a general test (described below); and (3) cross-testing of equivalent accruals or allocations (described below).<sup>37</sup> A plan is not discriminatory merely because benefit accruals or allocations for highly compensated and nonhighly compensated employees are provided as a percentage of compensation (up to \$260,000 for 2014).<sup>38</sup> Thus, the various testing approaches are generally applied to the amount of contributions or benefits provided as a percentage of compensation.

The general test is generally satisfied by measuring the allocation rate (under a defined contribution plan) or accrual rate (under a defined benefit plan) of each highly compensated employee to determine if the group of employees with the same or higher rate of accrual or allocation (referred to as a rate group) is a nondiscriminatory group.<sup>39</sup> This test generally is

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<sup>35</sup> Treas. Reg. sec. 1.401(a)(4)-1. With respect to the amount of contributions, employee elective deferrals under a section 401(k) plan and employer matching contributions and after-tax employee contributions to a defined contribution plan are subject to special testing rules, rather than being included in applying the general nondiscrimination requirements. In addition, the amount of employer contributions to an ESOP is tested separately from other employer contributions. Rules applicable to benefits, rights and features and the timing of plan amendments are provided in Treas. Reg. secs. 1.401(a)(4)-4 and -5 respectively.

<sup>36</sup> Sections 401(a)(5)(C)-(D) and 401 (l) and Treas. Reg. secs. 1.401(l)-1 through -6 provide rules under which the benefit or allocation formula may take into account the employer-paid portion of social security taxes or benefits, referred to as permitted disparity.

<sup>37</sup> These approaches are explained in Treas. Reg. secs. 1.401(a)(4)-2, -3 and -8.

<sup>38</sup> Sec. 401(a)(5)(B).

<sup>39</sup> An employee's allocation rate generally is the amount of employer contribution allocated to an employee's account for the plan year, expressed as a percentage of the employee's compensation for the plan year. An employee's accrual rate generally is the amount of the annual payments under the employee's accrued benefit payable at normal retirement age in the form of a straight life annuity divided by the employee's years of service

satisfied if the ratio percentage of the rate group (that is, the percentage of nonhighly employees in the rate group, compared with the percentage of highly compensated employees) satisfies the minimum coverage requirement. For this purpose, if the ratio percentage of the rate group is less than 70 percent, a simplified standard applies, which disregards the reasonable classification requirement and instead applies a minimum ratio percentage for the rate group (and still requires satisfaction of the average benefit percentage test). The minimum ratio percentage under this simplified standard depends on the percentage of the employer's workforce that consists of nonhighly compensated employees (the nonhighly compensated employee percentage) and ranges from (1) a minimum ratio percentage of 45 percent if the nonhighly compensated employee percentage is 60 percent (or less) to (2) a minimum ratio percentage 20.375 percent if the nonhighly compensated employee percentage is 99 percent.<sup>40</sup>

### Cross-testing

Cross-testing involves the conversion of allocations or accruals to actuarially equivalent accruals or allocations, with the resulting equivalencies tested under the general test.<sup>41</sup> Cross-testing can also involve the aggregation of a defined benefit plan and a defined contribution plan for purposes of satisfying the nondiscrimination requirements, with the aggregated plan tested on the basis of aggregate equivalent allocations or aggregate equivalent benefits. Cross-testing of allocations under a defined contribution plan (or an aggregated defined contribution and defined benefit plan) based on equivalent benefits (or aggregate equivalent benefits) is permitted only if certain threshold requirements are met.<sup>42</sup> The regulations provide a

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and expressed as a percentage of average annual compensation. Under the permitted disparity rules, allocation and accrual rates are then permitted to be increased by a factor to reflect the employer paid portion of social security taxes or benefits. If a defined benefit plan provides subsidized optional forms of benefit, the accrual rate for the actuarially most valuable benefit under the plan available to each employee is also calculated and tested.

<sup>40</sup> If a rate group includes all highly compensated employees, the ratio percentage described above represents the percentage of nonhighly compensated employees who must be in the rate group. However, if a rate group includes only a small percentage of the employer's highly compensated employees, such as executives, the actual percentage of nonhighly compensated employees in the rate group can be quite small. In some cases, a large benefit under a qualified retirement plan may be provided to executives under a special formula that applies to them and only a small group of nonhighly compensated employees, yet still satisfies the general nondiscrimination requirements. Further, benefits are taken into account in nondiscrimination testing without regard to whether the benefits are fully vested. If turnover is high among lower-paid employees, some of those employees may later forfeit their benefits under the special formula. For the executives, the benefit under the qualified retirement plan may be combined with an offset of the executives' nonqualified deferred compensation. This structure is sometimes referred to as a qualified supplemental executive retirement plan (QSERP).

<sup>41</sup> An interest rate of no less than 7.5 percent and not more than 8.5 percent is required to be used for the conversion.

<sup>42</sup> Treas. Reg. secs. 1.401(a)(4)-8(b)(1)(i)(B) and (iii)-(iv) and 1.401(a)(4)-9(b)(2)(v). These threshold requirements were added to the regulations after a review by the Treasury Department of issues related to so-called new comparability plans under which highly compensated employees receive high allocation rates, while nonhighly compensated employees, regardless of their age or years of service, receive comparatively low allocation rates. For example, highly compensated employees in such a plan might receive allocations of 18 or 20 percent of compensation, while nonhighly compensated employees might receive allocations of three percent of compensation. Commonly, the higher allocation rates never apply to nonhighly compensated, regardless of additional years of

number of different ways that this threshold requirement can be met, including two safe harbor minimum allocation thresholds under which the plan provides a minimum allocation for each nonhighly compensated employee of five percent of compensation if the cross testing involves only a defined contribution plan or a minimum aggregate allocation of 7.5 percent of compensation if the cross testing involves an aggregated defined benefit and defined contribution plan.<sup>43</sup>

### Closed defined benefit plans

A defined benefit plan may be amended to limit participation in the plan to individuals who are employees as of a certain date. That is, employees hired after that date are not eligible to participate in the plan. Such a plan is sometimes referred to as "closed" (to new entrants) or "soft frozen." In such a case, it is common for the employer also to maintain a defined contribution plan and to provide employer matching or nonelective contributions only to employees not covered by the defined benefit plan or at a higher rate to such employees.

Over time, the group of employees covered by the defined benefit plan may come to consist more heavily of highly compensated employees, for example, because of greater turnover among nonhighly compensated employees or because increasing compensation causes nonhighly compensated employees to become highly compensated. In that case, the defined benefit plan may have to be combined with the defined contribution plan and tested on a benefits basis. However, if none of the threshold conditions described is met, testing on a benefits basis may not be available.

Recent IRS guidance provides temporary relief allowing a defined benefit plan closed to new entrants as of December 13, 2013, to be aggregated with a defined contribution plan and tested on an aggregate equivalent benefits basis without meeting any of the threshold conditions.<sup>44</sup> To be eligible for this relief, for the 2013 plan year, (1) the defined benefit plan must have satisfied the minimum coverage and general nondiscrimination requirements without

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service or increasing age. New comparability and similar plans rely on cross-testing to satisfy the nondiscrimination requirements despite these disparate allocation rates. Moreover, there is a potential for substantially higher benefits for highly compensated employees when a defined benefit plan that benefits primarily highly compensated employees (or provides only minimal benefits to nonhighly compensated employees) is aggregated with a defined contribution plan for purposes of nondiscrimination testing. The cross-testing thresholds do not prevent an employer from structuring a defined benefit plan that includes a hybrid plan formula and a traditional annuity-based plan formula (as described in Part I, D) from providing benefits similar to a new comparability defined contribution plan (or aggregated defined contribution and defined benefit plan). For further discussion, see the preamble to Treasury Decision 8954, 66 F.R. 34545 (June 29, 2001).

<sup>43</sup> The other thresholds generally require either certain plan design characteristics with respect to the plan's allocation formula (or for an aggregated defined contribution plan and defined benefit plan, the benefit formula under the defined benefit plan) or testing and comparing of the rates of allocation (or rate of equivalent allocations) of the employees benefiting under the defined contribution plan (or an aggregated defined contribution and defined benefit plan).

<sup>44</sup> Notice 2014-5, 2014-2 I.R.B. 276. The notice also identifies additional possible amendments to the regulations to accommodate closed defined benefit plans and requests public comment.



aggregation with a defined contribution plan, or (2) if the defined benefit plan was aggregated with a defined contribution plan, the aggregated plan must satisfy one of two thresholds: (1) have either been primarily defined benefit in character<sup>45</sup> or (2) consisted of broadly available separate plans.<sup>46</sup> If a plan meets these requirements, the relief is available for plan years beginning before January 1, 2016.

### Benefits rights and features

To be nondiscriminatory, each benefit, right or feature offered under the plan generally must be available to a group of employees that has a ratio percentage that satisfies the minimum coverage requirements including the reasonable classification requirement if applicable, except that the average benefit percentage test does not have to be met, even if the ratio percentage is less than 70 percent.

### Enforcement of requirements

Enforcement of the requirements that apply to qualified retirement plans depends on the source of the requirements. If a plan fails to meet the qualification requirements, then the favorable tax treatment for such plans may be denied; that is, the employer may lose tax deductions and employees may have current income taxation. As a practical matter, the IRS rarely disqualifies a plan. Instead, the IRS may impose sanctions short of disqualification and require the employer to correct any violation of the qualification rules. Certain rules relating to qualified retirement plans are enforced through an excise tax rather than through disqualification. For example, plan contributions in excess of the deductible limits do not result in disqualification of the plan. Instead, an excise tax is imposed on the employer.

### Qualified annuity plans

A qualified annuity plan is a type of retirement plan that is subject to the same requirements as qualified retirement plans and receives comparable tax-favored treatment, but plan assets consist of annuity contracts, rather than investments held in a trust or custodial account.<sup>47</sup>

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<sup>45</sup> That threshold requires that, for more than fifty percent of the nonhighly compensated employees under the plan, their accrual rate under the defined benefit plan exceeds their equivalent accrual rate under the defined contribution plan.

<sup>46</sup> That threshold requires that the defined benefit plan and the defined contribution plan would separately satisfy simplified versions of the minimum coverage and nondiscriminatory amount requirements.

<sup>47</sup> Secs. 403(a) and 404(a)(2).

### 3. Types of qualified retirement plans

#### **Defined benefit and defined contribution plans**

Qualified retirement plans are broadly classified into two categories, defined benefit plans and defined contribution plans, based on the nature of the benefits provided.<sup>48</sup> Although both types of plans are subject to the qualification requirements, the requirements differ somewhat for the two types of plans.

Under a defined benefit plan, benefits are determined under a plan formula, generally based on compensation and years of service. For example, a defined benefit plan might provide an annual retirement benefit of two percent of final average compensation multiplied by total years of service completed by an employee. Benefits under a defined benefit plan are funded by the general assets of the trust established under the plan which are invested by plan fiduciaries in accordance with plan terms; individual accounts are not maintained for employees participating in the plan.

Employer contributions to a defined benefit plan are subject to minimum funding requirements to ensure that plan assets are sufficient to pay the benefits under the plan.<sup>49</sup> The minimum funding rules also require periodic valuation of defined benefit plan assets. The amount of required annual contributions depends on the type of plan and is determined under certain actuarial methods taking into account this valuation. This structure generally results in the risk of investment gain or loss under a defined benefit plan being born by the employer through increases or decreases in required contributions to fund the promised plan benefits. An employer is subject to an excise tax for a failure to make required contributions, unless the employer obtains a funding waiver.<sup>50</sup> Benefits under defined benefit plans are generally guaranteed (within limits) by the PBGC.<sup>51</sup>

Under a defined contribution plan, a separate account is maintained for each participant, to which contributions are allocated and investment earnings (and losses) are credited. A participant's benefits are based solely on the participant's account balance. In contrast to a defined benefit plan, the risk of investment gain or loss under a defined contribution plan is born by the participant rather than the employer.

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<sup>48</sup> Some qualified retirement plan requirements apply to "pension" plans, which include defined benefit plans and money purchase pension plans, a type of defined contribution plan discussed below. See Treas. Reg. sec. 1.401-1(b)(1)(i) for the definition of pension plan.

<sup>49</sup> Sec. 412.

<sup>50</sup> Sec. 4971.

<sup>51</sup> To the extent benefits are not guaranteed by the PBGC, participants in an underfunded defined benefit plan bear the risk of losing benefits in the case of a distress termination of a single-employer defined benefit plan or insolvency of a multiemployer defined benefit plan.

Certain types of qualified retirement plans are referred to as hybrid plans because they have features of both a defined benefit plan and a defined contribution plan. For example, a cash balance plan is a hybrid plan. Legally, a cash balance plan is a defined benefit plan; however, plan benefits are defined by reference to a hypothetical account balance.

### **Single-employer, multiple-employer and multiemployer plans**

Qualified retirement plans are also categorized by the number of employers that maintain the plan and the type of employees covered by the plan.

A single-employer plan is a plan maintained by one employer; members of controlled groups and affiliated service groups are treated as one employer for this purpose. A single-employer plan may cover employees who are also covered by a collective bargaining agreement (“collectively bargained employees”), pursuant to which the plan is maintained (a “collectively bargained plan”).<sup>52</sup> An employer may maintain separate plans for collectively and noncollectively bargained employees, or they may be covered by the same plan.

A multiple-employer plan is a single plan in which two or more unrelated employers (that is, not members of the same controlled group or affiliated service group) participate but that is not a multiemployer plan described below.<sup>53</sup> Multiple-employer plans are commonly maintained by employers in the same industry, and, more recently, are used by professional employer organizations (“PEOs”) to provide qualified retirement plan benefits to employees working for PEO clients.<sup>54</sup> Some qualification requirements are applied to a multiple-employer plan on a plan-wide basis. For example, all employees covered by the plan are treated as employees of all employers participating in the plan for purposes of the exclusive benefit rule. Similarly, an employee’s service with all participating employers is taken into account in applying the minimum participation and vesting requirements, and compensation with all participating employers is taken into account in applying limits on benefits and contributions. Other requirements are applied separately, including the minimum coverage requirements, nondiscrimination requirements (both the general requirements and the special tests for section 401(k) plans) and the top-heavy rules.

Multiemployer plans (also known as “Taft-Hartley” plans, and distinct from multiple-employer plans) are plans maintained pursuant to one or more collective bargaining agreements with two or more unrelated employers and to which the employers are required to contribute under the collective bargaining agreement(s).<sup>55</sup> Multiemployer plans commonly cover collectively bargained employees in a particular industry. A multiemployer plan is not operated

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<sup>52</sup> See, e.g., Treas. Reg. sec. 1.410(b)-6(d).

<sup>53</sup> Sec. 413(c).

<sup>54</sup> Rev. Proc. 2003-86, 2003-2 C.B. 1211, and Rev. Proc. 2002-21, 2002-1 C.B. 911, address the application of the multiple-employer plan rules to defined contribution plans maintained by PEOs.

<sup>55</sup> Sec. 414(f).

by the contributing employers; instead, it is governed by a board of trustees (“joint board”) consisting of labor and employer representatives.

#### **4. Prohibited transactions**

The Code prohibits certain transactions between qualified retirement plans and a disqualified person.<sup>56</sup> Under ERISA, similar prohibited transaction rules apply to employer-sponsored retirement plans and welfare benefit plans.<sup>57</sup> The prohibited transaction rules do not apply to governmental plans or church plans.<sup>58</sup>

Under the Code, if a prohibited transaction occurs, the disqualified person is subject to a two-tier excise tax.<sup>59</sup> The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved. Amount involved generally means the greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received.<sup>60</sup>

Prohibited transactions include certain direct or indirect transactions between a plan and a disqualified person: (1) the sale, exchange, or leasing of property; (2) the lending of money or other extension of credit; and (3) the furnishing of goods, services or facilities. Prohibited transactions also include any direct or indirect: (1) transfer to, or use by or for the benefit of a disqualified person of the income or assets of the plan; (2) in the case of a fiduciary, an act that deals with the plan’s income or assets for the fiduciary’s own interest or account; and (3) the receipt by a fiduciary of any consideration for the fiduciary’s own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

In general, “disqualified person” means: (1) a fiduciary; (2) a person providing services to the plan; (3) an employer any of whose employees are covered by the plan; (4) an employee organization any of whose members are covered by the plan; (5) a direct or indirect owner of a specified interest in such an employer or employee organization; (6) a member of the family of an individual which meets certain definitions of a disqualified person; (7) a corporation, partnership, or trust or estate of which (or in which) a specified interest is owned by certain other

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<sup>56</sup> Sec. 4975. The prohibited transaction rules under the Code also apply to IRAs, health savings accounts (sec. 223), medical savings accounts (sec. 220), and Coverdell education savings accounts (sec. 530).

<sup>57</sup> In general, IRAs are not subject to ERISA. However, pursuant to Reorganization No 4, guidance issued by DOL with respect to the prohibited transaction rules applies also for purposes of the Code rules, including in applying the Code rules to IRAs.

<sup>58</sup> However, under section 503, a governmental or church plan that engages in a prohibited transaction as defined under that section may lose its tax-exempt status.

<sup>59</sup> Sec. 4975(a)-(b).

<sup>60</sup> Sec. 4975(f)(4).

disqualified persons; (8) offers and directors (or individuals having powers or responsibilities similar to those of officers or directors), 10-percent or more shareholders, or highly compensated employees (earning 10 percent or more of the yearly wages of the employer) of certain other disqualified persons; or (9) a 10-percent or more (in capital or profits) partner or joint venturer of certain other disqualified persons.

Under this definition, disqualified persons include corporations of which 50 percent or more of: (1) the combined voting power of all classes of stock entitled to vote; or (2) the total value of shares of all classes of stock of such corporation, is owned directly or indirectly, or held by certain other disqualified persons.<sup>61</sup> Thus, for example, a corporation 50 percent of the voting stock of which is owned by a plan is a disqualified person with respect to that plan.

Additionally, for purposes of the definition of disqualified person, a fiduciary includes any person who: (1) exercises any authority or control respecting management or disposition of the plan's assets; (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so; or (3) has any discretionary authority or responsibility in the administration of the plan.<sup>62</sup>

The Code exempts certain transactions that meet specified conditions from the definition of prohibited transaction. Examples of exempt transactions are plan loans to participants, the acquisition of qualifying employer securities or employer real property, and loans to a leveraged ESOP.<sup>63</sup>

## **5. Taxation of distributions**

### **In general**

Distributions from qualified retirement plans and annuities, section 403(b) plans, and governmental section 457(b) plans (other than distributions from designated Roth accounts described below) are generally includible in gross income (to the extent the distribution exceeds basis) as ordinary income in the year in which distributed.<sup>64</sup> The part of any distribution that represents the participant's investment in the contract (*i.e.*, basis) is not includible in gross income. A participant generally has basis under the plan to the extent that the participant has made after-tax contributions to the plan that have not been recovered. The basis recovery rules differ depending on whether or not the distribution is received as an annuity payment.

As discussed in Part I.F.1., an additional 10-percent tax applies to distributions before age 59½ from qualified retirement plans and annuities and section 403(b) plans unless an exception applies. In addition, participants in qualified retirement plans and annuities, section

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<sup>61</sup> Sec. 4975(e)(2)(G).

<sup>62</sup> Sec. 4975(e)(2)(A).

<sup>63</sup> Sec. 4975(c)(2), (d), and (f).

<sup>64</sup> Secs. 72, 402(a)(1), 403(a)(1), 403(b)(1) and 457(a).

403(b) plans, and governmental section 457(b) plans are required to begin receiving distributions at the later of age 70½ or retirement.

