

**PRESENT LAW AND BACKGROUND RELATING TO THE
TAX TREATMENT OF RETIREMENT SAVINGS**

Scheduled for a Public Hearing
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on April 17, 2012

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



April 13, 2012
JCX-32-12

CONTENTS

	<u>Page</u>
INTRODUCTION AND SUMMARY	1
I. PRESENT LAW	10
A. Overview of Compensation and Tax Treatment	10
1. In general	10
2. Deferred compensation	11
3. Tax treatment of nonqualified deferred compensation	12
B. Tax-Favored Employer-Sponsored Retirement Plans	13
1. Overview of employer-sponsored tax-favored retirement plans	13
2. Qualified retirement plans and annuities	14
3. Types of qualified retirement plans	17
4. IRS administrative programs	18
5. Taxation of distributions	20
6. Owner-employees	21
7. Tax credit for small employer pension plan start-up costs	23
C. Defined Contribution Plans	24
1. General description and rules.....	24
2. General types of defined contribution plans	25
3. Section 401(k) plans	27
4. ESOPs	30
5. Diversification requirements for employer stock in defined contribution plans ..	33
6. Special types of plans for governmental and tax-exempt employers	35
7. Plan loans and hardship distributions	37
8. Lifetime income under defined contribution plans.....	38
9. Saver's credit	40
D. Individual Retirement Arrangements.....	42
1. Traditional and Roth individual retirement arrangements	42
2. Taxation of distributions from IRAs.....	44
3. Employer retirement plans using IRAs.....	46
E. Early Distributions and Required Minimum Distributions.....	49
1. Early distributions.....	49
2. Minimum distribution requirements	49
F. Other Tax-Favored Individual Savings Arrangements for Specific Purposes.....	53
1. Savings for education expenses	53
2. Savings for health expenses	54
II. SELECTED PROPOSALS RELATING TO RETIREMENT SAVINGS.....	56
A. Background Issues Relating to Retirement Savings	56
1. General issues	56
2. Issues relating to the establishment of and continuance of plans that provide broad coverage	57

3. Issues relating to individual retirement savings.....	58
4. Issues related to transitional rules	58
B. Description and Analysis of Proposals	59
1. Introduction.....	59
2. Retirement Savings Accounts and Lifetime Savings Accounts.....	59
3. Employer Retirement Savings Accounts	60
4. Expand the saver’s credit.....	61
5. Automatic enrollment payroll deduction IRA program.....	62
6. Limit the value of exclusions and deductions for pretax employee contributions to defined contribution plans and IRAs	64
7. Multiple-employer plans.....	65
III. ECONOMIC ISSUES RELATING TO RETIREMENT PLANS.....	68
IV. DATA RELATING TO QUALIFIED RETIREMENT PLANS.....	74
A. General Data on Qualified Retirement Plan Participation.....	74
B. Data on Qualified Retirement Plan Assets.....	78
V. DATA RELATING TO INDIVIDUAL RETIREMENT ACCOUNTS	81

INTRODUCTION AND SUMMARY

The Committee on Ways and Means has scheduled a public hearing on April 17, 2012, on Tax Reform and Tax-Favored Retirement Accounts. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a summary of the present law tax rules applicable to retirement savings arrangements, discussions of selected proposals and economic issues relating to retirement savings, and data on qualified retirement plans and IRAs.

I. Present Law

A. 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 (“FICA”),² in the case of employees, or the Self-Employment Contributions Act (“SECA”),³ 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.

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to the Tax Treatment of Retirement Savings* (JCX-32-12), April 13, 2012. This document can be found on our website at www.jct.gov.

² Secs. 3101-3128. All section references in this document are to the Internal Revenue Code of 1986 unless otherwise specified.

³ Secs. 1401-1403.

B. 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 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 if the arrangement is funded and 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 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.

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 are subject to minimum funding requirements and benefits are guaranteed, within limits, by the Pension Benefit Guaranty Corporation. 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.

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.

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.

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.

C. Defined Contribution Plans

In general

Defined contribution plans may provide for nonelective contributions and matching contributions by employers and pretax or after-tax contributions by employees. Total contributions made to an employee's account for a year cannot exceed the lesser of \$50,000 (for 2012) 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 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 2012, elective deferrals of up to \$17,000 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 are generally 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. The ESOP must hold the stock received in the sale for three years and must preclude allocation of the stock to certain individuals; violation of these requirements may result in an excise tax.

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 more narrow, 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 issued proposed amendments to 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 AGI.

D. Individual Retirement Arrangements

There are two basic types of individual retirement arrangements ("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 \$5,000 (for 2012), plus an additional \$1,000 (for 2012) 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 employee'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.

E. 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 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.

F. 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.

II. Selected Proposals Related to Retirement Savings

In evaluating proposals related to tax-favored retirement savings, an initial question is whether the proposal serves to better achieve the goals that justify the tax subsidy than present law. An employer's decision whether to have a retirement plan for employees and an individual's decision to contribute to a tax-favored plan are voluntary. Tax policy is concerned with encouraging employers and individuals, but also with the level of tax subsidy provided. A recurring concern is whether tax-favored arrangements result in increased savings or simply shifting savings that would otherwise occur.

Employer-sponsored plans receive a tax subsidy to further retirement savings by rank-and-file employees who may be less likely to save on their own. Retirement plan rules also provide safeguards to protect employees. The complexity of retirement plan rules, and frequent legislative changes, may deter employers from establishing or continuing retirement plans. Employer concern about ERISA liability may also be a barrier. Complexity, particularly the existence of various savings vehicles, may also be a barrier to individual savings.