## **Rollovers**

A distribution from a qualified retirement plan, section 403(b) plan, or a governmental section 457(b) plan that is an eligible rollover distribution may be rolled over to another such plan or an IRA. The rollover generally can be achieved by direct rollover (direct payment from the distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution (“60-day rollover”). Amounts that are rolled over are usually not included in gross income. Generally, any distribution of the balance to the credit of a participant is an eligible rollover distribution with exceptions, for example, certain periodic payments, required minimum distributions, and hardship distributions.<sup>65</sup>

Any distribution to a beneficiary other than the participant’s surviving spouse is only permitted to be rolled over to an IRA using a direct rollover; 60-day rollovers are not available to nonspouse beneficiaries.<sup>66</sup>

Qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans are required to offer a direct rollover with respect to any eligible rollover distribution before paying the amount to the participant or beneficiary.<sup>67</sup> If an eligible rollover distribution is not directly rolled over into an eligible retirement plan, the taxable portion of the distribution generally is subject to mandatory 20 percent income tax withholding.<sup>68</sup> Participants who do not elect a direct rollover but who roll over eligible distributions within 60 days of receipt also defer tax on the rollover amounts; however, the 20-percent withheld will remain taxable unless the participant substitutes funds within the 60 day period.<sup>69</sup> The direct rollover and 20-percent withholding rules are designed to encourage tax-free rollovers, and thereby, to keep retirement funds in eligible retirement plans.

Distributions from qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans may be rolled into a Roth IRA. Distributions from these plans that are

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<sup>65</sup> Section 402(c)(4). Treas. Reg. sec. 1.402(c)-1 identifies certain other payments that are not eligible for rollover, including, for example, certain corrective distributions, loans that are treated as deemed distributions under section 72(p), and dividends on employer securities as described in section 404(k).

<sup>66</sup> Sec. 402(c)(11).

<sup>67</sup> Sec. 401(a)(31). Unless a participant elects otherwise, a mandatory cashout of more than \$1,000 must be directly rolled over to an IRA chosen by the plan administrator or the payor.

<sup>68</sup> Treas. Reg. sec. 1.402(c)-2, Q&A-1(b)(3).

<sup>69</sup> For example, if Adam receives an eligible rollover distribution of \$10,000 and elects to have the entire amount paid directly to him, he will receive \$8,000 since \$2,000 would have been withheld as income tax. If within 60 days of receiving the distribution Adam decides to roll over the distribution into an IRA he will need to contribute an additional \$2,000 to the IRA in order to defer taxes on the entire distributed amount.

rolled over into a Roth IRA and that are not distributions from a designated Roth account (discussed below) must be included in gross income.

## **6. IRS administrative programs**

### **Preapproved plans**

Under the Code, an employer or other plan sponsor may obtain an advance determination from the IRS that the terms of its retirement plan comply with the qualification requirements.<sup>70</sup> In addition, the IRS has established an extensive program under which banks, insurance companies, and similar institutions (“service providers”) can obtain advance IRS approval of standardized qualified retirement plan documents (“preapproved plans”) that can be adopted by employers without each employer having to retain its own legal professionals to draft plan documents for the employer.<sup>71</sup> A service provider offering a preapproved plan document generally also offers plan-related services, such as holding and managing plan assets, plan record-keeping, participant notices and distributions, and annual reporting to the IRS, DOL and the PBGC. The preapproved plan program helps to make adopting and maintaining a qualified retirement plan more affordable for employers, especially smaller employers.

### **Group trusts**

Under longstanding IRS guidance, the assets of qualified retirement plans maintained by different, unrelated employers can be pooled and held by a “group trust,” thus enabling employers of various sizes to benefit from economies of scale for administrative and investment purposes.<sup>72</sup> In addition to qualified retirement plan assets, a group trust may also hold assets associated with other tax-favored retirement arrangements, including section 403(b) plans, governmental section 457(b) plans, and IRAs.

### **Employee Plans Compliance Resolution System**

Because of the complexity of the requirements for qualified retirement plans, errors in plan documents, as well as plan operation and administration commonly occur. Under a strict application of these requirements, such an error would cause a plan to lose its tax-favored status, the consequences of which would fall most heavily on plan participants. To avoid this result, the IRS has established the Employee Plans Compliance Resolution System (“EPCRS”), which

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<sup>70</sup> If the IRS fails to issue a favorable determination, under section 7476, the employer or plan sponsor may bring a declaratory judgment action in the U.S. Tax Court.

<sup>71</sup> See Rev. Proc. 2011-49, 2011-44 I.R.B. 608, for background on the preapproved plan program. Under the program, preapproved plans include master and prototype and volume submitter plans.

<sup>72</sup> Rev. Rul. 81-100, 1981-1 C.B. 326, most recently modified by Rev. Rul. 2011-1, 2011-2 I.R.B. 251, and Notice 2012-6, 2012-3 I.R.B. 293.

permits employers to correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis.<sup>73</sup>

EPCRS has three components, providing for self-correction, voluntary correction with IRS approval, and correction on audit. The Self-Correction Program (“SCP”) generally permits a plan sponsor that has established compliance practices and procedures to correct certain insignificant failures at any time (including during an audit), and certain significant failures generally within a two-year period, without payment of any fee or sanction. The Voluntary Correction Program (“VCP”) permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program (“Audit CAP”) provides for a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit.

Single-employer plans, multiple-employer plans and multiemployer plans are eligible for EPCRS. However, no specific correction methods or procedures have been provided to address the special structures of multiple-employer and multiemployer plans.

## **7. Owner-employees**

### **In general**

Qualified retirement plans are required to be maintained for the exclusive benefit of employees. Depending on the entity structure used for a business, business owners may be employees or self-employed. In the case of a corporation, including an S corporation, business owners are employees. In the case of a sole proprietorship or partnership, business owners are self-employed. However, for qualified retirement plan purposes, self-employed individuals are treated as employees.<sup>74</sup>

Although the qualified retirement plan rules generally apply to self-employed individuals in the same manner as to employees, special rules apply in determining the compensation of a self-employed individual and the deduction for plan contributions to provide the self-employed individual with contributions or benefits under the plan.

For qualified retirement plan purposes, a self-employed individual’s compensation (“earned income”) is net earnings from self-employment as defined for SECA purposes, with certain adjustments.<sup>75</sup> For example, the contributions made to a qualified retirement plan to provide the self-employed individual with contributions or benefits under the plan (the “self-employed deduction”) are not deductible for SECA purposes. However, the deduction does

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<sup>73</sup> Since establishing the program, the IRS has regularly updated and expanded it. The current program is described in Rev. Proc. 2013-12, 2013-4 I.R.B. 313.

<sup>74</sup> Sec. 401(c)(1).

<sup>75</sup> Sec. 401(c)(2). Under section 1402(a), net earnings from self-employment are generally the individual’s gross income from a trade or business minus deductions attributable to the business.



apply in calculating earned income, thus reducing the compensation used to determine contributions or benefits for the self-employed individual under the plan. In addition, if a self-employed individual has more than one trade or business, only earned income from the trade or business with respect to which the plan is maintained may be taken into account under the plan.

Subject to limits, an employer, including a self-employed individual, may deduct as business expenses contributions made to a qualified retirement plan to provide contributions or benefits for employees participating in the plan. In the case of a defined contribution plan, the limit is generally 25 percent of the employees' total compensation. The deduction for these contributions is in addition to any deduction for the employees' compensation used to determine their contributions or benefits. However, because the self-employed deduction reduces the self-employed individual's earned income, the amount that can be deducted is also reduced. For example, depending on the rate of contributions under a defined contribution plan, the self-employed deduction may be limited to 20 percent of net earnings from self-employment, rather than the 25-percent general limit.

### **Top heavy rules**

Top-heavy rules apply to limit the extent to which accumulated benefits or account balances under a qualified retirement plan can be concentrated with key employees.<sup>76</sup> Whereas the general nondiscrimination requirements (described above) are designed to test annual contributions or benefits for highly compensated employees, compared to those of nonhighly compensated employees, the top-heavy rules test the portion of the total plan contributions or benefits that have accumulated for the benefit of key employees as a group. If a plan is top-heavy, minimum contributions or benefits for nonkey employees and, in some cases, faster vesting is required.

For this purpose, a key employee is an officer with annual compensation greater than \$170,000 (for 2014), a five-percent owner, or a one-percent owner with compensation in excess of \$150,000. A defined benefit plan generally is top-heavy if the present value of cumulative accrued benefits for key employees exceeds 60 percent of the cumulative accrued benefits for all employees. A defined contribution plan is top-heavy if the aggregate of accounts for key employees exceeds 60 percent of the aggregate accounts for all employees. The nature of the top-heavy test is such that a plan of a large business with many employees is unlikely to be top-heavy. The top-heavy requirements are therefore viewed as primarily affecting plans of smaller employers in which the owners participate.

## **8. Tax credit for small employer pension plan start-up costs**

Present law provides a nonrefundable income tax credit for qualified start-up costs of an eligible small employer that adopts a new qualified retirement plan, SIMPLE IRA plan, or SEP, provided that the plan covers at least one nonhighly compensated employee.<sup>77</sup> Qualified start-up

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<sup>76</sup> Secs. 401(a)(10)(B) and 416.

<sup>77</sup> Sec. 45E.

costs are expenses connected with the establishment or administration of the plan or retirement-related education for employees with respect to the plan. The credit is the lesser of \$500 per year or 50 percent of the qualified start-up costs. The credit applies for up to three years beginning with the year the plan is first effective, or, at the election of the employer, the preceding year.

An eligible employer is an employer that, for the preceding year, had no more than 100 employees with compensation of \$5,000 or more. In addition, the employer must not have had a plan covering substantially the same employees as the new plan during the three years preceding the first year for which the credit would apply. Members of controlled groups and affiliated service groups are treated as single employers for purposes of these requirements.

## C. Defined Contribution Plans

### 1. General description and rules

As described above, benefits under a defined contribution plan are based solely on the contributions, earnings, and losses credited to the separate accounts maintained for plan participants. For defined contribution plans, a participant's accrued benefit is the participant's account balance. Accordingly, the participant benefits from investment gains and bears the risk of investment losses on the account.

A defined contribution plan may provide for various types of contributions by employees or the employer. In the case of a section 401(k) plan, employees may elect to have pretax contributions made to the plan, referred to as elective deferrals, rather than receive the same amount as current compensation. A section 401(k) plan may also allow employees to designate some or all of their elective deferrals as after-tax Roth contributions. A defined contribution plan may also allow employees to make other after-tax contributions. Possible employer contributions consist of two types: nonelective contributions and matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes pretax or after-tax contributions. Matching contributions are employer contributions that are made only if the employee makes contributions and can relate to pretax elective deferrals, designated Roth contributions, or other after-tax contributions.

The total contributions made to an employee's account for a year cannot exceed the lesser of \$52,000 (for 2014) or the employee's compensation.<sup>78</sup> Contributions made to more than one plan for an employee are aggregated for purposes of this limit, and employee contributions to a defined benefit plan, if any, are taken into account in applying the limit. However, catch-up contributions (discussed below) are not taken into account in applying the limit.

A defined contribution plan can use one of two alternative minimum vesting schedules with respect to the portion of a participant's account balance that is attributable to employer contributions, including investment returns on employer contributions. Under the first vesting schedule, the account balance attributable to employer contributions must be 100 percent vested upon completion of no more than three years of service (often referred to as "three-year cliff vesting"). Under the second vesting schedule (referred to as "graduated vesting"), the participant's account balance attributable to employer contributions must become vested at a rate of no less than 20 percent, 40 percent, 60 percent, 80 percent, and 100 percent, respectively, over the period from two to six years of service.

Defined contribution plans often provide for loans to participants, subject to certain conditions, discussed below. Defined contribution plans generally provide for distributions on severance from employment and, depending on the type of plan, may provide for distributions before severance from employment ("in-service" distributions). Defined contribution plans may provide for distributions to be made in a lump sum or installments. Defined contribution plans

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<sup>78</sup> Sec. 415(c).

may also provide for distributions in the form of a life annuity (through the purchase of an annuity contract), but generally are not required to provide annuity distributions.

The deduction for employer contributions to a defined contribution plan for a year is generally limited to 25 percent of the participants' compensation.<sup>79</sup> For this purpose, a participant's compensation in excess of \$260,000 (for 2014) is not taken into account. Elective deferrals (including designated Roth contributions) and employee contributions are not counted in applying the 25 percent limit. Special deduction rules apply to an ESOP (discussed below), or if an employer maintains both a defined contribution plan and a defined benefit plan. An excise tax may apply if contributions in excess of the deduction limits are made.<sup>80</sup>

As discussed in Part I.B.2, defined contribution plans are subject to the nondiscrimination rules, i.e., the rules prohibiting discrimination in favor of highly compensated employees as implemented under regulations.<sup>81</sup> In the case of a defined contribution plan, this requirement is applied on the basis of the contributions allocated to participants' accounts ("allocations"). For this purpose, allocations determined as a percentage of each participant's compensation (up to \$260,000 for 2014) are nondiscriminatory, even though this allows higher allocations for higher-paid employees. Three general approaches are available for compliance with the nondiscrimination requirements: (1) design-based safe harbors under which the plan's allocation formula satisfies certain uniformity standards;<sup>82</sup> (2) a general test comparing the rates of allocations provided under the plan to highly and nonhighly compensated employees;<sup>83</sup> and (3) cross-testing, which involves converting allocations under the plan to actuarially equivalent annuity accruals and comparing the rates of equivalent accruals for highly and nonhighly compensated employees.<sup>84</sup> Special testing rules apply to section 401(k) plans, discussed below.

## **2. General types of defined contribution plans**

Defined contribution plans fall into three general types: profit-sharing plans, stock bonus plans, and money purchase pension plans. The type of plan must be specified in the plan document.

Profit-sharing plans were originally intended as a means of enabling employees to share in the profits of the employer's business. However, under present law, contributions to a profit-sharing plan are permitted regardless of whether the business has profits. A profit-sharing plan may provide for regular employer contributions each year or may provide that contributions are

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<sup>79</sup> Sec. 404.

<sup>80</sup> Sec. 4972.

<sup>81</sup> Treas. Reg. secs. 1.401(a)(4)-1 through 13.

<sup>82</sup> Treas. Reg. sec. 1.401(a)(4)-2(b) and -8(b)(3).

<sup>83</sup> Treas. Reg. sec. 1.401(a)(4)-2(c).

<sup>84</sup> Treas. Reg. sec. 1.401(a)(4)-8.

made each year at the discretion of the employer (called a “discretionary” profit-sharing plan). A profit-sharing plan must provide a definite formula under which contributions are allocated to participant accounts and must specify the events upon which distributions will be made to participants, such as severance from employment.

A stock bonus plan is similar to a profit-sharing plan except that benefits are distributable in stock of the employer. The plan may provide for cash distributions, but must also allow participants to take distributions in the form of employer stock. In the case of employer stock that is not publicly traded, participants generally must be given the right to require the employer to repurchase the stock under a fair valuation formula.

A money purchase pension plan must provide for a set level of required employer contributions, generally as a specified percentage of participants’ compensation. A money purchase pension plan is subject to the minimum funding requirements, and the employer is generally subject to an excise tax if it fails to make the contributions required under the plan. A money purchase pension plan may not provide for in-service distributions except at normal retirement age (or age 62, if earlier) or in the case of plan termination.

Certain spousal protections apply to qualified retirement plans.<sup>85</sup> In the case of a pension plan (that is, a money purchase pension plan or a defined benefit plan), these protections generally require that benefits be paid in the form of a qualified joint and survivor annuity (“QJSA”) unless the participant elects a different form of distribution and the participant’s spouse consents in writing to the election. A QJSA is generally a life annuity for the participant with an annuity of at least 50 percent of the participant’s annuity amount payable to the surviving spouse after the participant’s death.<sup>86</sup> If a married participant dies before benefits begin, the plan must offer a survivor benefit for the spouse in the form of a qualified preretirement survivor annuity (“QPSA”), which is a survivor annuity for the spouse that is at least 50 percent of the employee’s accrued benefit.

Profit-sharing plans and stock bonus plans are generally not subject to these spousal protection requirements unless the participant elects an annuity form of distribution. However, a profit-sharing or stock bonus plan must provide that a participant’s entire vested account balance under the plan will be paid to the participant’s surviving spouse unless the spouse consents in writing to a different beneficiary.

Within the three general types of defined contribution plans are plan designs that contain special features, such as a section 401(k) plan or an ESOP, discussed below. In addition, special types of plans are available to certain governmental and tax-exempt employers.

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<sup>85</sup> Sec. 401(a)(11).

<sup>86</sup> A married participant must also be offered a qualified optional survivor annuity (“QOSA”), which is also a life annuity for the participant with an annuity payable to the surviving spouse as a percentage of the participant’s annuity, with the required percentage depending on the QJSA percentage. See Part I.D. for further discussion of the requirement for a QOSA.

### 3. Section 401(k) plans

#### **In general**

A section 401(k) plan legally is not a separate type of plan, but is a profit-sharing or stock bonus plan that contains a qualified cash or deferred arrangement.<sup>87</sup> Thus, such arrangements are subject to the rules generally applicable to qualified defined contribution plans. In addition, special rules apply to such arrangements.

As described above, an employee may make elective deferrals to a section 401(k) plan. The maximum annual amount of elective deferrals that can be made by an employee for a year is \$17,500 (for 2014) or, if less, the employee's compensation.<sup>88</sup> An employee who will attain age 50 by the end of the year may also make catch-up contributions to a section 401(k) plan.<sup>89</sup> As a result, the dollar limit on elective deferrals is increased by \$5,500 (for 2014) for an individual who has attained age 50. An employee's elective deferrals must be fully vested.

Elective deferrals, and attributable earnings, generally cannot be distributed from the plan before the earliest of the employee's severance from employment, death, disability or attainment of age 59½ or termination of the plan. Subject to certain conditions, elective deferrals, but not associated earnings, can be distributed in the case of hardship.

Elective deferrals are generally made on a pretax basis. However, a section 401(k) plan is permitted to include a "qualified Roth contribution program" that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as designated Roth contributions. Designated Roth contributions are elective deferrals that the participant designates as not excludable from the participant's gross income. The annual dollar limit on a participant's designated Roth contributions is the same as the limit on elective deferrals, reduced by the participant's elective deferrals that are not designated Roth contributions. Designated Roth contributions are generally treated the same as any other elective deferral for certain purposes, including the restrictions on distributions discussed above.

Qualified distributions from a designated Roth account are excluded from income, even though they include earnings not previously taxed. A qualified distribution is a distribution made after the end of a specified period (generally five years after the participant's first designated Roth contribution) and that is (1) made on or after the date on which the participant attains age 59½, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled.

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<sup>87</sup> Certain pre-ERISA money purchase plans and rural cooperative plans may also include a qualified cash or deferred arrangement. In addition, certain small employers may adopt a SIMPLE section 401(k) plan similar to a SIMPLE IRA plan discussed in Part I.E.3. Except for certain grandfathered plans, a State or local governmental employer may not maintain a section 401(k) plan.

<sup>88</sup> Sec. 402(g).

<sup>89</sup> Sec. 414(v).

A section 401(k) plan that includes a designated Roth program may permit participants to transfer amounts from a nonRoth account under the plan to a designated Roth account, whether or not the amounts in the nonRoth account are permitted to be distributed from the plan at the time of the transfer.<sup>90</sup> In effect, this transfer is a Roth conversion (with related income recognition) for all nonRoth amounts within the plan.