In recent years, various legislative proposals have been offered to simplify or better target tax-favored retirement savings under defined contribution plans and IRAs, including proposals relating to:

- Retirement Savings Accounts and Lifetime Savings Accounts,
- Employer Retirement Savings Accounts,
- Expanding the saver's credit,
- Automatic enrollment payroll deduction IRA programs,
- Limiting the value of exclusions and deductions for pretax employee contributions to defined contribution plans and IRAs, and
- Multiple-employer plans.

III. 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.

IV. Data Relating to Qualified Retirement Plans

The Current Population Survey shows that, in 2008, 43.6 percent of private-sector workers participated in a qualified retirement plan. Participation rates vary significantly with worker tenure, firm size, and type of industry. The number of participants in defined contribution plans has increased steadily since 1975 while the number of participants in defined benefit plans has stayed much the same. In recent years, the market value of total defined contribution plan assets has been consistently higher than the market value of total defined benefit plan assets.

V. Data Relating to Individual Retirement Accounts

Annual amounts rolled over to IRAs from employer-sponsored plans dwarf annual IRA contributions. Data on IRA contributions indicate greater contribution rates among high-income taxpayers than among lower-income taxpayers. The amount held in traditional IRAs is much greater than in Roth IRAs, but in recent years Roth IRA contributions have exceeded contributions to traditional IRAs.

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. 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 premiums⁴ and reimbursements for medical care,⁵ employer-provided dependent care assistance up to \$5,000 a year,⁶ and certain fringe benefits such as qualified transportation fringes.⁷ 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,

⁴ Sec. 106.

⁵ Sec. 105(b).

⁶ Sec. 129.

⁷ Sec. 132.

for example, the above-the-line deduction for health insurance premiums paid by a self-employed individual.⁸

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),⁹ as well as income tax withholding.¹⁰ Net compensation of a self-employed individual is subject to tax under the Self-Employment Contributions Act (“SECA”).¹¹

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 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 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.

⁸ Sec. 162(l).

⁹ Secs. 3101-3128.

¹⁰ Secs. 3401-3404.

¹¹ Secs. 1401-1403.

3. Tax treatment of nonqualified deferred compensation¹²

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.¹³ 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.¹⁴ 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.¹⁵ In addition, nonqualified deferred compensation for services performed for a tax-exempt or State or local government employer is included in income on vesting if it exceeds certain limits.¹⁶

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.¹⁷

¹² The Employee Retirement Income Security Act of 1974 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.

¹³ Secs. 83, 402(b), and 403(c).

¹⁴ Sec. 72.

¹⁵ Sec. 409A.

¹⁶ Sec. 457(f).

¹⁷ 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 the benefits of an employer-sponsored retirement plan 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 individual retirement arrangement ("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 the Employee Retirement Income Security Act of 1974 ("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,¹⁸ which may be a defined benefit plan or a defined contribution plan. A defined contribution plan may include a

¹⁸ Sec. 401(a).

qualified cash or deferred arrangement,¹⁹ which offers an employer great flexibility in designing a retirement program for its employees. Another option is a qualified annuity plan,²⁰ 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 annuities²¹ and eligible deferred compensation plans,²² which are sometimes offered in lieu of a section 401(k) plan. Certain small employers have the option of maintaining a SIMPLE IRA plan²³ or a simplified employee pension (“SEP”),²⁴ as discussed in Part I.D.3, which are funded through direct contributions by the employer to an IRA established for each employee.

2. Qualified retirement plans and annuities

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.²⁵ 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.²⁶ Some of these requirements define the rights of 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

¹⁹ Sec. 401(k).

²⁰ Sec. 403(a).

²¹ Sec. 403(b).

²² Sec. 457(b).

²³ Sec. 408(p).

²⁴ Sec. 408(k).

²⁵ Sec. 404.

²⁶ 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.

benefit of plan participants, and prohibited transaction rules (that is, rules prohibiting self-dealing by employers and plan fiduciaries) apply to plan assets.²⁷ Some qualified retirement plans are also subject to minimum funding requirements.

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 21.²⁸ 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 generally must become nonforfeitable after a specified period of service and at attainment of normal retirement age under the plan.²⁹ Benefits attributable to employee contributions 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). 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.

Qualified retirement plans are also subject to regulation under ERISA, which generally is under the jurisdiction of the Department of Labor ("DOL").³⁰ 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. 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 (\$250,000 for 2012) and limits on contributions, benefits and deductions.³¹

²⁷ Secs. 401(a)(2) and 4975.

²⁸ Sec. 410(a).

²⁹ Sec. 411. A plan may specify the plan's normal retirement age but may not specify a normal retirement age that is later than age 65 or, if later, the fifth anniversary of the time the participant commenced plan participation.

³⁰ The Pension Benefit Guaranty Corporation has jurisdiction over the defined benefit plan insurance program under Title IV of ERISA. Governmental plans and church plans are generally exempt from ERISA and from the Code requirements that correspond to ERISA requirements.

³¹ Secs. 401(a)(16) and (17) and 415.

Minimum coverage and nondiscrimination requirements³² are intended to ensure that a qualified retirement plan covers 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. For purposes of these requirements, an employee generally is treated as highly compensated if the employee (1) was a five-percent owner of the 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 2012).³³ Special rules apply to plans that primarily benefit key employees (called "top-heavy plans"), discussed below.