Section 401(k) plans are not required to provide for matching contributions, but often do. Many employers provide matching contributions because doing so encourages lower-paid employees to make elective deferrals, which makes it easier for the plan to satisfy the applicable nondiscrimination rules. A section 401(k) plan may also provide for employer nonelective contributions.

### **Automatic enrollment**

Section 401(k) plans may be designed so that the employee will receive cash compensation unless the employee affirmatively elects to make elective deferrals to the section 401(k) plan. Alternatively, a plan may provide that elective deferrals are made at a specified rate (when the employee becomes eligible to participate) unless the employee elects otherwise (*i.e.*, affirmatively elects not to make contributions or to make contributions at a different rate). This plan design is referred to as automatic enrollment.

Under a section 401(k) plan, an employee must have an effective opportunity to elect to receive cash in lieu of contributions. Whether an employee has an effective opportunity to receive cash is based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.<sup>91</sup>

Automatic enrollment was originally authorized by IRS guidance<sup>92</sup> and has been furthered by subsequent statutory changes providing special rules for automatic enrollment.<sup>93</sup> These rules include a nondiscrimination safe harbor (discussed further below) for a section 401(k) plan that includes a qualified automatic contribution arrangement. In addition, if a section 401(k) plan includes an eligible automatic contribution arrangement, elective deferrals that were automatically contributed to the plan (*i.e.*, without an affirmative deferral election by an employee) may be distributed to the employee in accordance with an election by the

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<sup>90</sup> Prior to 2013, such transfers of nonRoth amounts to a designated Roth account were only permitted for amounts that were permitted to be distributed from the plan at the time of the transfer.

<sup>91</sup> Treas. Reg. sec. 1.401(k)-1(e)(2). Similar rules apply to elective deferrals under section 403(b) plans and section 457(b) plans.

<sup>92</sup> Rev. Rul. 2000-8, 2000-7 I.R.B. 617; Rev. Rul. 2000-33, 2000-31 I.R.B. 142; Rev. Rul. 2000-35, 2000-31 I.R.B. 138; and Treas. Reg. sec. 1.401(k)-1(a)(3)(ii).

<sup>93</sup> The Pension Protection Act of 2006 (“PPA”), Pub. L. No. 109-280, added a number of special rules to the Code and ERISA with respect to automatic enrollment in section 401(k) plans. The Code rules generally apply also to section 403(b) plans and governmental section 457(b) plans.

employee within 90 days after the first automatic contribution.<sup>94</sup> Such a distribution is permitted, despite the general restriction on in-service distributions of elective deferrals, and the amount distributed is not subject to the 10-percent early withdrawal tax.

Use of these special rules is generally predicated on automatic contributions at a uniform rate (as a percentage of compensation) for all participants. In addition, a notice must be provided to participants explaining the choice between making or not making contributions and identifying the default contribution rate and investment, and each participant must be given a reasonable period of time after receipt of the notice to make an affirmative election with respect to contributions and investments.

### **Special nondiscrimination tests for section 401(k) plans**

#### General rule

A special annual nondiscrimination test, called the actual deferral percentage test (the “ADP” test) applies to elective deferrals under a section 401(k) plan.<sup>95</sup> The ADP test generally compares the average rate of deferral for highly compensated employees to the average rate of deferral for nonhighly compensated employees. The ADP test allows the average deferral rate for highly compensated employees to exceed that for nonhighly compensated employees within limits: (1) the average deferral rate for highly compensated employees can be up to 125 percent of the average deferral rate for nonhighly compensated employees; or (2) the average deferral rate for highly compensated employees can be two percentage points greater than the average deferral rate for nonhighly compensated employees or, if less, twice the average deferral rate for nonhighly compensated employees. Employer matching contributions and after-tax employee contributions are subject to a similar special nondiscrimination test (the actual contribution percentage test or “ACP test”) which compares the average rate of matching and after-tax contributions to the plan of the two groups.<sup>96</sup>

If the ADP test is not satisfied, a mechanism is provided for the employer to make immediately vested additional contributions for nonhighly compensated employees (and certain other corrections) or to distribute deferrals of highly compensated employees to such employees, so that the ADP test is satisfied. Similar correction mechanisms apply for purposes of satisfying the ACP test.

#### Design-based safe harbor nondiscrimination tests

There are also designed-based safe harbor methods of satisfying the ADP and ACP tests. These safe harbors are based on the premise that, for a 401(k) plan with certain design features with respect to contributions (elective, matching, and nonelective) and enrollment, satisfaction of the minimum coverage requirement is a sufficient test of the amount of whether the amount

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<sup>94</sup> Sec. 414(w).

<sup>95</sup> Sec. 401(k)(3).

<sup>96</sup> Sec. 401(m)(2).



elective deferrals and matching contributions are nondiscriminatory.<sup>97</sup> Under one safe harbor, a section 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement.<sup>98</sup> A plan generally satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the plan. The matching contribution requirement under the safe harbor is 100 percent of elective contributions of the employee for contributions not in excess of three percent of compensation, and 50 percent of elective contributions for contributions that exceed three percent of compensation but do not exceed five percent, for a total matching contribution of up to four percent of compensation. The required matching contributions and the three percent nonelective contribution must be immediately nonforfeitable (i.e., 100 percent vested) when made. Other requirements also apply, including requirements for satisfying the ACP test on a safe harbor basis.<sup>99</sup>

Another safe harbor applies for section 401(k) plans that include a qualified automatic contribution arrangement.<sup>100</sup> Under a qualified automatic contribution arrangement, unless an employee elects otherwise, the employee is treated as electing to make elective deferrals equal to a percentage of compensation as stated in the plan, not in excess of 10 percent and at least (1) three percent of compensation for the first year the deemed election applies to the participant, (2) four percent during the second year, (3) five percent during the third year, and (4) six percent during the fourth year and thereafter.<sup>101</sup> Under the safe harbor, the matching contribution requirement is 100 percent of elective contributions of the employee for contributions not in excess of one percent of compensation, and 50 percent of elective contributions for contributions that exceed one percent of compensation but do not exceed six percent (for a total matching contribution of up to 3.5 percent of compensation). The rate of the safe harbor nonelective contribution is three percent, as under the regular safe harbor. However, under a qualified automatic contribution arrangement, the matching and nonelective contributions are allowed to become 100 percent vested only after two years of service (rather than being immediately vested).

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<sup>97</sup> The safe harbors that only require certain matching contributions potentially allow satisfaction of the nondiscrimination requirement with respect to elective and matching contributions under a 401(k) plan for a year even though no contributions are ultimately provided to nonhighly compensated employees under the plan for the year due to a lack of voluntary participation.

<sup>98</sup> Sec. 401(k)(12). The plan satisfies the notice requirement if, within a reasonable time before the beginning of the plan year, the plan provides written notice to each eligible employee of the employee's rights and obligations under the plan.

<sup>99</sup> Sec. 401(m)(11).

<sup>100</sup> Secs. 401(k)(13) and (m)(12).

<sup>101</sup> These automatic increases in default contribution rates are required for plans using the safe harbor. Rev. Rul. 2009-30, 2009-39 I.R.B. 391, provides guidance for including automatic increases in other plans using automatic enrollment, including under a plan that includes an eligible automatic contribution arrangement.

## 4. ESOPs

### **In general**

An ESOP is a stock bonus plan that is designated as an ESOP and is designed to invest primarily in stock of the employer, referred to as “qualifying employer securities.”<sup>102</sup> An ESOP can be maintained by either a C corporation or an S corporation.<sup>103</sup> For purposes of ESOP investments, a “qualifying employer security” is generally defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP.

An ESOP can be an entire plan or it can be a portion of a defined contribution plan. An ESOP may provide for different types of contributions, including employer nonelective contributions and others. For example, an ESOP may include a section 401(k) feature that permits employees to make elective deferrals.<sup>104</sup> ESOPs are subject to additional requirements that do not apply to other plans that hold employer stock. For example, voting rights must generally be passed through to ESOP participants, employees must generally have the right to receive benefits in the form of stock, and certain ESOP participants must be given the right to diversify a portion of their plan benefits (discussed further below).

Certain benefits are available to ESOPs that are not available to other types of qualified retirement plans that hold employer stock. Under an exception to the prohibited transaction rules, an employer maintaining an ESOP may lend money to the ESOP, or the employer may guarantee a loan made by a third-party lender to the ESOP, to finance the ESOP’s purchase of employer securities.<sup>105</sup> An ESOP that borrows funds to acquire employer securities is generally called a leveraged ESOP.

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<sup>102</sup> Sec. 4975(e)(7). Participant accounts in other types of defined contribution plans can also be invested in employer stock.

<sup>103</sup> A C corporation is so named because its tax treatment is governed by subchapter C of the Code. An S corporation is so named because its tax treatment is governed by subchapter S of the Code. An S corporation is a passthrough entity for income tax purposes. That is, income tax does not apply at the S corporation level. Rather, items of income, gain, or loss are taken into account for tax purposes by the S corporation shareholders on their own tax returns.

<sup>104</sup> Subject to certain conditions, such as the diversification requirements described below, elective deferrals under a section 401(k) plan that is part of an ESOP are generally permitted to be invested in qualifying employer securities purchased by the ESOP.

<sup>105</sup> Sec. 4975(d)(3). To qualify for the loan exemption, the loan must be primarily for the benefit of participants and beneficiaries of the plan, the interest on the loan must be at a reasonable rate, and any collateral given to a disqualified person by the plan must consist only of qualifying employer securities.

In the case of an ESOP maintained by a C corporation, payments of principal on the ESOP loan are deductible to the extent permitted under the general deduction limits for contributions to qualified retirement plans (which generally limit the deduction for contribution to a defined contribution plan for a year to 25 percent of the participants' compensation), and interest payments are deductible without regard to the limitation.<sup>106</sup> In addition, a C corporation may deduct dividends paid on employer stock held by an ESOP if the dividends are used to repay a loan, if they are distributed to plan participants, or if the plan gives participants the opportunity to elect either to receive the dividends or have them reinvested in employer stock under the ESOP and the dividends are reinvested at the participants' election.<sup>107</sup> This deduction is also allowed without regard to the general deduction limits on contributions to qualified plans.

ESOPs maintained by S corporations are subject to special rules. Generally, if a tax-exempt entity, including a trust holding qualified retirement plan assets, holds S corporation stock, it is treated as holding an interest in an unrelated trade or business and is subject to unrelated business income tax ("UBIT").<sup>108</sup> However, an ESOP holding employer securities issued by an S corporation is exempt from UBIT.

In part to prevent interests in income attributable to employer stock of an S corporation held by an ESOP (and thus not subject to current taxation) from being concentrated in a small group of persons, a number of adverse tax consequences may apply if a "nonallocation year" occurs with respect to an ESOP maintained by an S corporation. If any "disqualified person" has an interest in the S corporation in the form of "synthetic equity"<sup>109</sup> during a nonallocation year, an excise tax is imposed on the S corporation equal to 50 percent of the amount of such synthetic

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<sup>106</sup> Sec. 404(a)(9).

<sup>107</sup> Sec. 404(k). If a dividend is paid with respect to stock allocated to a participant's account and is used to make a payment on an ESOP loan, the plan must allocate employer securities with a fair market value of not less than the amount of such dividend to the participant's account for the year in which such dividend would have been allocated to such participant. Distributions with respect to S corporation stock held in an ESOP may also be used to repay an ESOP loan under similar conditions, but the distribution is not deductible by the S corporation.

<sup>108</sup> Sec. 512(e). Section 511 imposes UBIT on a tax-exempt entity's income from an unrelated trade or business.

<sup>109</sup> Pursuant to Sec. 409(p)(5) and (6)(C), and Treas. Reg. sec. 1.409(p)-1(f), "synthetic equity" is any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest that gives the holder the right to acquire or receive stock of the S corporation in the future; a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value; and rights to nonqualified deferred compensation (even though it is neither payable in, nor calculated by reference to, stock in the S corporation) and rights to acquire interests in certain related entities. A person can be a disqualified person, and a nonallocation year can occur based solely on interests in the S Corporation in the form of synthetic equity, even if the person is not a participant in the ESOP. Synthetic equity is an interest in income attributable to employer stock held by an ESOP, and reduces the ESOP's economic ownership of the S corporation. On the other hand, it is possible in certain circumstances to grant options or warrants for S corporation stock (or other synthetic equity) to a single person that, when combined with the outstanding shares of the S corporation, are options for up to 49 percent of the S corporation stock without causing a nonallocation year.

equity. If there are “prohibited allocations”<sup>110</sup> for the benefit of disqualified persons during a nonallocation year, the amount of the prohibited allocations is treated as distributed to the disqualified persons; an excise tax equal to 50 percent of the amount of the prohibited allocation applies to the S corporation; the qualified plan ceases to be an ESOP; and there is a potential for disqualification of the plan.

A “nonallocation year” is a plan year of an ESOP maintained by an S corporation in which disqualified persons own (directly or indirectly) at least 50 percent of the S corporation shares. For this purpose, a person’s interest in the S corporation in the form of synthetic equity is treated as ownership of S corporation shares and is taken into account, but only if taking it into account causes a plan year to be a nonallocation year or a person to be a disqualified person.<sup>111</sup> Thus, both determinations are done with and without synthetic equity. “Disqualified persons” generally are persons who have at least a 10-percent interest (or who are a member of a family group having at least a 20-percent interest) in the portion of the S corporation shares held by the ESOP, either by having shares of S corporation employer stock allocated to the person’s account under the ESOP (or being treated as having a portion of unallocated shares), or by having an interest in the S corporation in the form of synthetic equity.

### **Nonrecognition of gain on sale of employer stock to an ESOP**

#### In general

A taxpayer may elect to defer the recognition of long-term capital gain on the sale of qualified securities to an ESOP maintained by a C corporation if the taxpayer purchases qualified replacement property within a specified replacement period and, immediately after the sale, the ESOP owns at least 30 percent of each class of outstanding stock, or the total value of all outstanding stock of the corporation issuing the qualified securities.<sup>112</sup> Qualified securities are qualifying employer securities (as defined for ESOP purposes) that (1) are issued by a domestic C corporation that, for at least one year before and immediately after the sale, has no readily tradable securities outstanding (and no member of the C corporation’s controlled group has readily tradable securities outstanding), and (2) have not been received by the seller as a distribution from a qualified plan or as a transfer pursuant to an option or similar right to acquire stock granted to an employee by an employer.

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<sup>110</sup> Generally a “prohibited allocation” for the benefit of a disqualified person occurs during a nonallocation year to the extent that S corporation employer stock owned by the ESOP (and any assets attributable to such stock) is held for the benefit of a disqualified person during the nonallocation year (whether the stock is allocated to the person’s account under the ESOP during the nonallocation year or an earlier year).

<sup>111</sup> An ESOP maintained by an S corporation may be able prevent a nonallocation year (or a prohibited allocation during a nonallocation year) by transferring S corporation employer stock allocated to the account of disqualified persons (or persons expected to become disqualified persons) to a separate portion of the qualified plan (or another qualified retirement plan of the S corporation) that is not designated as an ESOP and allocate it to the accounts of those persons under the separate portion (or other plan). In that case, the qualified retirement plan is subject to UBIT with respect to those transferred shares of S corporation stock.

<sup>112</sup> Sec. 1042. The taxpayer’s holding period with respect to the qualified securities must be at least three years at the time of the sale.

The ESOP must preclude the allocation to certain individuals of assets attributable to the qualified securities received in the sale; an excise tax may apply in the case of a prohibited allocation.<sup>113</sup> In addition, an excise tax may apply if the ESOP disposes of the qualified securities within three years of the date of the sale.<sup>114</sup>

Qualified replacement property consists of any security<sup>115</sup> issued by a domestic operating corporation, which did not, for the corporation's taxable year preceding the taxable year in which the security was purchased by the taxpayer seeking nonrecognition treatment, have passive investment income<sup>116</sup> exceeding 25 percent of the corporation's gross receipts for such preceding taxable year. In addition, securities of the domestic corporation that issued the qualified securities (and of any member of a controlled group of corporations with such corporation) are not qualified replacement property. The qualified replacement property must be purchased within a replacement period beginning on the date three months prior to the date the qualified securities are sold and ending twelve months after the date of such sale. The basis of the taxpayer in qualified replacement property acquired during the replacement period is reduced by an amount not greater than the amount of gain realized on the sale which was not recognized pursuant to the election provided by this provision. If a taxpayer disposes of any qualified replacement property, notwithstanding any other provision of the Code, gain (if any) must be recognized to the extent of the gain that was not recognized on the sale of stock to the ESOP, subject to certain exceptions.

## **5. Diversification requirements for employer stock in defined contribution plans**

### **In general**

Defined contribution plans commonly hold employer securities.<sup>117</sup> Participants whose accounts include employer securities generally must be given diversification rights, that is, the right to have the participant's account invested in assets other than employer securities. The diversification requirements that apply depend on the type of plan, the type of employer securities, and the type of plan contributions invested in employer securities.

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<sup>113</sup> Secs. 409(n) and 4979A.

<sup>114</sup> Sec. 4978.

<sup>115</sup> Security is defined for this purpose as under section 165(g), *i.e.*, a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

<sup>116</sup> Passive investment income is defined for this purpose as under section 1362(d)(3)(D), relating to termination of an S corporation election.

<sup>117</sup> Under section 407 of ERISA, retirement plans can hold only qualifying employer securities. Any stock issued by the employer or an affiliate of the employer is a qualifying employer security. Qualifying employer securities also include certain publicly traded partnership interests and certain marketable obligations (*i.e.*, a bond, debenture, note, certificate or other evidence of indebtedness). ERISA imposes limits on employer securities held by a money purchase pension plan.

## **Diversification requirements for ESOPs**

ESOPs are subject to a requirement that a participant who has attained age 55 and who has at least 10 years of participation in the plan must be permitted to diversify the investment of the participant's account in assets other than employer securities.<sup>118</sup> The diversification requirement applies to a participant for six years, starting with the year in which the individual first meets the eligibility requirements (*i.e.*, age 55 and 10 years of participation). The participant must be allowed to elect to diversify up to 25 percent of the participant's account (50 percent in the sixth year), reduced by the portion of the account diversified in prior years.

The participant must be given 90 days after the end of each plan year in the election period to make the election to diversify. In the case of participants who elect to diversify, the plan satisfies the diversification requirement if: (1) the plan distributes the applicable amount to the participant within 90 days after the election period; (2) the plan offers at least three alternative investment options and, within 90 days of the election period, invests the applicable amount in accordance with the participant's election; or (3) the applicable amount is transferred within 90 days of the election period to another qualified defined contribution plan of the employer providing investment options in accordance with (2).<sup>119</sup>

## **Diversification requirements for applicable defined contribution plans**

Applicable defined contribution plans are required to provide diversification rights with respect to amounts invested in employer securities.<sup>120</sup> Such a plan is required to permit applicable individuals to direct that the portion of the individual's account held in employer securities be invested in other investments. An applicable individual includes (1) a plan participant, and (2) a beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant.

An applicable defined contribution plan is a defined contribution plan holding securities issued by the employer or a member of the employer's controlled group of corporations that are publicly traded, that is, readily tradable on an established securities market.<sup>121</sup> Subject to certain exceptions, a plan holding employer securities that are not publicly traded is generally treated as holding publicly traded employer securities if the employer (or any member of the employer's controlled group of corporations) has issued a class of stock that is a publicly traded employer security. An ESOP generally is not an applicable defined contribution plan unless it holds elective deferrals, employee contributions, employer matching contributions, or nonelective employer contributions used to satisfy the special nondiscrimination tests applicable to

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<sup>118</sup> Sec. 401(a)(28).

<sup>119</sup> Notice 88-56, 1988-1 C.B. 540, Q&A-16.

<sup>120</sup> Code sec. 401(a)(35) and ERISA sec. 204(j).

<sup>121</sup> For this purpose, "controlled group of corporations" has the same meaning as under section 1563(a), except that, in applying that section, 50 percent is substituted for 80 percent.

section 401(k) plans.<sup>122</sup> An applicable defined contribution plan does not include a one-participant retirement plan, that is, a plan that covers only the business owner or owners and the spouse(s) of the owner(s).

The diversification requirements under an applicable defined contribution plan depend on the type of contributions invested in employer securities. In the case of amounts attributable to elective deferrals and employee contributions, an applicable individual must be permitted to direct that such amounts be invested in other investments. In the case of amounts attributable to nonelective employer contributions and employer matching contributions, an applicable individual who is a participant with three years of service, a beneficiary of such a participant, or a beneficiary of a deceased participant must be permitted to direct that such amounts be invested in other assets. Applicable individuals must be given a choice of at least three investment options, other than employer securities, each of which is diversified and has materially different risk and return characteristics.

## **6. Special types of plans for governmental and tax-exempt employers**

### **Tax-sheltered annuities (section 403(b) plans)**

Section 403(b) plans are another form of tax-favored employer-sponsored plan that provide tax benefits similar to qualified retirement plans. Section 403(b) plans may be maintained only by (1) charitable organizations tax-exempt under section 501(c)(3), and (2) educational institutions of State or local governments (i.e., public schools, including colleges and universities). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans. Employers may make nonelective or matching contributions to such plans on behalf of their employees, and the plan may provide for employees to make elective deferrals, designated Roth contributions or other after-tax contributions.

Contributions to a section 403(b) plan are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the special limits for elective deferrals (\$17,500 for 2014) and catch-up contributions (\$5,500 for 2014) under a section 401(k) plan, or, if less, the employee's compensation. If elective deferral and catch-up contributions are made to both a qualified defined contribution plan and a section 403(b) plan for the same employee, a single limit applies to the elective deferrals under both plans. Special contribution limits apply to certain employees under a section 403(b) plan maintained by a church. In addition, under a special catch-up rule, an increased elective deferral limit applies under a plan maintained by an educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches in the case of employees who have completed 15 years of service. In this case, the limit is increased by the least of (1) \$3,000, (2) \$15,000, reduced by the employee's total elective deferrals in prior years,

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<sup>122</sup> An ESOP that is an applicable defined contribution plan and subject to the related diversification requirements is excepted from the specific ESOP diversification requirements.

and (3) \$5,000 times the employee's years of service, reduced by the employee's total elective deferrals in prior years.<sup>123</sup>

Section 403(b) plans are generally subject to the minimum coverage and nondiscrimination rules that apply to qualified defined contribution plans.<sup>124</sup> However, pretax contributions and designated Roth contributions made by an employee under a salary reduction agreement (i.e., elective deferrals) are not subject to nondiscrimination rules similar to those applicable to elective deferrals under section 401(k) plans. Instead, all employees of the employer generally must be eligible to make salary reduction contributions. Certain employees may be disregarded for purposes of this rule.

### **Governmental section 457(b) plans**

Special rules with respect to deferred compensation arrangements of State and local government and tax-exempt employers.<sup>125</sup> Amounts deferred under an eligible deferred compensation plan, i.e., a section 457(b) plan, are not currently included in income. In the case of a State or local government employer, a section 457(b) plan is generally limited to elective deferrals and provides tax benefits similar to a section 401(k) or 403(b) plan in that deferrals are contributed to a trust or custodial account for the exclusive benefit of participants, but are not included in income until distributed (and may be rolled over to another tax-favored plan).<sup>126</sup>

Deferrals under a governmental section 457(b) plan are subject to the same limits as elective deferrals (\$17,500 for 2014) and catch-up contributions (\$5,500 for 2014) under a section 401(k) plan or a section 403(b) plan, or, if less, the employee's compensation. However, the section 457(b) plan limits apply separately from the combined limit applicable to section 401(k) and 403(b) plan contributions, so that an employee covered by a governmental section 457(b) plan and a section 401(k) or 403(b) plan can contribute the full amount to each plan. In addition, under a special catch-up rule, for one or more of the participant's last three years before normal retirement age, the otherwise applicable limit is increased to the lesser of (1) two times the normal annual limit (\$35,000 for 2014) or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

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<sup>123</sup> Because contributions to a defined contribution plan cannot exceed an employee's compensation, contributions for an employee are generally not permitted after termination of employment. However, under a special rule, a former employee may be deemed to receive compensation for up to five years after termination of employment for purposes of receiving employer nonelective contributions under a section 403(b) plan.

<sup>124</sup> As in the case of a qualified retirement plan, a governmental section 403(b) plan is not subject to these nondiscrimination rules.

<sup>125</sup> Sec. 457.

<sup>126</sup> In the case of a tax-exempt employer, section 457(b) and 457(f) limit the amount of unfunded nonqualified deferred compensation that can be provided on a tax-deferred basis.



A governmental section 457(b) plan may include a qualified Roth contribution program, allowing a participant to elect to have all or a portion of the participant's deferrals under the plan treated as designated Roth contributions.

## **7. Plan loans and hardship distributions**

### **Plan loans**

Defined contribution plans, section 403(b) plans, and governmental section 457(b) plans generally are permitted, but are not required, to offer plan loans to participants. Plan loans must comply with certain conditions so that the loan is not treated as a taxable distribution to the participant.<sup>127</sup> Generally, a loan that does not satisfy all of the requirements will be treated as a deemed distribution, resulting in current income taxation and, for participants younger than 59½, a 10-percent early distribution tax. The requirements both limit the amount of the loan and the repayment terms. If the actual repayment of the loan does not satisfy the required repayment terms during the period the loan is outstanding, a deemed distribution of the loan outstanding occurs at that time.

In order not to be treated as a deemed distribution, a plan loan may not exceed the lesser of (1) \$50,000 reduced by the excess of the highest outstanding loan balance from the plan during the one-year period ending on the day before the date on which the loan is made over the outstanding loan balance on the date on which the loan is made, or (2) the greater of (a) 50 percent of the present value of the vested accrued benefit of the participant or (b) \$10,000. Generally, a plan loan is treated as a deemed distribution unless it provides for repayment within five years of the loan date<sup>128</sup> and for substantially equal payments of both principal and interest at least no less frequently than quarterly over the term of the loan.<sup>129</sup>

Deemed distributions, resulting from a failure to comply with the Code's loan requirements, are treated as actual distributions for tax purposes. They are not, however, treated as actual distributions for purposes of plan qualification or rollovers requirements.

Distribution of a plan loan offset amount occurs when, pursuant to plan terms, the accrued benefit of a participant or beneficiary is reduced in order to repay a loan. For example, it

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<sup>127</sup> Sec. 72(p). Generally, if a participant or beneficiary assigns or pledges any portion of his or her interest in a qualified plan as security for a loan, the assigned or pledged portion is treated as a loan from the plan to the participant for purposes of section 72(p).

<sup>128</sup> There is an exception to the five-year rule in the case of a loan used to purchase the participant's principal residence. Plans also may suspend repayment of a loan while the participant is performing services in the uniformed services of the United States. The loan repayments must resume, however, on completion of the period of military service and the loan must be repaid by amortization in substantially level installments over a period ending no later than the end of the latest permissible term (generally five years) plus the permitted period of suspension for military leave). Treas. Reg. sec. 1.72(p)-1, Q&A-9(b) and (c).

<sup>129</sup> Repayment on an accelerated schedule is permitted, as is a plan requirement of full repayment on termination of employment. Substantially level amortization does not apply to periods of a year or less during which the participant is on a leave of absence without pay.

is common for plans to provide that, if a participant requests a plan distribution while a loan is outstanding, the loan must be repaid immediately or treated as in default. In the event of a loan offset, the amount of the account balance that is offset against the loan is an actual, not a deemed, distribution. In contrast to a deemed distribution, a loan offset amount can be an eligible rollover distribution. A plan is not, however, required to offer a direct rollover with respect to the loan offset amount and the amount is generally not subject to mandatory 20-percent withholding.

### **Hardship distributions**

Hardship distributions are an exception to the general prohibition on in-service distributions before age 59½ of amounts in a section 401(k) plan or 403(b) plan that are attributable to elective deferrals.<sup>130</sup> Section 401(k) and 403(b) plans are permitted, but are not required, to permit participants to take hardship withdrawals, provided two conditions are met. First, the distribution must be made on account of an immediate and heavy financial need of the employee. Second, the distribution must be necessary to satisfy that financial need. Determinations regarding whether an immediate and heavy financial need exists, and whether a distribution is necessary to meet that need, must be made in accordance with nondiscriminatory and objective standards set forth in the plan.<sup>131</sup> There are, however, regulatory safe harbors whereby the requirements may be deemed to have been met, such as for the purchase of a home or the payment of education expenses.<sup>132</sup> Hardship distributions must generally be limited to the amount of the employee's total elective deferrals as of the date of the distribution, reduced by the amount of any previous hardship distributions.

Section 457(b) plans may provide for distributions in the case of an unforeseeable emergency.<sup>133</sup> The concept of unforeseeable emergency is narrower than the concept of hardship under the section 401(k) and 403(b) rules and the regulatory safe harbors do not apply.

## **8. Lifetime income under defined contribution plans**

As discussed above, pension plans (defined benefit and money purchase pension plans) are required to provide participants with life annuity forms of benefit, including forms that provide life annuity benefits for surviving spouses. Pension plans are viewed as furthering retirement income security in that a participant (or surviving spouse) receiving benefits in life annuity form cannot "outlive" his or her benefits under the plan.<sup>134</sup> However, profit-sharing and

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<sup>130</sup> Sec. 401(k)(2)(B)(i)(IV). This exception does not apply to other contributions subject to the limitations on in-service distributions under section 401(k)(2)(B), such as safe harbor nonelective or matching contributions.

<sup>131</sup> Treas. Reg. sec. 1.401(k)-1(d)(3)(i).

<sup>132</sup> Treas. Reg. secs. 1.401(k)-1(d)(3) and 1.403(b)-6(d)(2).

<sup>133</sup> Sec. 457(d)(1)(iii).

<sup>134</sup> Social Security benefits already represent annuitization of a significant portion of retirement income for many individuals. According to the March 2010 Annual Social and Economic Supplement to the Current Population Survey, Social Security benefits provide at least 50 percent of total income for 66 percent of

stock bonus plans are not required to offer annuity forms of distribution; instead, a participant's (or surviving spouse's) benefit consists of an account balance, which can be depleted during the participant's (or surviving spouse's) lifetime.<sup>135</sup> The increase in the number of employees who are covered only by a profit-sharing plan or stock bonus plan (including section 401(k) plans, which are usually profit-sharing plans) has increased concern that participants (and surviving spouses) will outlive their account balances. Similar concerns arise with respect to IRA owners.<sup>136</sup>

Lifetime income concerns have been a focus of discussion in recent years and of an initiative by the Department of the Treasury and the IRS in collaboration with the DOL to expand the availability of options that enable a participant or surviving spouse to take distributions in a form that is more likely to last over his or her lifetime ("lifetime income").<sup>137</sup> These agencies have sought public input on changes that would encourage employers to include lifetime income options in defined contribution plans and to encourage defined contribution plan participants and IRA owners to elect such options, at least with respect to part of their account balances.<sup>138</sup> In response to comments, changes have been made to the minimum required distribution rules (discussed in Part I.F.) to provide special rules for annuity contracts under which payments may begin at age 85.<sup>139</sup> In separate guidance, the IRS clarifies the application of the spousal consent and QJSA and QPSA requirements when a deferred annuity contract is offered as an investment option under a profit-sharing plan.<sup>140</sup>

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beneficiaries age 65 or older, and at least 95 percent of total income for 35 percent of beneficiaries. Social Security Administration, "Fast Facts and Figures about Social Security, 2011," SSA Publication No. 13-11785, August 2011, p. 7.

<sup>135</sup> Although defined benefit plans are required to offer annuities, they may also offer lump sums, and many participants elect to receive a lump sum (perhaps rolling it over to an IRA), rather than an annuity.

<sup>136</sup> Much of the savings in IRAs results from rollovers from qualified retirement plans. In addition, profit-sharing (and stock bonus) plans often offer lump sums as the only form of distribution. In that case, a participant wishing to take installment distributions has to roll his or her account balance over to an IRA and take installments from the IRA.

<sup>137</sup> An annuity by definition provides lifetime income, but lifetime income options also include, for example, installment payments over an individual's lifetime.

<sup>138</sup> Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans, 75 Fed. Reg. 5253 (February 2, 2010).

<sup>139</sup> Because the annuity is scheduled to begin at a time when an individual's life expectancy has declined, such an annuity contract generally costs much less than a contract providing an annuity with an earlier start date. Because the individual's retirement account balances are likely to have been at least partially depleted by the time the annuity is scheduled to begin, such an annuity is sometimes referred to as a longevity annuity or longevity insurance.

<sup>140</sup> Rev. Rul. 2012-3, 2012-8 I.R.B. 383. As part of the same lifetime income project, the IRS issued guidance to increase annuity distributions from defined benefit plans. Proposed changes to regulations under section 417(e), relating to the calculation of minimum lump sums, address the situation in which a participant's accrued benefit under a defined benefit plan is bifurcated and the bifurcated portions paid in separate forms, such as

## 9. Saver's credit

Present law provides a nonrefundable tax credit for eligible taxpayers who make qualified retirement savings contributions.<sup>141</sup> Subject to AGI limits, the credit is available to individuals who are 18 or older, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return. The AGI limits for 2014 (as indexed for inflation) are \$60,000 for married taxpayers filing joint returns, \$45,000 for head of household taxpayers, and \$30,000 for single taxpayers and married taxpayers filing separate returns.

For purposes of the credit, qualified retirement savings contributions include (1) elective deferrals to a section 401(k) plan, a section 403(b) plan, a governmental section 457 plan, a SIMPLE IRA, or a SEP; (2) contributions to a traditional or Roth IRA; and (3) voluntary after-tax employee contributions to a qualified retirement plan or annuity or a section 403(b) plan. The maximum amount of qualified retirement savings contributions taken into account for purposes of the credit is \$2,000. The amount of any contribution eligible for the credit is reduced by distributions received by the taxpayer (or by the taxpayer's spouse if the taxpayer files a joint return with the spouse) from any plan or IRA to which eligible contributions can be made during the taxable year for which the credit is claimed, the two taxable years prior to the year the credit is claimed, and during the period after the end of the taxable year for which the credit is claimed and prior to the due date for filing the taxpayer's return for the year. Distributions that are rolled over to another retirement plan do not affect the credit.

The credit is a percentage of the taxpayer's qualified retirement savings contributions up to \$2,000. The credit percentage depends on the AGI of the taxpayer, varying from 10 percent to 50 percent, as shown in the table below. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability.

**Table 1.—Credit Rates for Saver's Credit  
(for 2014)**

Joint Filers	Head of Household	All Other Filers	Credit Rate
\$0 – \$36,000	\$0 – \$27,000	\$0 – \$18,000	50 percent
\$36,001 – \$39,000	\$27,001 – \$29,250	\$18,001 – \$19,500	20 percent
\$39,001 – \$60,000	\$29,251 – \$45,000	\$19,501 – \$30,000	10 percent

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an annuity and a lump sum. Prop. Treas. Reg. sec. 1.417(e)-(d), 77 Fed. Reg. 5454 (February 2, 2012). In addition, Rev. Rul. 2012-4, 2012-8 I.R.B. 386, provides guidance on transferring a participant's account balance under a defined contribution plan to a defined benefit plan in order to provide an increased annuity under the defined benefit plan.

<sup>141</sup> Sec. 25B.

## D. Defined Benefit Plans

### General description and rules

As described in Part I.B.3 under a defined benefit plan, benefits are determined under a plan formula, rather than based on an actual account balance or plan assets. Traditionally, benefits under a defined benefit plan have been expressed as a life annuity commencing at normal retirement age (as designated under the plan), with accruals for each year of service expressed as a percentage of compensation (generally the participant's highest average compensation for a period of years). However, recent decades have seen the development and growth of hybrid defined benefit plans, such as cash balance plans, under which a participant's benefit is expressed as a hypothetical account balance. For example, accruals under a cash balance plan are expressed as hypothetical contributions to the account (or "pay credits") with a right to future hypothetical earnings (or "interest credits").

Defined benefit plans are generally funded by employer contributions, in an amount determined on an actuarial basis to be needed to provide the benefits under the plan, and employers are subject to minimum funding requirements with respect to defined benefit plans (other than most governmental and church plans). Employers therefore bear the risk of investment loss on plan assets and benefit from investment gains, subject to the employer's ability to terminate a single-employer plan in the case of bankruptcy without fully funding the benefits earned under the plan and to insolvency of a multiemployer plan. Most defined benefit plans of private employers are insured by the PBGC, for which specified premiums are required.<sup>142</sup>

Some defined benefit plans (including most governmental defined benefit plans) also require employee contributions. Employer contributions to a defined benefit plan are currently deductible (subject to limits), but benefits are not includible in employee's income until distributed. Employee contributions to defined benefit plans are generally made on an after-tax basis, except in the case of employee contributions to a State or local government plan that are "picked up" by the employer.<sup>143</sup>

Defined benefit plans may not provide for in-service distributions before age 62 (or normal retirement age, if earlier) or in the case of plan termination. Defined benefit plans must allow participants who have terminated employment and reached normal retirement age to receive distributions and often provide for distributions on early retirement or other severance from employment before normal retirement age. Defined benefit plans, including hybrid plans, must generally provide benefits in the form of an annuity payable at normal retirement age (or any other time a distribution is made), but may also provide benefits in other forms, including lump sums.

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<sup>142</sup> Title IV of ERISA.

<sup>143</sup> Section 414(h)(2).

Annuity distributions from a defined benefit plan for a year cannot exceed the lesser of \$210,000 (for 2014) or the employee's average compensation for the three consecutive years of highest compensation for the employee.<sup>144</sup> The dollar limit is reduced if distributions begin before age 62 and increased if distributions begin after age 65. An actuarially adjusted limit applies to a form of benefit other than an annuity, such as a lump sum.

As discussed in Part I.B.2, defined benefit plan are subject to the nondiscrimination rules, i.e., the rules prohibiting discrimination in favor of highly compensated employees as implemented under regulations.<sup>145</sup>

### **Vesting and related rules**

For purposes of the vesting requirements, in the case of a defined benefit plan, a participant's accrued benefit at any given time is the portion of the annuity payable at normal retirement age under the plan's benefit formula (the "normal retirement benefit") that the participant has earned as of that time. That is, if a participant terminates employment before reaching normal retirement age, the benefit to which the participant is entitled is the accrued benefit (to the extent vested). A defined benefit plan using a traditional benefit formula may use one of two vesting schedules for the portion of the accrued benefit attributable to employer contributions:<sup>146</sup> (1) 100 percent vesting after completion of no more than five years of service ("five-year cliff vesting") and (2) vesting of no less than 20 percent, 40 percent, 60 percent, 80 percent, and 100 percent, respectively, over the period from three to seven years of service. A hybrid plan must use a vesting schedule of 100 percent vesting after completion of no more than three years of service. In conjunction with the vesting requirements, "anti-backloading" rules require that participants earn (*i.e.*, accrue) benefits in a relatively even pattern over their period of service in order to prevent benefits from being denied to shorter-service employees by delaying accruals until later years of service.<sup>147</sup>

A defined benefit plan is permitted to provide a wide variety of optional forms of distribution with respect to the accrued benefit, but each form must be at least the actuarial equivalent of the accrued benefit.<sup>148</sup> The assumptions for determining actuarial equivalence (interest rate and mortality) must be specified in the plan in a manner that precludes employer discretion. In the case of certain forms of benefit, including lump sums, specific actuarial

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<sup>144</sup> Section 415(b). After-tax employee contributions to a defined benefit plan are taken into account in applying the limit on contributions to a defined contribution plan as discussed below.