Under the minimum coverage rules, a plan must satisfy one of the following requirements: (1) the plan benefits at least 70 percent of employees who are nonhighly compensated employees; (2) the plan benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan; or (3) the plan satisfies an average benefits test, which compares the benefits received by highly compensated employees and nonhighly compensated employees. Under a general nondiscrimination requirement, a qualified retirement plan may not discriminate in favor of highly compensated employees. This requirement generally applies to all benefits, rights, and features under the plan, not just to contributions and benefits.

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 are generally subject to the same requirements as qualified retirement plans and receive comparable tax-favored treatment. However, plan assets are invested in annuity contracts rather than held in a trust or custodial account.

³² Secs. 401(a)(3) and (4) and 410(b). A qualified retirement plan of a governmental employer is not subject to the nondiscrimination requirements. Under section 403(b)(1)(D) and (b)(12), the nondiscrimination requirements generally apply to a section 403(b) plan of a nongovernmental tax-exempt employer (other than a church).

³³ 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.

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.³⁴ 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; 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.³⁵ The amount of required annual contributions depends on the type of plan and is determined under certain actuarial methods. An employer is subject to an excise tax for a failure to make required contributions, unless the employer obtains a funding waiver.³⁶ Benefits under defined benefit plans are generally guaranteed (within limits) by the Pension Benefit Guaranty Corporation (“PBGC”).

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.

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.

³⁴ 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.

³⁵ Sec. 412.

³⁶ Sec. 4971.

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”).³⁷ 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.³⁸ 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.³⁹ 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 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).⁴⁰ Multiemployer plans commonly cover collectively bargained employees in a particular industry. A multiemployer plan is not operated by the contributing employers; instead, it is governed by a board of trustees (“joint board”) consisting of labor and employer representatives.

4. IRS administrative programs

Preapproved plans

The IRS office responsible for qualified retirement plan oversight, the Employee Plans Division of the Tax-Exempt & Government Entities Operating Division, 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

³⁷ See, e.g., Treas. Reg. sec. 1.410(b)-6(d).

³⁸ Sec. 413(c).

³⁹ 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.

⁴⁰ Sec. 414(f).

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.⁴¹ 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.⁴² 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 permits employers to correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis.⁴³

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 2-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.

⁴¹ 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.

⁴² 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.

⁴³ Since establishing the program, the IRS has regularly updated and expanded it. The current program is described in Rev. Proc. 2008-50, 2008-35 I.R.B. 464.

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.

5. Taxation of distributions

In general

Distributions from qualified retirement plans and annuities, section 403(b) plans, and governmental section 457(b) plans are generally includible in gross income (to the extent the distribution exceeds basis) as ordinary income in the year in which distributed.⁴⁴ 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.E, 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 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.⁴⁵

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.⁴⁶

⁴⁴ Secs. 72, 402(a)(1), 403(a)(1), 403(b)(1) and 457(a).

⁴⁵ 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).

⁴⁶ Sec. 402(c)(11).

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.⁴⁷ 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.⁴⁸ 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.⁴⁹ 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 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. 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.⁵⁰

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

⁴⁷ 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.

⁴⁸ Treas. Reg. sec. 1.402(c)-2, Q&A-1(b)(3).

⁴⁹ 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 \$8000 since \$2000 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 \$2000 to the IRA in order to defer taxes on the entire distributed amount.

⁵⁰ Sec. 401(c)(1).

certain adjustments.⁵¹ 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 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, 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.⁵² 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.

⁵¹ 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.

⁵² Secs. 401(a)(10)(B) and 416.

For this purpose, a key employee is an officer with annual compensation greater than \$165,000 (for 2012), 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.

7. 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.⁵³ Qualified start-up 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.

⁵³ Sec. 45E.

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.

A defined contribution plan may provide for various types of contributions by employees or the employer. If the plan includes a qualified cash or deferred arrangement (*i.e.*, 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 \$50,000 (for 2012) or the employee’s compensation.⁵⁴ 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 ratably 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 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.

⁵⁴ Sec. 415(c).

The deduction for employer contributions to a defined contribution plan for a year is generally limited to 25 percent of the participants' compensation.⁵⁵ For this purpose, a participant's compensation in excess of \$250,000 (for 2012) 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 employee stock ownership plan ("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.⁵⁶

As mentioned above, 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.⁵⁷ 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 \$250,000 for 2012) 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;⁵⁸ (2) a general test comparing the rates of allocations provided under the plan to highly and nonhighly compensated employees;⁵⁹ 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.⁶⁰ 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 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

⁵⁵ Sec. 404.

⁵⁶ Sec. 4972.

⁵⁷ Treas. Reg. secs. 1.401(a)(4)-1 through 13.

⁵⁸ Treas. Reg. sec. 1.401(a)(4)-2(b) and -8(b)(3).

⁵⁹ Treas. Reg. sec. 1.401(a)(4)-2(c).

⁶⁰ Treas. Reg. sec. 1.401(a)(4)-8.

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.⁶¹ 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. 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.

⁶¹ Sec. 401(a)(11).

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.⁶² 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 \$17,000 (for 2012) or, if less, the employee's compensation.⁶³ 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.⁶⁴ As a result, the dollar limit on elective deferrals is increased by \$5,500 (for 2012) 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. As of 2010, a section 401(k) plan may permit participants to transfer amounts from a nonRoth account under

⁶² 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 below. Except for certain grandfathered plans, a State or local governmental employer may not maintain a section 401(k) plan.

⁶³ Sec. 402(g).