<sup>145</sup> Treas. Reg. secs. 1.401(a)(4)-1 through 13.

<sup>146</sup> Specific rules apply for determining the portion of a participant's accrued benefit under a defined benefit plan that is attributable to employer contributions.

<sup>147</sup> Sec. 411(b).

<sup>148</sup> A defined benefit plan may also provide for "ancillary" benefits, which are not part of the participant's accrued benefit, such as disability or death benefits. Ancillary benefits are not subject to the vesting requirements and generally can be eliminated or reduced retroactively by a plan amendment.

assumptions must be used.<sup>149</sup> A defined benefit plan may provide for a subsidized early retirement benefit or other retirement type subsidies, the right to which is not required to vest or accrue in accordance with the vesting schedules or anti-backloading requirements. For example, a plan with a normal retirement age of 65 might provide for payment of a participant's accrued benefit at age 55 without actuarial reduction for early commencement, but conditioned on the participant's having at least 30 years of service.

Under the "anti-cutback" rules, amendments that reduce the employee's accrued benefit (whether or not vested), or eliminate optional forms of benefit or eliminate or reduce early retirement benefits or retirement-type subsidies with respect to the employee's accrued benefit, generally are prohibited.<sup>150</sup> Amendments are generally permitted to reduce future rates of accrual, or eliminate optional forms of benefits or eliminate or reduce early retirement benefits or retirement-type subsidies, only with respect to future accruals. Exceptions to the "anti-cutback" rules apply.

Spousal protections applicable to defined benefit plans generally require that benefits be paid in the form of a qualified joint and survivor annuity ("QJSA") unless the participant elects a different form of distribution and the participant's spouse provides notarized consent to the election. A QJSA is generally a life annuity for the participant with an annuity of at least 50 percent of the participant's annuity amount payable to the surviving spouse after the participant's death. A married participant must also be offered a qualified optional survivor annuity ("QOSA"), which is also a life annuity for the participant with an annuity payable to the surviving spouse as a percentage of the participant's annuity, with the required percentage depending on the QJSA percentage. Specifically, if the survivor annuity under the QJSA is less than 75 percent of the participant's annuity, the survivor annuity under the QOSA must be 75 percent, and, if the survivor annuity under the QJSA is 75 percent or more of the participant's annuity, the survivor annuity under the QOSA must be 50 percent. If a married participant dies before benefits begin, the plan must offer a survivor benefit for the spouse in the form of a qualified preretirement survivor annuity ("QPSA"), which is a survivor annuity for the spouse that is at least 50 percent of the employee's accrued benefit.

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<sup>149</sup> Sec. 417(e). Special rules apply for valuing the accrued benefit under certain hybrid plans.

<sup>150</sup> Sec. 411(d)(6).

## E. Individual Retirement Arrangements

### 1. Traditional and Roth individual retirement arrangements

#### Contribution limits

##### In general

There are two basic types of IRAs under present law: traditional IRAs,<sup>151</sup> to which both deductible and nondeductible contributions may be made,<sup>152</sup> and Roth IRAs, to which only nondeductible contributions may be made.<sup>153</sup> The principal difference between these two types of IRAs is the timing of income tax inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, but distributions are includible in gross income to the extent attributable to earnings on the account and the deductible contributions. For a Roth IRA, all contributions are after-tax (that is, no deduction is allowed) but, if certain requirements are satisfied, distributions are not includible in gross income.

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth) for a taxable year is the lesser of a certain dollar amount (\$5,500 for 2014) or the individual's compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount.

An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. For this purpose, the aggregate dollar limit is increased by \$1,000. Thus, for example, if an individual over age 50 contributes \$6,500 to a Roth IRA for 2014 (\$5,500 plus \$1,000 catch-up), the individual will not be permitted to make any contributions to a traditional IRA for that year. In addition, deductible contributions to traditional IRAs and after-tax contributions to Roth IRAs generally are subject to AGI limits. IRA contributions generally must be made in cash.

##### Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with AGI for the taxable year over certain indexed levels. In the case of an individual who is an active participant in an employer-sponsored plan, the AGI phase-out ranges for 2014 are: (1) for

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<sup>151</sup> Sec. 408.

<sup>152</sup> Sec. 219.

<sup>153</sup> Sec. 408A.



single taxpayers, \$60,000 to \$70,000; (2) for married taxpayers filing joint returns, \$96,000 to \$116,000; and (3) for married taxpayers filing separate returns, \$0 to \$10,000. If an individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with AGI for 2014 between \$181,000 and \$191,000.

To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible contributions to a traditional IRA (that is, no AGI limits apply), subject to the same contribution limits as the limits on deductible contributions, including catch-up contributions. An individual who has attained age 70½ prior to the close of a year is not permitted to make contributions to a traditional IRA.

### Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels. The AGI phase-out ranges for 2014 are: (1) for single taxpayers, \$114,000 to \$129,000; (2) for married taxpayers filing joint returns, \$181,000 to \$191,000; and (3) for married taxpayers filing separate returns, \$0 to \$10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70½.

### Separation of traditional and Roth IRA accounts

Contributions to traditional IRAs and to Roth IRAs must be segregated into separate IRAs, meaning arrangements with separate trusts, accounts, or contracts, and separate IRA documents. Except in the case of a conversion or recharacterization, amounts cannot be transferred or rolled over between the two types of IRAs.

Taxpayers generally may convert a traditional IRA into a Roth IRA through a distribution from a traditional IRA and rollover to a Roth IRA as described below. The amount converted is includible in the taxpayer's income as if a withdrawal had been made, except that the early distribution tax (discussed below) does not apply. However, the early distribution tax is imposed if the taxpayer withdraws the amount within five years of the conversion.

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize (in a trustee-to-trustee transfer) the amount of that contribution as a contribution to the other type of IRA (traditional or Roth) before the due date for the individual's income tax return for that year.<sup>154</sup> In the case of a recharacterization, the contribution will be treated as having been made to the transferee plan (and not the transferor plan). The amount transferred must be accompanied by any net income allocable to the contribution and no deduction is allowed with respect to the contribution to the transferor plan. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as

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<sup>154</sup> Sec. 408A(d)(6).

having been made to a traditional IRA. However, Treasury regulations limit the number of times a contribution for a taxable year may be recharacterized.<sup>155</sup>

### **Excise tax on excess contributions**

To the extent that contributions to an IRA exceed the contribution limits, the individual is subject to an excise tax equal to six percent of the excess amount.<sup>156</sup> This excise tax generally applies each year until the excess amount is distributed. Any amount contributed for a taxable year that is distributed with allocable income by the due date for the taxpayer's return for the year will be treated as though not contributed for the year.<sup>157</sup> To receive this treatment, the taxpayer must not have claimed a deduction for the amount of the distributed contribution.

## **2. Taxation of distributions from IRAs**

### **Traditional IRAs**

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent that the withdrawal is a return of the individual's basis.<sup>158</sup> All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs. The portion of the individual's basis that is recovered with any distribution is the ratio of the amount of the aggregate basis in all the individual's traditional IRAs to the amount of the aggregate account balances in all the individual's traditional IRAs.

### **Roth IRAs**

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income. A qualified distribution is a distribution that (1) is made after the five-taxable-year period beginning with the first taxable year for which the individual first made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to \$10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings; amounts that are attributable to a return of contributions to the Roth IRA are not includible in income. All Roth IRAs are treated as a single contract for purposes of determining the amount that is a return of contributions. To determine the amount includible in income, a distribution that is not a qualified distribution is treated as made in the following order: (1) regular Roth IRA contributions (including contributions rolled over from other Roth IRAs); (2) conversion contributions (on a first in, first out basis); and

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<sup>155</sup> Treas. Reg. sec. 1.408A-6.

<sup>156</sup> Secs. 4973(b) and (f).

<sup>157</sup> Sec. 408(d)(4).

<sup>158</sup> Basis results from after-tax contributions to the IRA or a rollover to the IRA of after-tax amounts from another eligible retirement plan.

(3) earnings. To the extent a distribution is treated as made from a conversion contribution, it is treated as made first from the portion, if any, of the conversion contribution that was required to be included in income as a result of the conversion. Thus, nonqualified distributions from all Roth IRAs are excludable from gross income until all amounts attributable to contributions have been distributed.

## **Rollovers**

Distributions from IRAs are permitted to be rolled over tax-free to another IRA or any other eligible retirement plan. The general 60-day rollover rule (discussed above) applies to IRA rollovers as well as rollovers from qualified retirement plans, section 403(b) annuities, and governmental section 457(b) plans. There is no provision for direct rollovers from an IRA, but direct payment to another eligible retirement plan generally satisfies the requirements. Distributions from an inherited IRA (except in the case of an IRA acquired by the surviving spouse by reason of the IRA owner's death) and required minimum distributions are not permitted to be rolled over.<sup>159</sup> The portion of any distribution from an IRA that is not includible in gross income is only permitted to be rolled over to another IRA. Generally, distributions from a traditional IRA may only be rolled over tax-free to another IRA and distributions from a Roth IRA may only be rolled over tax-free to another Roth IRA. However, a distribution from a traditional IRA may be rolled over to a Roth IRA as a Roth conversion with the required income inclusion (as described above).

## **3. Employer retirement plans using IRAs**

### **SIMPLE IRA plan**

A small employer that employs no more than 100 employees who earned \$5,000 or more during the prior calendar year can establish a simplified tax-favored retirement plan, which is called the SIMPLE retirement plan. A SIMPLE IRA plan is generally a plan under which contributions are made to an IRA for each employee (a "SIMPLE IRA"). A SIMPLE IRA plan allows employees to make elective deferrals to a SIMPLE IRA, subject to a limit of \$12,000 (for 2014). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions under a SIMPLE IRA plan up to a limit of \$2,500 (for 2014).

In the case of a SIMPLE IRA plan, the group of eligible employees generally must include any employee who has received at least \$5,000 in compensation from the employer in any two preceding years and is reasonably expected to receive \$5,000 in the current year. A SIMPLE IRA plan is not subject to the nondiscrimination rules generally applicable to qualified retirement plans.

Employer contributions to a SIMPLE IRA must satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee

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<sup>159</sup> A trustee to trustee transfer between IRAs is not treated as a distribution and rollover. Thus, nonspouse beneficiaries of IRAs can move funds to another inherited IRA established as a beneficiary of the decedent IRA owner. In contrast, a surviving spouse is permitted to roll over a distribution to his or her own IRA.

elective contributions on a dollar-for-dollar basis up to three percent of the employee's compensation. The employer can elect a lower percentage matching contribution for all employees (but not less than one percent of each employee's compensation); however, a lower percentage cannot be elected for more than two years out of any five year period. Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a nonelective contribution of two percent of compensation on behalf of each eligible employee with at least \$5,000 in compensation for such year, whether or not the employee makes an elective contribution.

The employer must provide each employee eligible to make elective deferrals under a SIMPLE IRA plan a 60-day election period before the beginning of the calendar year and a notice at the beginning of the 60-day period explaining the employee's choices under the plan.<sup>160</sup>

No contributions other than employee elective contributions, required employer matching contributions, or employer nonelective contributions can be made to a SIMPLE IRA plan, and the employer may not maintain any other qualified retirement plan.

### **Simplified employee pensions**

A simplified employee pension ("SEP") is an IRA to which the employer may make contributions for an employee up to the lesser of 25 percent of the employee's compensation or the dollar limit applicable to contributions to a qualified defined contribution plan (\$52,000 for 2014).<sup>161</sup> All contributions must be fully vested. Any employee must be eligible to participate in the SEP if the employee has (1) attained age 21, (2) performed services for the employer during at least three of the immediately preceding five years, and (3) received at least \$550 (for 2014) in compensation from the employer for the year. Contributions to a SEP generally must bear a uniform relationship to compensation.

Effective for taxable years beginning before January 1, 1997, certain employers with no more than 25 employees could maintain a salary reduction SEP ("SARSEP") under which employees could make elective deferrals. The SARSEP rules were generally repealed with the enactment of the SIMPLE IRA plan rules. However, contributions may continue to be made to SARSEPs that were established before 1997. Salary reduction contributions to a SARSEP are subject to the same limit that applies to elective deferrals under a section 401(k) plan (\$17,500 for 2014). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SARSEP up to a limit of \$5,500 (for 2014).

### **Deemed IRAs**

Certain types of employer-sponsored retirement plans are permitted to provide IRAs to employees as a part of the plan.<sup>162</sup> This option is available to qualified retirement plans, section

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<sup>160</sup> Notice 98-4, 1998-1 C.B. 269.

<sup>161</sup> Sec. 408(k).

<sup>162</sup> Sec. 408(q).

403(b) plans, and governmental section 457(b) plans. The Code permits these plans to allow employees to elect to make contributions to a separate account or annuity under the plan that are treated as contributions to a traditional IRA or a Roth IRA. To receive this treatment, under the terms of the plan, the account or annuity must satisfy the requirements of the Code for being a traditional or Roth IRA. Implementing the basic provision that the account satisfy the requirements to be an IRA, Treasury regulations require that the trustee with respect to the account be a bank or a nonbank trustee approved by the IRS.<sup>163</sup>

### **Payroll deduction IRA**

An employer is permitted to establish a program under which each employee can elect to have the employer withhold an amount each pay period and contribute the amount to an IRA established by the employee. In the Conference report to the Taxpayer Relief Act of 1997,<sup>164</sup> Congress indicated that “employers that chose not to sponsor a retirement plan should be encouraged to set up a payroll deduction system to help employees save for retirement by making payroll deduction contributions to their IRAs.” Congress encouraged the Secretary of the Treasury to “continue his efforts to publicize the availability of these payroll deduction IRAs.”<sup>165</sup> In response to that directive, the IRS published guidance to remind employers of the availability of this option for their employees.<sup>166</sup>

In 1975, DOL issued a regulation describing circumstances under which the use of an employer payroll deduction program for forwarding employee monies to an IRA will not constitute an employee pension benefit plan subject to ERISA.<sup>167</sup> In 1999, DOL restated and updated its positions on these programs.<sup>168</sup> Under the DOL guidance, the general rule is that, in order for an IRA payroll program not to be a pension plan subject to ERISA, the employer must not endorse the program. To avoid endorsing the program the employer must maintain neutrality with respect to an IRA sponsor in its communication to its employees and must otherwise make clear that its involvement in the program is limited to collecting the deducted amounts and remitting them promptly to the IRA sponsor and that it does not provide any additional benefit or promise any particular investment return on the employee’s savings..

In January 2014, the Treasury Department announced that it is developing a new type of payroll deduction IRA program with Roth IRAs called myRAs, established for employees of

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<sup>163</sup> Treas. Reg. sec. 1.408(q)-1. Special rules apply in the case of deemed IRAs under plans of State and local government employers.

<sup>164</sup> Pub. L. No. 105-34.

<sup>165</sup> H. Rep. No. 102-220, p. 775 (1997).

<sup>166</sup> Announcement 99-2, 1999-1 C.B. 305. The IRS also includes information on its website concerning the rules for this option and the pros and cons for an employer adopting a payroll deduction IRA program.

<sup>167</sup> Labor Reg. sec. 2510.3-2(d).

<sup>168</sup> Interpretive Bulletin 99-1, 64 Fed. Reg. 32999 (June 18, 1999); Labor Reg. sec. 2509.99-1.

participating employers. Under the program as announced,<sup>169</sup> myRAs are intended for employees who do not have access to an employer sponsored retirement plan. MyRAs will be backed by the U.S. Treasury, not go down in value, and earn the same variable rate as the Government Securities Fund in the Thrift Savings Plan for Federal employees. Employees of participating employers will be able to sign up online for a minimum contribution of \$25 and elect to have \$5 or more deducted from each paycheck and directly deposited into their myRA. Amounts held in a myRA account may be rolled over to another Roth IRA that is not a myRA at any time. However, once a myRA account reaches \$15,000 or after 30 year, the balance will be transferred to a Roth IRA that is not a myRA.

#### **4. Requirements for IRA trust and investment of IRA funds**

##### **In general**

An IRA can be a trust, a custodial account, or an annuity contract. The Code requires that the trustee or custodian of an IRA be a bank (which is generally subject to Federal or State supervision) or an IRS approved nonbank trustee, that an annuity contract be issued by an insurance company (which is subject to State supervision), and that an IRA trust or custodial account be created and organized in the United States.

Certain restrictions apply in the handling and investment of IRA funds. An IRA trust or custodial account is not permitted to be invested in life insurance contracts.<sup>170</sup> If a disqualified person engages in a prohibited transaction with an IRA, the two-tiered excise tax on prohibited transactions (described in Part I.B.4) applies to the disqualified person. However, if an IRA owner or beneficiary engages in a prohibited transaction with respect to an IRA, the excise tax does not apply.<sup>171</sup> Instead, in that case, the trust or custodial account ceases to be an IRA as of the first day of the taxable year in which the prohibited transaction occurred.<sup>172</sup> Similarly if an IRA annuity owner borrows any money under or from the contract, the contract ceases to be an individual retirement annuity as of the first day of such taxable year.<sup>173</sup>

In contrast, if an IRA trust or custodial account is used as security for a loan then only the amount pledged is treated as distributed.<sup>174</sup> Similarly, if an IRA is invested in certain

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<sup>169</sup> Treasury Department, *myRA: A Simple, Safe, Affordable Savings Account*, available at <http://www.treasury.gov/connect/blog/Documents/FINAL%20myRA%20Fact%20Sheet.pdf>

<sup>170</sup> Sec. 408(a)(3).

<sup>171</sup> As discussed above, in general, “disqualified person” includes: (1) a fiduciary; and (2) a person providing services to the plan. An IRA owner with authority to control the investment of the assets in the IRA (a “self-directed IRA”) is a fiduciary, and therefore, a disqualified person under the prohibited transactions rules.

<sup>172</sup> Sec. 408(e)(1). If the IRA ceases to be an IRA due to a prohibited transaction by the owner, a distribution equal to the fair market value of all assets of the account are treated as occurring on the first day of the taxable year.

<sup>173</sup> Sec. 408(e)(3).

<sup>174</sup> Sec. 408(e)(4).

collectibles, an amount equal to the cost of such collectible is treated as distributed to the IRA owner or beneficiary.<sup>175</sup> Collectibles for this purpose include any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage, or any other tangible personal property specified as a collectible for this purpose.<sup>176</sup> In addition, a trustee or custodian for an IRA may limit the choice of investments allowed in the IRA, and other law, such as the Securities Exchange Act,<sup>177</sup> may limit the investors who qualify to make certain types of investments, such as investments in private equity or hedge funds.<sup>178</sup> Beyond these restrictions, there are few limitations on the types of assets in which an IRA may be invested.