⁶⁴ Sec. 414(v).

the plan to a designated Roth account, in effect providing a Roth conversion (with related income recognition) 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 are generally 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.⁶⁵

Automatic enrollment was originally authorized by IRS guidance⁶⁶ and has been furthered by subsequent statutory changes providing special rules for automatic enrollment.⁶⁷ 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 employee within 90 days after the first automatic contribution.⁶⁸ 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.

⁶⁵ 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.

⁶⁶ 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).

⁶⁷ 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.

⁶⁸ Sec. 414(w).

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.⁶⁹ 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.⁷⁰

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. 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.⁷¹ 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

⁶⁹ Sec. 401(k)(3).

⁷⁰ Sec. 401(m)(2).

⁷¹ 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.

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.⁷²

Another safe harbor applies for section 401(k) plans that include a qualified automatic contribution arrangement.⁷³ 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.⁷⁴ 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).

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.”⁷⁵ An ESOP can be maintained by either a C corporation or an S corporation.⁷⁶ For purposes of ESOP

⁷² Sec. 401(m)(11).

⁷³ Secs. 401(k)(13) and (m)(12).

⁷⁴ 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.

⁷⁵ Sec. 4975(e)(7). Participant accounts in other types of defined contribution plans can also be invested in employer stock.

⁷⁶ 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.

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. 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.⁷⁷ An ESOP that borrows funds to acquire employer securities is generally called a leveraged ESOP.

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.⁷⁸ 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.⁷⁹ This deduction is also allowed without regard to the general deduction limits on contributions to qualified plans.

⁷⁷ 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.

⁷⁸ Sec. 404(a)(9).

⁷⁹ 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.

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”).⁸⁰ However, an ESOP holding employer securities issued by an S corporation is exempt from UBIT. Certain restrictions apply in order to assure that an ESOP maintained by an S corporation benefits rank-and-file employees, as well as highly compensated employees and historical owners, and that the ESOP is not used by S corporation owners to obtain inappropriate tax deferral or avoidance. These restrictions limit the grant of stock options (or the provision of other “synthetic equity”) by an S corporation that maintains an ESOP.⁸¹ However, it is possible in certain circumstances to grant options or warrants for S corporation stock (or other synthetic equity) that, when combined with the outstanding shares of the S corporation, are options for up to 49 percent of the S corporation stock.

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.⁸² 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.

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.⁸³ In addition, an excise tax may apply if the ESOP disposes of the qualified securities within three years of the date of the sale.⁸⁴

⁸⁰ Sec. 512(e). Section 511 imposes UBIT on a tax-exempt entity’s income from an unrelated trade or business.

⁸¹ See section 409(p) for the definition of synthetic equity for this purpose and the limits on stock options and other synthetic equity provided by an S corporation that maintains an ESOP, and section 4979A for a related excise tax.

⁸² 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.

⁸³ Secs. 409(n) and 4979A.

⁸⁴ Sec. 4978.

Qualified replacement property consists of any security⁸⁵ 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 income⁸⁶ 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.⁸⁷ 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.

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.⁸⁸ The diversification requirement applies to a participant for six years, starting with the year in which the individual

⁸⁵ 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.

⁸⁶ Passive investment income is defined for this purpose as under section 1362(d)(3)(D), relating to termination of an S corporation election.

⁸⁷ 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.

⁸⁸ Sec. 401(a)(28).

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).⁸⁹

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.⁹⁰ 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.⁹¹ 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 section 401(k) plans.⁹² 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

⁸⁹ Notice 88-56, 1988-1 C.B. 540, Q&A-16.

⁹⁰ Code sec. 401(a)(35) and ERISA sec. 204(j).

⁹¹ 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.

⁹² An ESOP that is an applicable defined contribution plan and subject to the related diversification requirements is excepted from the specific ESOP diversification requirements.

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 (\$17,000 for 2012) and catch-up contributions (\$5,500 for 2012) 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, and (3) \$5,000 times the employee's years of service, reduced by the employee's total elective deferrals in prior years.⁹³

⁹³ 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.

Section 403(b) plans are generally subject to the minimum coverage and nondiscrimination rules that apply to qualified defined contribution plans.⁹⁴ 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.⁹⁵ 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).⁹⁶

Deferrals under a governmental section 457(b) plan are subject to the same limits as elective deferrals (\$17,000 for 2012) and catch-up contributions (\$5,500 for 2012) 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 (\$34,000 for 2012) 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.

As of 2011, 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.

⁹⁴ As in the case of a qualified retirement plan, a governmental section 403(b) plan is not subject to these nondiscrimination rules.

⁹⁵ Sec. 457.

⁹⁶ 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.

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.⁹⁷ 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 date⁹⁸ and for substantially equal payments of both principal and interest at least no less frequently than quarterly over the term of the loan.⁹⁹

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 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

⁹⁷ 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).

⁹⁸ 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).

⁹⁹ 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.

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.¹⁰⁰ 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.¹⁰¹ 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.¹⁰² 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.¹⁰³ The concept of unforeseeable emergency is more narrow 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 annuity forms of benefit, including forms that provide benefits for surviving spouses. Because annuities provide income for the life of the participant (or participant and surviving spouse), annuities, and therefore pension plans, are viewed as furthering retirement income security in that a participant (or surviving spouse) cannot "outlive" his or her benefits under the plan.¹⁰⁴ However, profit-sharing and stock bonus plans are not

¹⁰⁰ 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.

¹⁰¹ Treas. Reg. sec. 1.401(k)-1(d)(3)(i).

¹⁰² Treas. Reg. secs. 1.401(k)-1(d)(3) and 1.403(b)-6(d)(2).

¹⁰³ Sec. 457(d)(1)(iii).

¹⁰⁴ 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 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.

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.¹⁰⁵

On the other hand, inflation can erode the purchasing power of a fixed annuity, whereas an account balance under a defined contribution plan can remain invested in assets that may offset the effects of inflation. In addition, an annuity may make it difficult to plan for large one-time expenses in retirement, requiring annuitants to save out of their annuity payments. Thus, there are risks of having inadequate savings under an annuity or an account balance.

Nonetheless, 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.¹⁰⁶ These 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").¹⁰⁷ 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.¹⁰⁸

An issue identified in this process is the treatment under the minimum required distribution rules (discussed in Part I.E.2 below) of annuity contracts held in a defined contribution plan account or IRA. Discussion focused in particular on deferred annuity contracts under which annuity distributions are scheduled to begin at an advanced age, such as age 80 or 85. 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. Comments suggested that the minimum distribution rules can be a barrier to the purchase of these annuities because the value of the annuity contract is included in the account balance used to determine an individual's

¹⁰⁵ 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.

¹⁰⁶ 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.

¹⁰⁷ An annuity by definition provides lifetime income, but lifetime income options also include, for example, installment payments over an individual's lifetime.

¹⁰⁸ Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans, 75 Fed. Reg. 5253 (February 2, 2010).

required distributions, but, until annuity payments begin, the required distributions must be paid from other assets in the account. At some point, other assets may be insufficient to cover the required distributions, and the individual could be subject to an excise tax.

The IRS recently issued proposed changes to the minimum required distribution regulations to allow the value of a 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.¹⁰⁹ Among other conditions, the proposed regulations limit the portion of an account that can be invested in a longevity annuity contract (the lesser of 25 percent or \$100,000), require the annuity to begin no later than age 85, and include disclosure and reporting requirements for the annuity issuer.

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.¹¹⁰

9. Saver's credit

Present law provides a nonrefundable tax credit for eligible taxpayers who make qualified retirement savings contributions.¹¹¹ Subject to adjusted gross income ("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 2012 (as indexed for inflation) are \$57,500 for married taxpayers filing joint returns, \$43,125 for head of household taxpayers, and \$28,750 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

¹⁰⁹ Prop. Treas. Reg. sec. 1.401(a)(9)-5, A-3, 77 Fed. Reg. 5443 (February 3, 2012). The proposed 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.

¹¹⁰ 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 an annuity and a lump sum. Prop. Treas. Reg. sec. 1.417(e)-1(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.

¹¹¹ Sec. 25B.

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 2012)

Joint Filers	Heads of Households	All Other Filers	Credit Rate
\$0 – \$34,500	\$0 – \$25,875	\$0 – \$17,250	50 percent
\$34,501 – \$37,500	\$25,876 – \$28,125	\$17,251 – \$18,750	20 percent
\$37,501 – \$57,500	\$28,126 – \$43,125	\$18,751 – \$28,750	10 percent

D. Individual Retirement Arrangements

1. Traditional and Roth individual retirement arrangements

Contribution limits

In general

There are two basic types of individual retirement arrangements (“IRAs”) under present law: traditional IRAs,¹¹² to which both deductible and nondeductible contributions may be made,¹¹³ and Roth IRAs, to which only nondeductible contributions may be made.¹¹⁴ 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 (\$5,000 for 2012) 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 \$6,000 to a Roth IRA for 2012 (\$5,000 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

¹¹² Sec. 408.

¹¹³ Sec. 219.

¹¹⁴ Sec. 408A.

active participant in an employer-sponsored plan, the AGI phase-out ranges for 2012 are: (1) for single taxpayers, \$58,000 to \$68,000; (2) for married taxpayers filing joint returns, \$92,000 to \$112,000; 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 2012 between \$173,000 and \$183,000.

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 2012 are: (1) for single taxpayers, \$110,000 to \$125,000; (2) for married taxpayers filing joint returns, \$173,000 to \$183,000; 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.¹¹⁵ The amount converted is includible in the taxpayer's income as if a withdrawal had been made,¹¹⁶ 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.

¹¹⁵ For taxable years beginning prior to January 1, 2010, taxpayers with modified AGI in excess of \$100,000 and married taxpayers filing separate returns were generally not permitted to convert a traditional IRA into a Roth IRA. Under the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, these limits on conversion are repealed for taxable years beginning after December 31, 2009. Thus, although an individual with AGI exceeding the limits described above cannot make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA.

¹¹⁶ A special rule is provided in the case of a conversion made in 2010. In such case, unless the taxpayer elects otherwise, the amount includible in income as a result of the conversion is included in income ratably in 2011 and 2012.

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.¹¹⁷ 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 having been made to a traditional IRA. However, Treasury regulations limit the number of times a contribution for a taxable year may be recharacterized.¹¹⁸

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.¹¹⁹ 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.¹²⁰ 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.¹²¹ 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

¹¹⁷ Sec. 408A(d)(6).

¹¹⁸ Treas. Reg. sec. 1.408A-6.

¹¹⁹ Secs. 4973(b) and (f).

¹²⁰ Sec. 408(d)(4).

¹²¹ Basis results from after-tax contributions to the IRA or a rollover to the IRA of after-tax amounts from another eligible retirement plan.

disability, or is made for first-time homebuyer expenses of up to \$10,000. Tax-free distributions from Roth IRAs have created an incentive for some taxpayers 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.¹²²

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 (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.¹²³ 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 if the distributions are included in gross income in accordance with the general rules for distributions from traditional IRAs.