Tax-free distributions from Roth IRAs may create an incentive for some taxpayers to attempt to structure investments so as to transfer value into a Roth IRA that is not legitimately characterized as return on investment for the assets held by the Roth IRA but rather is a disguised additional contribution.<sup>179</sup> Typically, such a transfer of value is structured to use the tax exempt status of the Roth IRA to also avoid current income tax liability by the individual on the amount transferred.

### **Rules for approved nonbank trustees**

In order for a trustee or custodian that is not a bank to be an IRA trustee or custodian, the entity must apply to the IRS for approval. Treasury Regulations list a number of factors that are taken into account in approving an applicant to be a nonbank trustee.<sup>180</sup> The applicant must demonstrate fiduciary ability (ability to act within accepted rules of fiduciary conduct including continuity and diversity of ownership), capacity to account (experience and competence with other activities normally associated with handling of retirement funds), and ability to satisfy other rules of fiduciary conduct which includes a net worth requirement. Because it is an

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<sup>175</sup> Sec. 408(m).

<sup>176</sup> There are exceptions from the definition of collectible for certain Federally minted gold, silver, or platinum coins, or coins issued under the laws of any State, and for gold, silver, platinum, or palladium bullion in the physical possession of the IRA trustee that is of a certain level of investment grade fineness.

<sup>177</sup> 15 U.S.C. sec.78a et seq.

<sup>178</sup> Some investments have the potential to generate unrelated trade or business taxable income imposed under section 511, such as income generated by certain debt-financed property.

<sup>179</sup> Notice 2004-8, 2004-1 C.B. 333, describes certain abusive Roth transactions that involve this type of transfer of value and identifies the transactions as “listed transactions.” See *Repetto and Repetto v. Commissioner*, T.C. Memo 2012-168, in which the basic principles described in Notice 2004-8 were applied by the Tax Court, and Commissioner’s denial of certain deductions, and imposition of the excise tax on excess IRA contributions based on being a disguised excess contribution were upheld. The preamble to Treasury Decision 9220, Converting an IRA Annuity to a Roth IRA, 70 FR 48868, published August 22, 2005, describes transactions in which taxpayers have attempted to structure conversions of a traditional IRA annuity to a Roth IRA annuity to permit including in gross income less than the fair market value of the traditional IRA annuity on the date of the conversion.

<sup>180</sup> Treas. Reg. sec. 1.408-2(e).

objective requirement that may be difficult for some applicants to satisfy, the net worth requirement is the most significant of the requirements for nonbank trustees.

To be approved, the entity must have a net worth of at least \$250,000 at the time of the application. There is a maintenance rule that varies depending on whether the trustee is an active trustee or a passive trustee and that includes minimum dollar amounts and minimum amounts as a percentage of assets held in fiduciary accounts. A special rule is provided for nonbank trustees that are members of the Security Investor Protection Corporation (“SIPC”).



## F. Early Distributions and Required Minimum Distributions

### 1. Early distributions

The Code imposes an early distribution tax on distributions made from qualified retirement plans, 403(b) plans and IRAs before employee or an IRA owner attains age 59½.<sup>181</sup> The tax is equal to 10 percent of the amount of the distribution that is includible in gross income unless an exception applies. The 10-percent tax is in addition to the taxes that would otherwise be due on distribution. This additional tax is designed to help insure that distributions from qualified retirement plans are preserved for retirement.

There are a number of exceptions to the early distribution tax. Some exceptions apply to all plans and others apply only to IRAs or only to qualified retirement plans and section 403(b) annuities. The exceptions that apply to all plans include distributions due to death or disability; distributions made in the form of certain periodic payments; distributions made on account of a tax levy on the plan; distributions to the extent that they do not exceed the amount allowable as a deduction for amounts paid during the taxable year due to medical care (determined without regard to whether the employee itemizes deductions for such year);<sup>182</sup> or distributions made to a member of a reserve unit called to active duty for 180 days or longer.

The exceptions that only apply to distributions from IRAs include distributions used to purchase health insurance for certain unemployed individuals; used for higher education expenses; and used for first-time homebuyer expenses of up to \$10,000. The exceptions that only apply to distributions from qualified retirement plans and 403(b) plans include distributions made subsequent to the employee's separation from service after attaining age 55;<sup>183</sup> distributions made to an alternate payee pursuant to a qualified domestic relations order; and distribution of dividends paid with respect to stock held by an ESOP.

### 2. Minimum distribution requirements

#### In general

Minimum distributions rules apply to tax-favored employer-sponsored retirement plans and IRA, and limit the tax deferral allowed for these plans and arrangements. By requiring that minimum annual distributions at a required beginning date (generally at age 70½), the rules are designed to ensure that these plans are used to provide funds for retirement. Distributions to an employee are required to begin no later than the required beginning date and to be distributed, in accordance with regulations, over the life of the employee or over the lives of the employee and a designated beneficiary (or over a period not extending beyond the life expectancy of the

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<sup>181</sup> Sec. 72(t). The early distribution tax does not apply to distributions from governmental section 457(b) plans.

<sup>182</sup> Sec. 213.

<sup>183</sup> Age 50 is substituted for age 55 in the case of distributions to a qualified public safety officer from a governmental defined benefit plan.

employee or the life expectancy of the employee and a designated beneficiary).<sup>184</sup> Minimum distribution rules also apply to benefits payable with respect to an employee or IRA owner who has died.

The regulations provide a methodology for calculating the required minimum distribution from an individual account under a defined contribution plan or from an IRA. In the case of annuity payments under a defined benefit plan or an annuity contract, the regulations provide requirements that the annuity stream of payments must satisfy. Failure to comply with the minimum distribution requirement may result in an excise tax imposed on the individual who was required to be the distributee equal to 50 percent of the required minimum distribution not distributed for the year.<sup>185</sup> The excise tax may be waived in certain cases.

## **Lifetime rules**

### General rules

While an employee or IRA owner is alive, distributions of the individual's interest starting from the required beginning date are required to be made (in accordance with regulations) over the life or life expectancy of the employee or IRA owner, or over the joint lives or joint life expectancy of the employee or IRA owner and a designated beneficiary.<sup>186</sup> For defined contribution plans and IRAs, the required minimum distribution for each year is determined by dividing the account balance as of the end of the prior year by a distribution period which, while the employee or IRA owner is alive, is the factor from the uniform lifetime table included in the Treasury regulations.<sup>187</sup> This table is based on the joint life and last survivor expectancy of the individual and a hypothetical beneficiary 10 years younger. For an individual with a spouse as designated beneficiary who is more than 10 years younger (and thus the number of years in the couple's joint life and last survivor expectancy is greater than the uniform lifetime table), the joint life expectancy and last survivor expectancy of the couple (calculated using the table in the regulations) is used.

### Required beginning date

For traditional IRAs, the required beginning date is April 1 following the calendar year in which the IRA owner attains age 70½. For tax-favored employer-sponsored retirement plans, for an employee other than an employee who is a five-percent owner in the year the employee attains age 70½, the employee's required beginning date is April 1 after the later of the calendar year in which the employee attains age 70½ or retires. For an employee who is a five-percent owner under a tax-favored employer-sponsored retirement plan in the year the employee attains age 70½, the required beginning date is the same as for IRAs even if the employee continues to work past age 70½.

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<sup>184</sup> Sec. 401(a)(9)(A).

<sup>185</sup> Sec. 4974.

<sup>186</sup> Sec. 401(a)(9)(A).

<sup>187</sup> Treas. Reg. sec. 1.401(a)(9)-5.

## Lifetime income rule for annuities commencing at age 85

In July 2014, the minimum required distribution regulations were amended to allow the value of a qualifying longevity annuity contract held in a defined contribution plan account or traditional IRA to be disregarded in some circumstances in determining minimum required distributions for years before annuity payments under the contract are scheduled to begin.<sup>188</sup> Among the conditions on such disregard, the regulations limit the portion of an account that can be invested in a longevity annuity contract (the lesser of 25 percent or \$125,000), require the annuity to begin no later than age 85, and include reporting requirements for the annuity issuer.

### **Distributions after death**

#### Payments over a distribution period

The after-death rules vary depending on (1) whether an employee or IRA owner dies on or after the required beginning date or before the required beginning date, and (2) whether there is a designated beneficiary for the benefit. A designated beneficiary is an individual designated as a beneficiary under the plan.<sup>189</sup> Similar to the lifetime rules, for defined contribution plans and IRAs, the required minimum distribution for each year after the death of the employee or IRA owner is generally determined by dividing the account balance as of the end of the prior year by a distribution period.

If an employee or IRA owner dies on or after the required beginning date, the statutory rule is that the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death.<sup>190</sup> For individual accounts, if there is a designated beneficiary, the distribution period is the beneficiary's life expectancy calculated using the life expectancy table in the regulations, calculated in the year after the year of the death.<sup>191</sup> If there is no designated beneficiary, the distribution period is equal to the remaining years of the employee or IRA owner's life, as of the year of death.<sup>192</sup>

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<sup>188</sup> Treasury Decision 9673, 79 F.R. 37633 (July, 2, 2014) and Treas. Reg. secs. 1.401(a)(9)-5, A-3 and 1.401(a)(9)-6, A-12. The regulations, and the conditions on longevity annuity contracts, do not apply to Roth IRAs because an individual is not required to take distributions from a Roth IRA at age 70½. The regulations also do not apply to defined benefit plans but the preamble to the final regulation requests comments regarding the desirability of making available in defined benefit plans a form of benefit that replicates the structure for qualified longevity annuity contracts.

<sup>189</sup> Treas. Reg. sec. 1.401(a)(9)-4, A-1. The individual need not be named as long as the individual is identifiable under the terms of the plan. There are special rules for multiple beneficiaries and for trusts named as beneficiary (where the beneficiaries of the trust are individuals). However, if an individual is named as beneficiary through the employee or IRA owner's will or the estate is named as beneficiary, there is no designated beneficiary for purposes of the minimum distribution requirements.

<sup>190</sup> Sec. 401(a)(9)(B)(i)

<sup>191</sup> Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

<sup>192</sup> Treas. Reg. sec. 1.401(a)(9)-5, A-5(a).

If an employee or IRA owner dies before the required beginning date and any portion of the benefit is payable to a designated beneficiary, distributions are permitted to begin within one year of the employee's (or IRA owner's) death (or such later date as prescribed in regulations) and to be paid (in accordance with regulations) over the life or life expectancy of the designated beneficiary.<sup>193</sup> For individual accounts, the distribution period is measured by the designated beneficiary's life expectancy, calculated in the same manner as if the individual dies on or after the required beginning date.<sup>194</sup>

In all cases where distribution after death is based on life expectancy (either the remaining life expectancy of the employee or IRA owner or a designated beneficiary), the distribution period generally is fixed at death and then reduced by one for each year that elapses after the year in which it is calculated. If the designated beneficiary dies during the distribution period, distributions continue to the subsequent beneficiaries over the remaining years in the distribution period. If the distribution period is based on the surviving spouse's life expectancy (whether the employee or IRA owner's death is before or after the required beginning date), the spouse's life expectancy generally is recalculated each year while the spouse is alive and then fixed the year after the spouse's death.

#### Five-year rule

If an employee or IRA owner dies before the required beginning date and there is no designated beneficiary, then the entire remaining interest of the employee or IRA owner must generally be distributed by the end of the fifth year following the individual's death.<sup>195</sup>

#### **Defined benefit plans and annuity distributions**

The regulations provide rules for annuity distributions from a defined benefit plan or an annuity purchased from an insurance company paid over life or life expectancy. Annuity distributions are generally required to be nonincreasing with certain exceptions, which include, for example, increases to the extent of certain specified cost of living indexes, a constant percentage increase (for a qualified plan, the constant percentage cannot exceed five percent per year), certain accelerations of payments, increases to reflect when an annuity is converted to a single life annuity after the death of the beneficiary under a joint and survivor annuity or after termination of the survivor annuity under a QDRO.<sup>196</sup> If distributions are in the form of a joint and survivor annuity and the survivor annuitant both is not the surviving spouse and is younger

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<sup>193</sup> Sec. 401(a)(9)(B)(iii). Special rules apply if the beneficiary of the employee or IRA owner is the individual's surviving spouse. In that case, distributions are not required to commence until the year in which the employee or IRA owner would have attained age 70½. If the surviving spouse dies before the employee or IRA owner would have attained age 70½, the after-death rules for death before distributions have begun are applied as though the spouse were the employee or IRA owner.

<sup>194</sup> Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

<sup>195</sup> Treas. Reg. sec. 1.401(a)(9)-3, A-2.

<sup>196</sup> Treas. Reg. sec. 1.401(a)(9)-6, A-14.

than the employee or IRA owner, the survivor annuitant is limited to a percentage of the life annuity benefit for the employee or IRA owner.<sup>197</sup> The survivor benefit as a percentage of the benefit of the primary annuitant is required to be smaller (but not required to be less than 52 percent) as the difference in the ages of the primary annuitant and the survivor annuitant become greater.

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<sup>197</sup> Treas. Reg. sec. 1.401(a)(9)-6, A-2.

## **G. Other Tax-Favored Individual Savings Arrangements for Specific Purposes<sup>198</sup>**

### **1. Savings for education expenses**

#### **Qualified tuition programs**

Present law provides tax-exempt status to a qualified tuition program, defined as a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions.<sup>199</sup> Under a qualified tuition program, a person may purchase tuition credits or certificates on behalf of a designated beneficiary, or in the case of a State program, may make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. Contributions to a qualified tuition program must be made in cash, and the program must have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary's qualified higher education expenses. Contributions to a qualified tuition program are not deductible. Contributions to a qualified tuition program generally are treated as a completed gift eligible for the gift tax annual exclusion.

Distributions from a qualified tuition program are not includible in the distributee's gross income to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. If a distribution from a qualified tuition program exceeds the qualified education expenses incurred by the beneficiary during the year of the distribution, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 10-percent tax. Amounts in a qualified tuition program may be rolled over on a tax-free basis to another qualified tuition program for the same beneficiary or for a member of the family of that beneficiary.

#### **Coverdell education savings accounts**

Present law provides tax-exempt status to Coverdell education savings accounts, meaning certain trusts or custodial accounts that are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a designated beneficiary.<sup>200</sup> The aggregate annual contributions that can be made by all contributors to Coverdell education savings accounts for the same beneficiary is \$2,000 per year. In the case of contributors who are individuals, the maximum contribution limit is reduced for individuals with adjusted gross income between \$95,000 and \$110,000 (\$190,000 to \$220,000 in the case of married taxpayers filing a joint return). Contributions to a Coverdell education savings account are not deductible.

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<sup>198</sup> Tax-favored treatment applies also to certain other arrangements and investments, such as annuity contracts, life insurance, and tax-exempt bonds.

<sup>199</sup> Sec. 529.

<sup>200</sup> Sec. 530.

Distributions from a Coverdell education savings account are not includible in the distributee's income to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. If a distribution from a Coverdell education savings account exceeds the qualified education expenses incurred by the beneficiary during the year of the distribution, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 10-percent tax. Amounts in a Coverdell education savings account may be rolled over on a tax-free basis to another Coverdell education savings account of the same beneficiary or of a member of the family of that beneficiary.

## **2. Savings for health expenses**

### **Health savings accounts**

A health savings account ("HSA") is a trust or custodial account used to accumulate funds on a tax-preferred basis to pay for qualified medical expenses.<sup>201</sup> Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual. Contributions to an HSA made by an individual's employer are excludable from income and not subject to employment taxes. Earnings on amounts in HSAs are not taxable. Distributions from an HSA for qualified medical expenses are not includible in gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional 20-percent tax unless the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan. A high deductible health plan is a health plan that has a deductible that is at least \$1,250 for self-only coverage or \$2,500 for family coverage (for 2014) and that has an out-of-pocket expense limit that is no more than \$6,350 in the case of self-only coverage and \$12,700 in the case of family coverage (for 2014).

The maximum aggregate annual contribution that can be made to an HSA in 2014 is \$3,300 in the case of self-only coverage and \$6,550 in the case of family coverage. The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by \$1,000.

### **Archer medical savings accounts**

Like HSAs, an Archer medical savings account ("Archer MSA") is a tax-exempt trust or custodial account to which tax-deductible contributions may be made by individuals with a high deductible health plan.<sup>202</sup> Archer MSAs provide tax benefits similar to, but generally not as

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<sup>201</sup> Sec. 223.

<sup>202</sup> Sec. 220.

favorable as, those provided by HSAs for certain individuals covered by high deductible health plans. For example, only self-employed individuals and employees of small employers are eligible to have an Archer MSA. After 2007, no new contributions can be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer.



## II. ECONOMIC ISSUES RELATING TO RETIREMENT PLANS

Policymakers often desire to reinforce individual retirement security and boost economic growth. To this end, they attempt to develop policies that encourage personal saving. A variety of policy designs target individual saving behavior by offering incentives through the tax system. These include, among others, individual tax subsidies and tax subsidies to employers who provide retirement plans. An important question is whether these subsidies have the desired effect on retirement saving outcomes. This section explores two sets of economic issues relating to retirement plans: the effect of retirement policies on saving; and the interaction of consumption tax principles with incentives in retirement policies.

### **The effect of retirement policies on saving**

#### The life-cycle models

Standard economic models show that rational individuals maximize their well-being by choosing to smooth their consumption over their life-cycles.<sup>203</sup> That is, individuals save during their working years and dissave when they retire from work. According to these standard life-cycle models, tax subsidies to workers and to employers that effectively increase the net rate of return may encourage individuals to delay consumption and encourage employers to provide retirement plans, thereby increasing saving by individuals during their working years.<sup>204</sup> However, there are a number of reasons why individuals may not smooth consumption by increasing saving in this way.

First, individuals may be sufficiently liquidity constrained that they do not respond to small changes in the rate of return by altering their saving.<sup>205</sup> Since government subsidies for retirement saving are often accompanied by additional taxes for early withdrawal, individuals must accurately anticipate their current and future need for liquidity to avoid additional taxes and may choose alternative methods of saving rather than risk these additional taxes.

Second, uncertainty over liquidity needs over the life-cycle creates a need for precautionary saving. Because precautionary saving tends to be relatively insensitive to the after-tax rate of return,<sup>206</sup> the existence of uncertainty over a life-cycle may reduce the extent to

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<sup>203</sup> This idea is captured in models built on the Life-Cycle Hypothesis. See F. Modigliani and R. Brumberg, "Utility Analysis and the Consumption Function: an Interpretation of Cross-Section Data," in K.K. Kurihara, ed., *Post-Keynesian Economics*, Rutgers University Press, New Brunswick, NJ, 1954, pp. 388-436.

<sup>204</sup> A.J. Auerbach, L.J. Kotlikoff, and J. Skinner, "The Efficiency Gains From Dynamic Tax Reform," *International Economic Review*, Vol. 24, 1983, pp. 80-100.

<sup>205</sup> See Douglas W. Elmendorf, "The Effect of Interest-Rate Changes on Household Saving and Consumption: a Survey," *Finance and Economics Discussion Series*, 96-27, (Board of Governors of the Federal Reserve System), 1996.