¹²² Notice 2004-8, 2004-1 CB 333, describes certain abusive Roth transactions that involve this type of transfer of value and identifies the transaction as a "listed transaction." The preamble to TD 9220, Converting an IRA Annuity to a Roth IRA, 70 Fed. Reg. 48868 (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.

¹²³ 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.

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 individual retirement arrangement 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 \$11,500 (for 2012). 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 2012).

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 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.¹²⁴

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 (\$50,000 for

¹²⁴ Notice 98-4, 1998-1 C.B. 269.

2012).¹²⁵ 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 2012) 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 (\$17,000 for 2012). 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 2012).

Deemed IRAs

Certain types of employer-sponsored retirement plans are permitted to provide IRAs to employees as a part of the plan.¹²⁶ This option is available to qualified retirement plans, section 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.¹²⁷

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 1997,¹²⁸ 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

¹²⁵ Sec. 408(k).

¹²⁶ Sec. 408(q).

¹²⁷ Treas. Reg. sec. 1.408(q)-1. Special rules apply in the case of deemed IRAs under plans of State and local government employers.

¹²⁸ Pub. L. No. 105-34.

IRAs.”¹²⁹ In response to that directive, the IRS published guidance to remind employers of the availability of this option for their employees.¹³⁰

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.¹³¹ In 1999, DOL restated and updated its positions on these programs.¹³² 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.

¹²⁹ H. Rep. No. 102-220, p. 775 (1997).

¹³⁰ 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.

¹³¹ Labor Reg. sec. 2510.3-2(d).

¹³² Interpretive Bulletin 99-1, 64 Fed. Reg. 32999 (June 18, 1999); Labor Reg. sec. 2509.99-1.

E. Early Distributions and Required Minimum Distributions

1. Early distributions

The Code imposes provides an early distribution tax on distributions made from qualified retirement plans, 403(b) plans and IRAs before employee or an IRA owner attains age 59½.¹³³ 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);¹³⁴ 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;¹³⁵ 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 individual retirement arrangements ("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 not 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

¹³³ Sec. 72(t). The early distribution tax does not apply to distributions from governmental section 457(b) plans.

¹³⁴ Sec. 213.

¹³⁵ Age 50 is substituted for age 55 in the case of distributions to a qualified public safety officer from a governmental defined benefit plan.

extending beyond the life expectancy of the employee or the life expectancy of the employee and a designated beneficiary).¹³⁶ 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.¹³⁷ 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.¹³⁸ 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.¹³⁹ 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

¹³⁶ Sec. 401(a)(9)(A).

¹³⁷ Sec. 4974.

¹³⁸ Sec. 401(a)(9)(A).

¹³⁹ Treas. Reg. sec. 1.401(a)(9)-5.

age 70½, the required beginning date is the same as for IRAs even if the employee continues to work past age 70½.

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.¹⁴⁰ 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.¹⁴¹ 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.¹⁴² 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.¹⁴³

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.¹⁴⁴ For individual accounts, the distribution period is measured by the designated

¹⁴⁰ 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.

¹⁴¹ Sec. 401(a)(9)(B)(i)

¹⁴² Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

¹⁴³ Treas. Reg. sec. 1.401(a)(9)-5, A-5(a).

¹⁴⁴ 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.

beneficiary's life expectancy, calculated in the same manner as if the individual dies on or after the required beginning date.¹⁴⁵

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.¹⁴⁶

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.¹⁴⁷ 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 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.¹⁴⁸ 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.

¹⁴⁵ Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

¹⁴⁶ Treas. Reg. sec. 1.401(a)(9)-3, A-2.

¹⁴⁷ Treas. Reg. sec. 1.401(a)(9)-6, A-14.

¹⁴⁸ Treas. Reg. sec. 1.401(a)(9)-6, A-2.

F. Other Tax-Favored Individual Savings Arrangements for Specific Purposes¹⁴⁹

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.¹⁵⁰ 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.¹⁵¹ 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

¹⁴⁹ Tax-favored treatment applies also to certain other arrangements and investments, such as annuity contracts, life insurance, and tax-exempt bonds.

¹⁵⁰ Sec. 529.

¹⁵¹ Sec. 530.

filing a joint return).¹⁵² Contributions to a Coverdell education savings account are not deductible.

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.¹⁵³ 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 \$1,200 for self-only coverage or \$2,400 for family coverage (for 2012) and that has an out-of-pocket expense limit that is no more than \$6,050 in the case of self-only coverage and \$12,100 in the case of family coverage (for 2012).

The maximum aggregate annual contribution that can be made to an HSA in 2012 is \$3,050 in the case of self-only coverage and \$6,150 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.

¹⁵² Under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, the present-law contribution limit, adjusted gross income levels, and certain other rules do not apply for years beginning after December 31, 2012. Thus, for example, the limit on annual contributions to a Coverdell education savings account is \$500 after 2012.

¹⁵³ Sec. 223.

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.¹⁵⁴ Archer MSAs provide tax benefits similar to, but generally not as 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.

¹⁵⁴ Sec. 220.

II. SELECTED PROPOSALS RELATING TO RETIREMENT SAVINGS

A. Background Issues Relating to Retirement Savings

1. General issues

The provisions for tax-favored retirement savings in the Code deviate from the normal structure for individual income tax and result in significant tax subsidies.¹⁵⁵ In evaluating proposals related to vehicles for retirement savings arrangements (both employer-sponsored and individual arrangements), including the tax treatment of contributions and distributions, an initial question is whether the proposal serves to better achieve the goals that justify the tax subsidy than present law.

An employer's decision to establish or continue a retirement plan for employees is voluntary. The Federal tax laws provide favorable tax treatment for certain employer-sponsored retirement plans in order to further retirement income policy by encouraging the establishment and continuance of employment-based plans that provide broad coverage, including rank-and-file employees who may be less likely to save for retirement on their own. On the other hand, tax policy is concerned also with the level of tax subsidy provided to retirement plans. Thus, the tax law limits the total amount that may be provided to any one employee under a tax-favored retirement plan and includes strict nondiscrimination rules to prevent highly compensated employees from receiving a disproportionate amount of the tax subsidy provided with respect to employer-sponsored retirement plans.

Similarly, an individual's decision to save for retirement by making contributions to IRAs or by making elective deferrals under a tax-favored employer-sponsored plan is voluntary. However, tax policy is concerned also with the level of tax subsidy provided to any one individual for retirement savings, and thus, the tax law limits the total amount that may be provided to any one individual under a tax-favored retirement savings arrangement. Recognizing that employers have less control over individual decisions to save for retirement, the tax law provides special nondiscrimination rules that allow averaging of individual contribution rates and allows a higher rate for highly compensated employees with certain specified margins.

One concern with tax-favored retirement savings generally and, in particular, savings based on individual decisions, is whether tax-favored arrangements result in increased savings for retirement rather than simply shifting savings that would otherwise occur into tax-favored arrangements. Generally, the individuals otherwise not likely to save for retirement tend to be middle-income and lower-income taxpayers. However, due to the progressive rate structure of the Federal income tax, these taxpayers receive less of a tax subsidy for participating in tax-favored retirement savings arrangements and are thus the least incentivized by the tax savings.

¹⁵⁵ In Joint Committee on Taxation, Estimate of Federal Tax Expenditures For Fiscal Years 2011 - 2015, JCS-1-12, January 2012, p. 43, for fiscal years 2011 - 2015, the total tax expenditure is estimated to be \$375.9 billion for defined contributions plans, \$263.7 for defined benefit plans, \$78.7 billion for plans covering partners and sole proprietors, and \$86.5 billion for traditional and Roth IRAs combined.

Finally, the Federal laws with respect to employer-sponsored retirement savings provide safeguards to protect employees, for example, by requiring that plans be maintained for the exclusive benefit of employees and their beneficiaries.

2. Issues relating to the establishment of and continuance of plans that provide broad coverage

The rules governing employer-sponsored retirement plans, particularly the nondiscrimination rules, are generally regarded as complex.¹⁵⁶ In addition, frequent legislation causes the rules to change, even as often as every year. Some argue that this complexity and the frequent changes increase costs that deter employers from establishing qualified retirement plans or causes employers to terminate such plans. These factors also make it difficult to assure that a plan is operated in a manner that complies with the legal requirements and result in compliance errors, which can be costly for an employer to correct. Others assert that the complexity of the rules governing employer-sponsored retirement plans is a necessary byproduct of attempts to ensure that retirement benefits are delivered to more than just business owners and the most highly compensated employees of an employer and to provide employers, particularly large employers, with the flexibility needed to recognize differences in the way that employers do business and differences in workforces.

Another source of complexity in the present-law rules relating to employer-sponsored retirement plans is the existence of numerous vehicles with similar purposes but different rules.¹⁵⁷ Thus, employers desiring to adopt a retirement plan must determine which vehicles are available to that employer and which of the various vehicles available it wishes to adopt. This determination may entail a costly and time-consuming analysis and comparison of a number of different types of plans.

Concern about obligations and liability under ERISA is also cited as a barrier to establishing or continuing an employer-sponsored retirement plan. Some argue that the ERISA disclosure obligations and the potential for liability under ERISA fiduciary requirements may deter employers, particularly small employers, from establishing qualified retirement plans. Others view ERISA requirements, and parallel Code requirements, as necessary to ensure that plans are maintained in a manner that provides retirement income security in order to justify the tax subsidy and adequately protects the rights of employees. Many ERISA and Code protections have been added in response to cases in which participants lost retirement plan benefits on which they had relied.

¹⁵⁶ For a detailed discussion of complexity issues related to retirement savings, see, Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001.

¹⁵⁷ This issue is discussed in Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, vol. II, Part III.A.1 (General simplification issues, pp. 149-150) and Part III.C.5 (Sources of Complexity, p. 186), and in Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 2005, Part IV.E, pp. 122-129.

3. Issues relating to individual retirement savings

Complexity is also cited as a barrier to individual savings, particularly the existence of numerous individual savings vehicles, including multiple types of IRAs, with different eligibility requirements and different distribution rules. For individuals with limited resources, understanding the rules for the different types of savings vehicles and determining which is the most appropriate may be so daunting that the individual ends up not using any of them.

In contrast, for higher-income individuals, multiple tax-favored savings vehicles provide multiple opportunities to use tax-favored savings vehicles with similar purposes and thereby defer greater amounts of income than may have been intended. Tax-favored individual savings arrangements are sometimes criticized for simply enabling higher-income taxpayers to shift into tax-favored savings vehicles savings that would occur even without a tax subsidy. Higher-income taxpayers are also likely to have access to an employer-sponsored retirement plan, which provides even further opportunity for tax-favored saving.

Perhaps the greatest challenge for any proposal with respect to individual savings is designing the proposal to encourage new saving, and saving by middle-income and lower-income taxpayers. The present-law saver's credit attempts to achieve that result.