<sup>206</sup> Doug Bernheim, "Taxation and Saving," in A.J. Auerbach and M. Feldstein, eds., *Handbook of Public Economics*, Vol. 3, Elsevier, 2002, pp. 1173-1249.

which individuals alter their saving behavior in response to tax subsidies that attempt to encourage saving.<sup>207</sup>

Third, implicit in the life-cycle models are the assumptions that individuals have both the cognitive ability and the willpower to save and dissave the correct amounts at the correct times throughout their lives. Due to the high level of complexity in intertemporal planning, individuals often do not make correct economic calculations about when and how much to save and dissave.<sup>208</sup> Furthermore, the life-cycle models assume perfect self-control, that is, the ability to forego short-term rewards to reap long-term gains. In practice, individuals often do not practice adequate self-control. Some researchers attempt to formalize these cognitive and self-control problems and incorporate them into the standard life-cycle models.<sup>209</sup> In doing so, the implications of saving policies on individual saving decisions are no longer clear. One study posits that individuals in fact have neither the cognitive ability nor the willpower to make optimal decisions about retirement savings. They note that effective policy must take into account a correct set of assumptions about individual behavior.<sup>210</sup>

### Empirical evidence

Empirical investigations of the responsiveness of personal saving to the taxation of investment earnings provide no conclusive results. Some find personal saving responds strongly to increases in the net return to saving, while others find little or a negative response.<sup>211</sup> Studies of retirement savings incentives follow a similar pattern, with some finding an increase in saving as a result of the incentives,<sup>212</sup> while others find little or no increase as retirement plan savings

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<sup>207</sup> E.M. Engen and W.G. Gale, "Taxation and Saving: the Role of Uncertainty," *Mimeo* (Federal Reserve Board, Washington DC), 1997.

<sup>208</sup> B.D. Bernheim, "Personal Saving, Information, and Economic Literacy: New Directions for Public Policy," in C.E. Walker, M. Bloomfield, and M. Thorning, eds., *Tax Policy for Economic Growth in the 1990's* (American Council for Capital Formation, Washington DC), 1994, pp. 53-78.

<sup>209</sup> D. Laibson, A. Repetto, J. Tobacman, "Self-Control and Saving for Retirement," *Brookings Papers on Economic Activity*, Vol. 1, 1998, pp. 91-196.

<sup>210</sup> Benartzi, Shlomo and Richard H. Thaler, "Heuristics and Biases in Retirement Savings Behavior," *Journal of Economic Perspectives*, vol. 21, no. 3, Summer, 2007, pp. 81-104.

<sup>211</sup> George von Furstenberg, "Saving," in Henry Aaron and Joseph Pechman (eds.), *How Taxes Affect Economic Behavior*, (Brookings Institution), 1981.

<sup>212</sup> Daniel J. Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," *Journal of Public Economics*, vol. 87, issues 5-6, May 2003, pp. 1259-1290; James M. Poterba, Steven F. Venti, and David A. Wise, "Do 401(k) Contributions Crowd Out Other Personal Saving?" *Journal of Public Economics*, vol. 58, issue 1, September 1995, pp. 1-32; James M. Poterba, Steven F. Venti, and David A. Wise, "How Retirement Saving Programs Increase Saving," *The Journal of Economic Perspectives*, vol. 10, no. 4, Autumn, 1996, pp. 91-112.

substitute for other saving.<sup>213</sup> In particular, economists disagree as to whether tax-advantaged saving vehicles raise total wealth accumulation or whether they “crowd-out” existing saving, and merely induce shifting of saving across vehicles.<sup>214</sup> Because of limitations in available data and in research designs, the answer to this question largely remains unclear.

One area of empirical research that has yielded some valuable insights is the evaluation of auto-enrollment and default features in retirement saving vehicles. Some recent work by behavioral economists find that policies that incentivize saving by setting appropriate defaults significantly increase saving. For example, an evaluation of Save More Tomorrow, a prescriptive saving program in which individuals commit now to automatic increases in saving in the future, shows a significant increase in the saving rate of individual participants.<sup>215</sup> Similarly, studies show that auto-enrollment features such as default contribution rates and investment choices have a strong effect on individual saving behavior within a plan.<sup>216</sup> Furthermore, some new research in this area tentatively shows that auto-enrollment and default features which raise retirement contributions through passive decision making induce not only increased saving within retirement plans, but also higher levels of overall individual saving. In other words, these policy features do not appear to support significant crowd-out of existing saving.<sup>217</sup>

## **Consumption tax principles and retirement plans**

### In general

Tax policy experts often describe the U.S. individual income tax system as a hybrid of an income tax system and a consumption tax system. This assertion may appear counterintuitive, because an income tax and the best-known forms of consumption taxes (*e.g.*, a sales tax or a value added tax (“VAT”)) at first glance seem to be very different. Economists, however, look to the underlying incidence (the parties on whom the burden of a tax actually comes to rest) and the effect of different taxes, rather than their form. From this perspective, the substantive

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<sup>213</sup> Karen M. Pence, “401(k)s and Household Saving: New Evidence from the Survey of Consumer Finances” (December 2001), FEDS Working Paper No. 2002-06; William G. Gale and John Karl Scholz, “IRAs and Household Saving,” *The American Economic Review*, vol. 84, no. 5, pp. 1233-1260, December, 1994.

<sup>214</sup> Bernheim, *supra* note 4.

<sup>215</sup> Richard Thaler and Shlomo Benartzi, “Save More Tomorrow™: Using Behavioral Economics to Increase Employee Saving,” *Journal of Political Economy*, 112, 2004, pp. 164-187.

<sup>216</sup> Bridgitte Madrian and Dennis Shea, “The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior,” *Quarterly Journal of Economics*, 116, 2001, pp. 1149-1187.

<sup>217</sup> Raj Chetty, John Friedman, Soren Leth-Petersen, Torben Nielsen, and Tore Olsen, “Active vs. Passive Decisions and Crowdout in Retirement Savings Accounts: Evidence from Denmark,” *NBER Working Paper No. 18565*, January, 2014.

difference between an idealized income tax and an idealized consumption tax is that an income tax, but not a consumption tax, taxes income from savings (*i.e.* the “return to waiting”).<sup>218</sup>

Because the purpose of saving is to fund future consumption, an idealized income tax imposes greater burdens on a taxpayer’s decision to defer consumption than does an idealized consumption tax. For this reason, some tax policy analysts assert that, at least in their pure form, income taxes distort the decision to invest current after-tax income rather than to spend it: current consumption bears one level of income tax, while deferred consumption bears two – current tax, only after payment of which are there savings to be invested, and tax on the time value of money (the return to waiting) while consumption is being deferred. Since by definition that time value of money is the market’s mechanism for compensating a taxpayer for his or her agreement to defer consumption, taxing the return to waiting discourages postponed consumption (*i.e.*, savings), compared to current consumption.

IRAs, qualified retirement plans (including section 401(k) plans), and other tax-favored forms of saving modify the tax treatment of saving that would apply in a pure income tax, by permitting taxpayers to defer income tax on substantial amounts of current income. As described below, in an income tax system, the deferral of income tax on income that is saved indirectly achieves substantially the same economic effects (that is, an exemption from tax on the normal return to saving) as a consumption tax.<sup>219</sup> The existence of IRAs and other tax-advantaged forms of saving is thus a principal reason why the U.S. individual income tax system is described as a hybrid of an income tax and a consumption tax.

There is voluminous literature on consumption taxation and the relative merits of consumption taxation versus income taxation.<sup>220</sup> Proponents of consumption taxation have argued its superiority to income taxation on various grounds, including that (1) it is better to tax what one takes from society (consumption) rather than one’s contribution to society (income), (2) consumption is simpler to measure than income, (3) consumption is less variable than income

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<sup>218</sup> See Joseph Bankman and David Weisbach, “The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax,” *Stanford Law Review*, vol. 58, 2005-2006. The difference between income taxes and consumption taxes can be seen by considering the classic Haig-Simons definition of income, which states that:  $\text{Income} = \text{Consumption} + \text{Change in Wealth}$ . A consumption tax, of course, imposes tax only on the first term of the right-hand side of the equation (*i.e.*, consumption). The only difference then between a pure consumption tax and a pure income tax is the second term on the right-hand side of the equation. This term, “change in wealth,” comprises new investment (or withdrawals of previously-invested capital) and returns on capital. In other words, in a pure income tax, savings come out of after-tax income (because new savings are included in the definition of “income”), and returns on those savings are taxed.

<sup>219</sup> The general observation made in the text does not strictly apply to equity investments in taxable “C” corporations because in that case there is an income tax imposed at the corporate level that is not deferred by the investor-level deferral rules for IRAs, or similar retirement plans. The extent to which the corporate income tax succeeds in taxing capital income is itself a controversial topic beyond the scope of this pamphlet.

<sup>220</sup> For an overview of some of the issues raised by consumption taxation, see David F. Bradford and the U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform, Tax Analysts*, 1984; Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS-18-95), June 5, 1995; Congressional Budget Office, *The Economic Effects of Comprehensive Tax Reform*, July 1997.

and thus a better measure of an individual's lifetime well-being, and (4) consumption taxation does not tax the return to saving, and thus encourages saving, capital formation, and economic growth. Moving from an income tax to a consumption tax has drawbacks as well, including (1) the need for a higher nominal rate of tax to raise the same revenue (since consumption of current income is usually less than that income), (2) difficulties in making a consumption tax as progressive as an income tax, since the poor consume a larger share of their income immediately, and (3) many difficult transition issues in moving from an income tax system to a consumption tax, including whether and how to tax "old" capital that was created under an income tax system.

#### Cash-flow approach to consumption taxation

Because income equals the sum of consumption and changes to wealth, consumption represents income that is not saved. Accordingly, one way to tax consumption is to begin with income as the base, but allow a full deduction for savings. This approach to consumption taxation is known as a "consumed income" tax, or a "cash-flow" tax. It is called a cash-flow tax because it measures the tax base through cash-flow accounting: monetary income is included in the tax base, and monetary outflows to savings are deductible.

Under present law, cash-flow consumption tax is similar to the treatment of IRAs to which deductible contributions are made ("deductible IRAs"). Using deductible IRAs, taxpayers deduct contributions to qualified accounts in the year they make contributions, but upon withdrawal they include in income the entire amount withdrawn. A full cash-flow consumption tax treats all saving as if it were done in a qualified account. Furthermore, under a cash-flow consumption tax there would be no requirement to hold the savings until retirement, nor any required distributions from the account in retirement. The accounts would be subject to taxation whenever the account holder chose to withdraw funds for consumption for any purpose.

The effect of cash-flow treatment, as in a deductible IRA, is that the taxpayer receives a tax-free return on his savings, assuming the tax rate is the same at the time of deduction and withdrawal. Specifically, the taxpayer is able to defer consumption from one period to the next and earn the full pre-tax rate of return on the deferred consumption.

The following example illustrates how the cash-flow or deductible IRA approach (initial deduction plus inclusion of all proceeds) results in the exemption from tax of the return to saving. Assume that the marginal tax rate is 20 percent and the taxpayer saves \$1,000 of his income in a savings account. The \$1,000 of savings gives the taxpayer a \$1,000 deduction and thereby reduces the taxpayer's tax liability by \$200 (20 percent of \$1,000). Thus, the taxpayer has reduced current period consumption by \$800. Assume that the taxpayer withdraws the savings (plus interest) one year later. If the account yields a five percent rate of return, the taxpayer withdraws \$1,050. The withdrawal is included in the tax base and is taxed at the 20-percent rate, for an extra tax liability of \$210, leaving the taxpayer with net proceeds of \$840. The \$840 represents the \$800 prior period reduction in consumption plus the full five-percent return.

### Tax prepayment approach to consumption taxation

Another way to implement a consumption tax indirectly is to include in the base only earned income. Taxpayers claim no deduction for savings, but their returns to saving, whether in the form of interest, dividends, rents, royalties, or capital gains, are excluded from the base of the tax and thus are received tax-free. This “tax prepayment” approach<sup>221</sup> treats all savings as coming from after-tax dollars. In terms of the previous example, a taxpayer initially pays tax of \$200 on the \$1,000 he sets aside from current consumption. When he withdraws the \$840 in the following year (the \$800 he was able to put in the account plus a five-percent return), none of that is included in the tax base. This tax prepayment approach is similar to that provided under present law for Roth IRAs and to the individual portion of the Hall-Rabushka flat tax<sup>222</sup> and the Bradford X-tax.<sup>223</sup>

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<sup>221</sup> This approach is sometimes described as a “yield exemption” approach.

<sup>222</sup> Robert E. Hall and Alvin Rabushka, *The Flat Tax*, Hoover Institution Press, Stanford, CA, 2<sup>nd</sup> ed. 1995.

<sup>223</sup> David F. Bradford, “A Tax System for the Twenty-First Century” in Alan J. Auerbach and Kevin A. Hassett (eds.), *Toward Fundamental Tax Reform*, AEI Press, 2005. See also David F. Bradford, *The X Tax in the World Economy*, AEI Press, 2004. See also David F. Bradford, *Untangling the Income Tax*, Harvard University Press, 1986.

### III. DATA RELATING TO RETIREMENT SAVINGS

#### A. General Data on Retirement Plan Participation

According to the National Compensation Survey (“NCS”),<sup>224</sup> in 2014, 65 percent of U.S. workers employed in the private sector had access to a qualified retirement plan and 48 percent of workers employed in the private sector participated in a qualified retirement plan. This translates to a take-up rate of 75 percent, meaning 75 percent of those with access participated. Take-up rates were stable at 75 or 76 percent over the four year period, 2011 to 2014. These take-up rates indicate that while a large percentage of employees participate in an employer plan if available to them, some employees do not.

**Table 2.—Retirement benefits: Access, Participation and Take-Up Rates in the Private Sector (percentage of all workers)**

Year	Access	Employee Participation	Take-Up Rate
2011	64	49	76
2012	65	48	75
2013	64	49	76
2014	65	48	75

Source: Bureau of Labor Statistics, National Compensation Survey Data, 2011-2014.

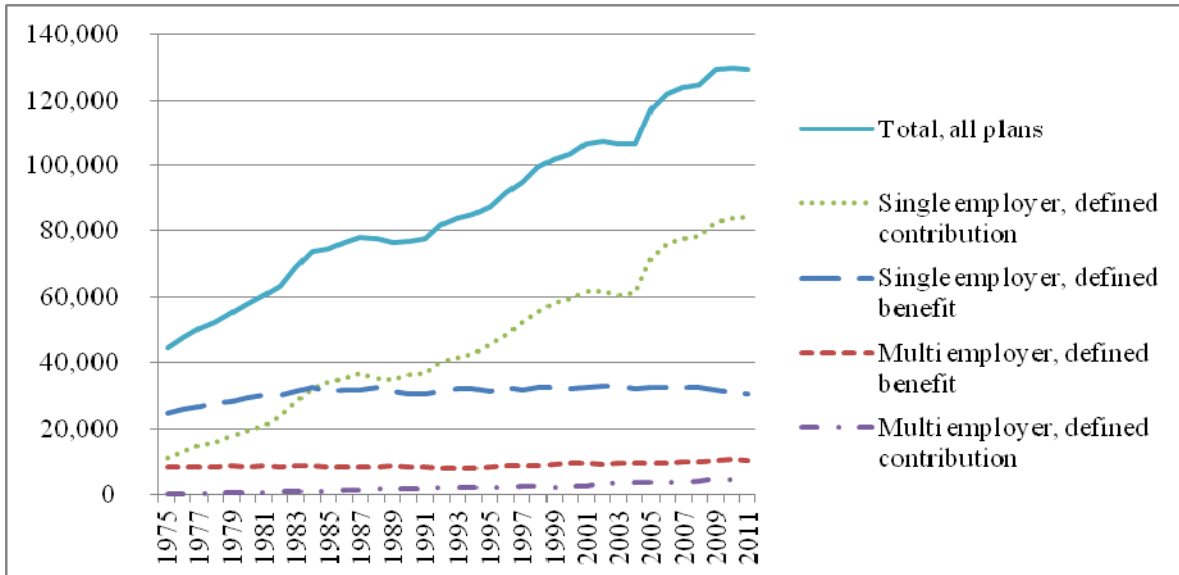
**Note:** All workers = 100 percent. Rates are rounded to the nearest percent. As a result, take-up rates may not be exactly equal to the employee participation rate divided by the access rate as presented in this table.

Figure 1 below shows that the number of participants in private-sector single-employer defined contribution plans has consistently increased since at least 1975 and up to 2011, while the number of participants in private-sector single-employer defined benefit plans has held steady over this same period. Both defined contribution and defined benefit plan participation rates have remained steady for those in multiemployer plans. Almost all of the total rise in plan participation over this period can be attributed to the increase in private-sector single-employer defined contribution plan participation.

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<sup>224</sup> The National Compensation Survey (“NCS”) is an annual survey conducted by the U.S. Department of Labor, Bureau of Labor Statistics (“BLS”). Each release contains data on civilian, private industry, and State and local government workers in the United States. Excluded are federal government workers, the military, agricultural workers, private household workers, and the self-employed.

**Figure 1.—Number of Private-Sector Plan Participants by Type of Plan 1975-2011 (thousands)**



Source: Form 5500 filings with the U.S. Department of Labor.

Note: The term “Participants” refers to active, retired, and separated vested participants not yet in pay status. The number of participants also includes double counting of workers in more than one plan. For Form 5500 Short Form filers, this number may also include deceased participants whose beneficiaries are receiving or are entitled to receive benefits. Excludes plans covering only one participant.

Table 3 shows the percentage of households in 2010 with an IRA balance, defined contribution account balance, or a defined benefit pension. These data show that married households are more likely to have retirement savings in the form of IRA, defined contribution, and defined benefit accounts than single households.

Table 3 also shows that a greater percentage of older households have defined benefit pensions relative to defined contribution accounts and a greater percentage of younger households have defined contribution accounts relative to defined benefit pensions. This is consistent with an overall decline in pension plan coverage over the past few decades, and a concurrent increase in defined contribution plan coverage.<sup>225</sup>

<sup>225</sup> See for example, Barbara A. Butrica, Karen Elizabeth Smith, and Eric Toder *et al.*, *The Disappearing Defined Benefit Pension and its Potential Impact on the Retirement Incomes of Boomers*, Center for Retirement Research, January 2, 2009.



**Table 3.—Percentage of Households in 2010 with an IRA Balance, DC Account Balance, or a Defined Benefit Pension, By Age Category**

Single Household				Married Household			
Age	IRA	DC	DB	Age	IRA	DC	DB
<35	10.3	24.0	7.8	<35	17.1	39.6	16.6
35 – 44	13.9	30.4	14.2	35 – 44	25.8	49.5	22.6
45 – 54	19.9	29.5	21.4	45 – 54	33.5	52.7	32.8
55 – 64	30.3	21.1	32.0	55 – 64	48.8	43.3	46.0
65 – 74	25.6	3.0	42.0	65 – 74	50.1	16.4	49.9
75+	22.0	0.8	52.9	75+	43.5	3.5	62.4

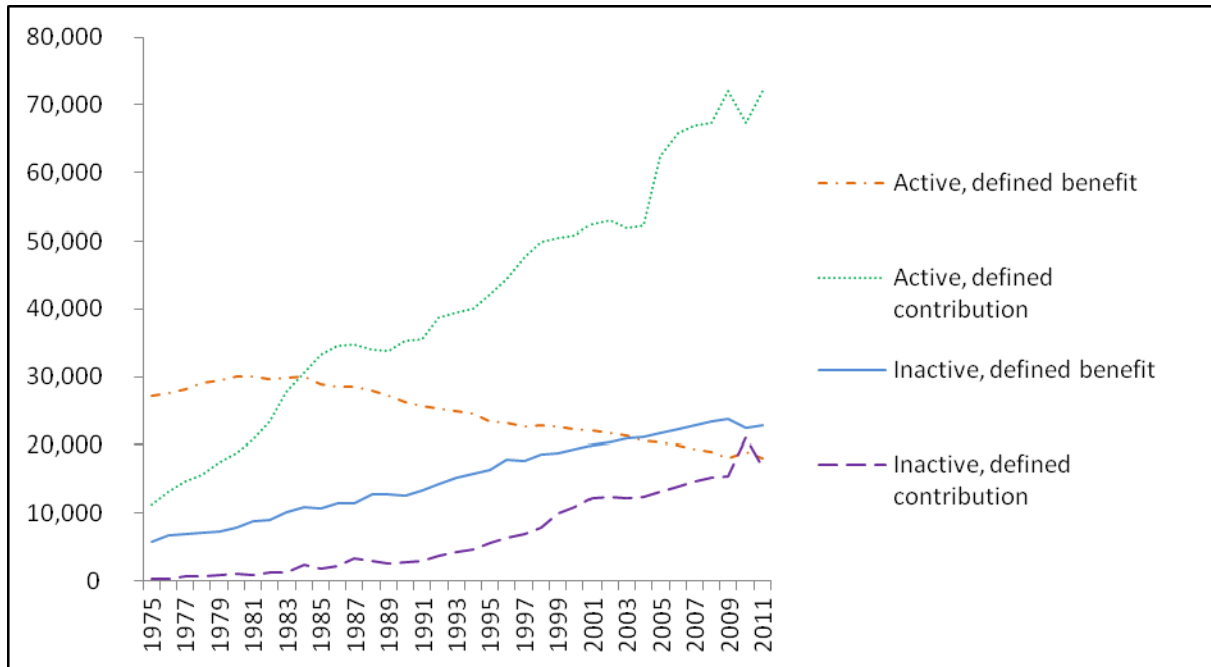
Source: Congressional Research Survey, *U.S. Household Savings for Retirement in 2010*. Analysis of the 2010 Survey of Consumer Finances.

Note: Percentages represent percentages of households that had the type of plan at the time of the survey. Households may have had more than one type of plan.

Figure 2 below shows trends from 1975 to 2011 in the number of participants by active and inactive status. Active participants are current employees who participate in an employer’s retirement plan. Inactive participants are former employees who still have an accrued benefit or account balance under an employer’s retirement plan, including retirees receiving benefits. The numbers of inactive participants in defined benefit and defined contribution plans both increased over this period, though there are larger numbers of inactive participants in defined benefit plans than defined contribution plans throughout. Between 1975 and 2011, the number of active participants in defined benefit plans decreased and the number of active participants in defined contribution plans increased. The percent of active participants in defined benefit plans relative to active participants in defined contribution plans declined relatively sharply over this period.

The data in Figure 2 also show that a decreasing proportion of defined benefit participants are active participants (and an increasing proportion of defined benefit participants are inactive). Consistent with overall patterns, an increasing proportion of defined contribution participants are active participants (and a decreasing proportion of defined contribution participants are inactive).

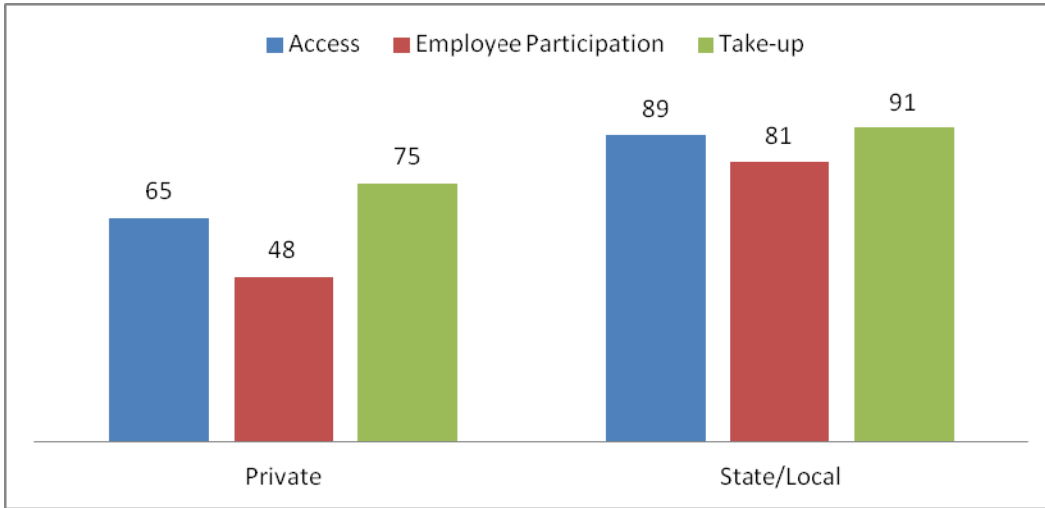
**Figure 2.—Number of Private-Sector Participants by Active or Inactive Status and Type of Plan 1975-2011 (thousands)**



Source: Form 5500 filings with the U.S. Department of Labor.

Rates of access and participation in qualified retirement plans vary by a number of worker and industry characteristics. Figure 3 shows that access rates are lower in the private sector than they are in the State and local government sector. In addition, rates of employee participation are lower in the private sector than in the government sector. As a result, the take-up rate in the private sector is 75 percent compared to a 91 percent take-up rate in the State and local government sector.

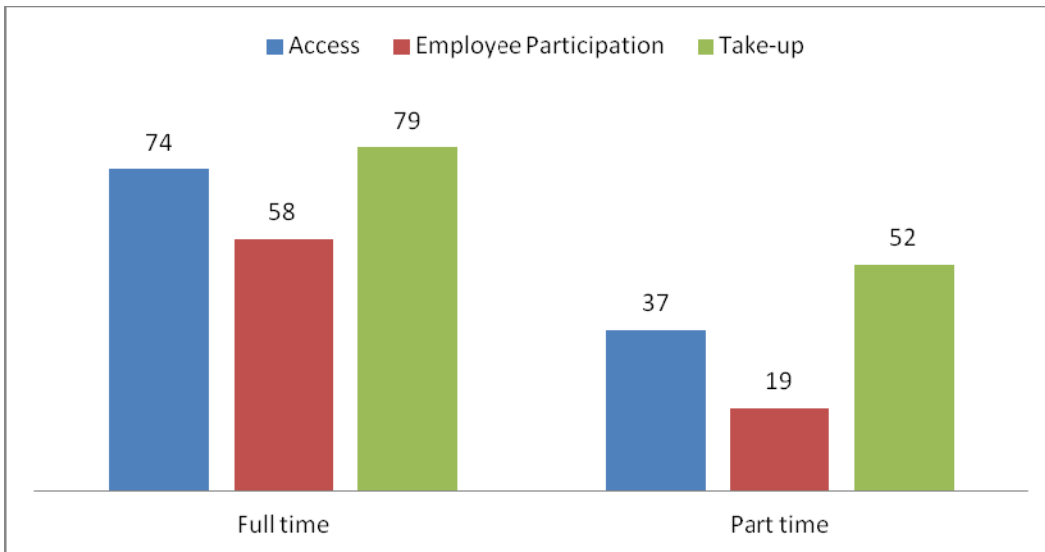
**Figure 3.—Access, Participation, and Take-up Rates by Sector in 2014  
(percentage)**



Source: Bureau of Labor Statistics, National Compensation Survey Data, 2014.  
Note: All workers=100 percent.

The data in Figure 4 show that access, employee participation, and take-up rates are significantly higher for full time workers than for part time ones. Overall take-up rates are only 52 percent for part time workers, compared to a 79 percent take-up rate for full time workers.

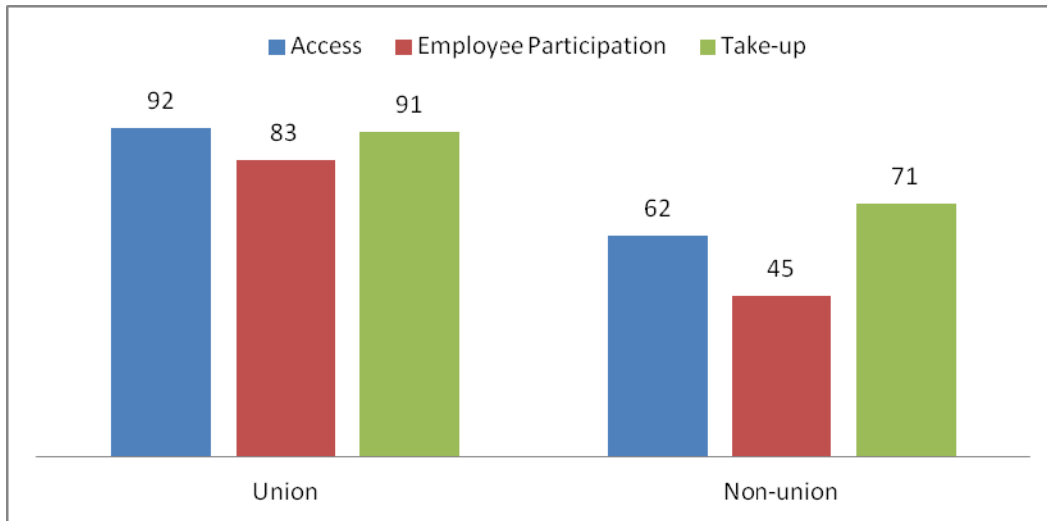
**Figure 4.—Access, Participation, and Take-up Rates in the  
Private Sector by Full-time Status in 2014  
(percentage)**



Source: Bureau of Labor Statistics, National Compensation Survey Data, 2014.  
Note: All workers=100 percent.

There is also a disparity in take-up rates between union and non-union workers. As shown in Figure 5, access, participation, and take-up rates are significantly higher for union workers than they are for non-union workers.

**Figure 5.—Access, Participation, and Take-up Rates in the Private Sector by Union Status in 2014 (percentage)**



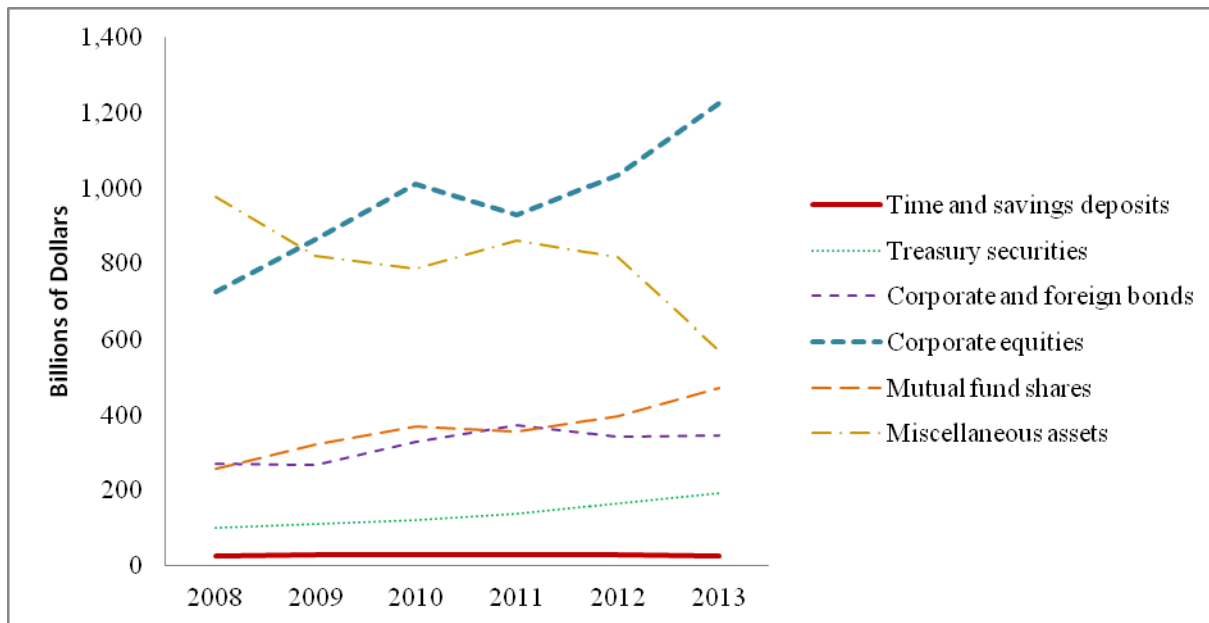
Source: Bureau of Labor Statistics, National Compensation Survey Data, 2014.

Note: All workers=100 percent.

## B. Data on Retirement Plan Assets

Data from the Board of Governors of the Federal Reserve, Flow of Funds Accounts show some of the types of assets held in qualified retirement plans. Figure 6 below shows a large share of assets in private defined benefit plans are held in corporate equities, with smaller holdings of Treasury securities, time and savings deposits, and corporate and foreign bonds. In 2013, the total value of assets held in private defined benefit plans was \$3,068.5 billion. Of these total assets, 40 percent were in corporate equities. The data show that the value of holdings of corporate equities have increased at a moderate to rapid rate since 2008.

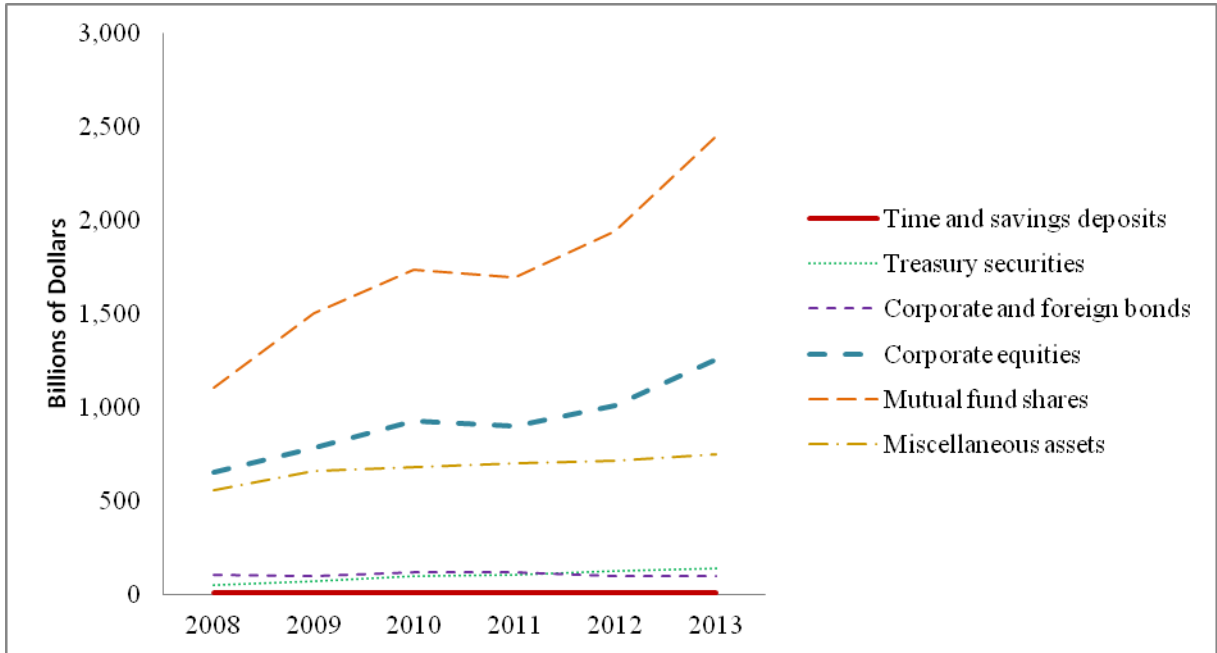
**Figure 6.—Composition of Selected Assets Held in Private Defined Benefit Plans (billions of dollars)**



Source: Board of Governors, Federal Reserve, Flow of Funds Accounts, 2014.

In contrast to private defined benefit plans, Figure 7 below shows the largest share of assets in private defined contribution plans is held in mutual fund shares. In 2013, the total value of assets held in defined contribution plans was \$4,905.1 billion. In 2013, 49.9 percent of this total value was held in mutual funds. Corporate equities also represent a significant share of holdings. In 2013, corporate equities constituted 25.6 percent of total holdings. There are smaller holdings of other miscellaneous assets in private defined contribution plans, and nominal holdings of time and savings deposits and Treasury securities.

**Figure 7.—Composition of Selected Assets Held in Private Defined Contribution Plans  
(billions of dollars)**



Source: Board of Governors, Federal Reserve, Flow of Funds, 2014.

According to the data in Figure 8 below, the largest share of assets held in IRAs are in mutual funds and other self-directed accounts. The market value of assets held in money market mutual funds and commercial banking are also significant though much smaller than the value of assets held in mutual funds and other self-directed accounts.

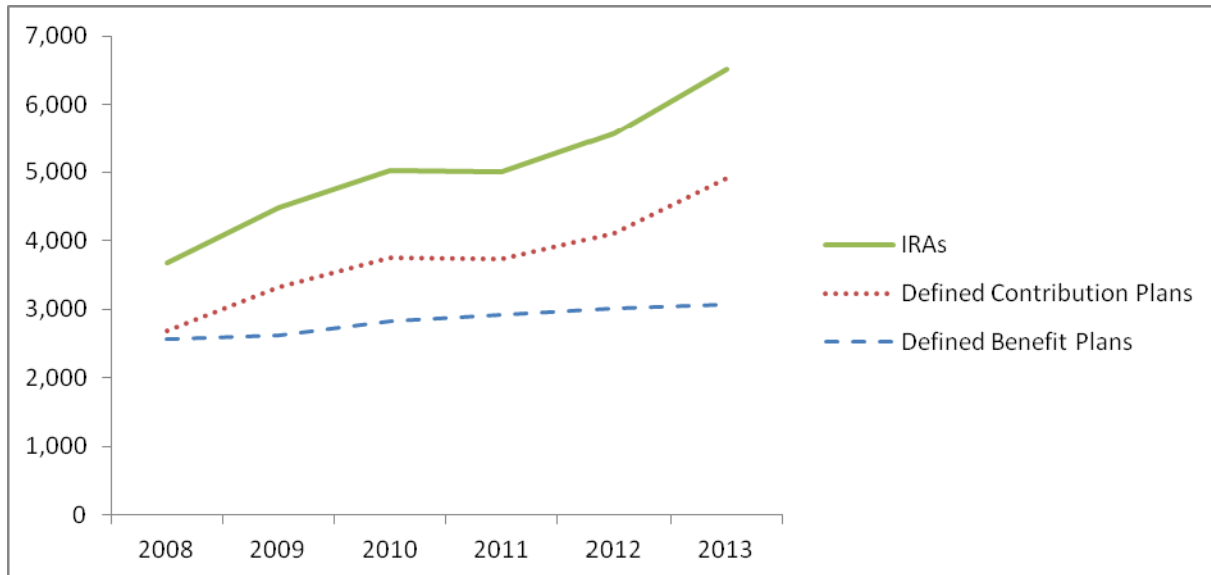
**Figure 8.—Assets Held in IRAs by Financial Institution  
(billions of dollars)**



Source: Board of Governors, Federal Reserve, Flow of Funds, 2014.

Figure 9 below shows the market value of assets held in private defined contribution plans is consistently higher than those held in private defined benefit plans since at least 2008. Market value in IRAs and defined contribution plans exhibited modest to rapid growth since 2008. Assets held in defined benefit plans also exhibited growth, though this growth was more modest than in the defined contribution plans. As of December 31, 2013,<sup>226</sup> total assets held in private defined benefit plans was \$3,068.5 billion; in private defined contribution plans was \$4,905.1 billion; and in IRAs was \$6,521.0 billion.

**Figure 9.—Market Value of Holdings in Private Qualified Retirement Plans, By Type of Plan, and IRAs (billions of dollars)**



Source: Board of Governors, Federal Reserve, Flow of Funds, 2014.

<sup>226</sup> This is the most recent year for which data on financial assets held in IRAs is available.