4. Issues related to transitional rules

Changes to present law generally include transition rules to accommodate taxpayers who may have made financial decisions relying on present law. Unless carefully crafted, transitional rules under a proposal have the potential to increase the complexity of the tax law and undercut the intended objectives of the proposal.

B. Description and Analysis of Proposals

1. Introduction

The President's budget proposals for fiscal years 2004 through 2013 contain a number of proposals related to individual and employer-sponsored savings arrangements. In some cases, the proposals would expand savings opportunities generally; others attempt to better target tax subsidies for saving to lower-income and middle-income individuals. In addition, some have suggested that the multiple-employer plan structure, with changes, could be a means to facilitate formation of defined contribution plans by small businesses. Several of these budget proposals and proposals relating to multiple-employer plans are described below.

2. Retirement Savings Accounts and Lifetime Savings Accounts

Description

The President's budget proposals for fiscal years 2004 through 2009 included proposals for two new retirement savings vehicles for individuals.¹⁵⁸ The first, called a Retirement Savings Account ("RSA"), would consolidate traditional and Roth IRAs into a single type of account. The limit on IRA contributions would apply to RSA contributions. The ability to make RSA contributions would not be subject to AGI limits. Additional contributions to existing IRAs would not be permitted, although rollovers from existing Roth IRAs, and conversions from existing traditional IRAs, to RSAs could be made. The second type of account, called a Lifetime Savings Account ("LSA"), could be used to save for any purpose. The annual limit for contributions to an LSA would be \$2,000.

The tax treatment of both RSAs and LSAs would be generally similar to that of present-law Roth IRAs. That is, contributions would not be deductible, and earnings on contributions generally would not be taxable when distributed. Earnings on both types of accounts would accumulate on a tax-free basis. The major difference between the tax treatment of LSAs and RSAs is that all distributions from LSAs would be tax-free, whereas tax-free treatment of earnings on amounts in RSAs would apply only to distributions made after age 58 or in the event of death or disability.

Analysis¹⁵⁹

Proposals such as the RSA and LSA proposals are intended to simplify the savings decision-making process for individual taxpayers and further encourage individual saving. The complexity of multiple retirement savings arrangements under present law is cited as a reason that individual taxpayers may fail to save. Proponents of these proposals also argue that such new savings vehicles would provide an incentive to taxpayers to increase savings by increasing

¹⁵⁸ Some details of the proposals varied during this period.

¹⁵⁹ A more detailed analysis of this proposal is provided at Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2009 Budget Proposal*, JCS-1-08, March 2008, p. 8.

their opportunity to save without the return to savings being reduced by taxes. Others have argued that saving has not necessarily increased as a result of existing tax incentives for savings. Some argue that much existing savings have merely been shifted into tax-favored accounts and thus do not represent new saving.¹⁶⁰

Because an LSA allows tax-free withdrawal of funds for any reason, lower-income taxpayers may be more motivated to save using an LSA. Lower-income taxpayers are often reluctant to save for retirement if they view the funds as not being available for unanticipated financial needs prior to retirement. However, without an AGI limit on contributions, the availability to use this enhanced savings vehicle is not limited to lower-income and middle-income taxpayer.

A policy rationale for permitting higher contributions under employer-sponsored plans than under IRAs is that the tax benefits for employer-sponsored plans require employers to provide benefits for a broad group of their employees. Some argue that expanding individual tax-favored savings opportunities will reduce the incentive for small business owners to maintain qualified retirement plans for themselves and their employees, which in turn is likely to reduce savings by lower-paid employees.

3. Employer Retirement Savings Accounts

Description

The President's budget proposals for fiscal years 2004 through 2009 included a proposal for consolidating the various present-law employer-sponsored retirement arrangements under which individual accounts are maintained for employees and under which employees may make contributions into a single type of arrangement called an employer retirement savings account (an "ERSA"). An ERSA would be available to all employers (with a special version available to small employers) and would be subject to simplified qualification requirements. The present law limits on elective deferrals and on total defined contribution plan contributions would apply to ERSAs, as well as the present law rules for the taxation of distributions from employer-sponsored retirement plans.

The present-law ADP and ACP tests for nondiscrimination would be replaced with a single, simplified nondiscrimination test, using a contribution percentage calculated for each employee as the sum of employee pretax and after-tax contributions, employer matching contributions, and qualified nonelective contributions for the employee, divided by the employee's compensation. In the case of an average contribution percentage for nonhighly compensated employees of six percent or less, the average contribution percentage for highly compensated employees could not exceed 200 percent of the nonhighly compensated employees' average contribution percentage. If the average contribution percentage for nonhighly compensated employees exceeds six percent, the nondiscrimination test is met. A design-based

¹⁶⁰ See Karen C. Burke and Grayson M.P. McCouch, "Lipstick, Light Beer, and Backloaded Savings Accounts," *Virginia Tax Review*, vol. 25, Spring 2006, pp. 1101, 1139.

safe harbor would also be available for an ERSA to satisfy the nondiscrimination test, similar to present law.

Analysis¹⁶¹

The ERSA proposal reflected a goal of simplifying the rules for tax-favored employer-sponsored retirement savings by consolidating the types of plans that allow individual deferral elections and simplifying the nondiscrimination provisions for these vehicles. By providing only one type of defined contribution plan to which pretax and after-tax employee contributions may be made, the proposal makes it easier for employers to determine whether to adopt a plan and what type of plan to provide. Having a single type of plan may also make it easier for employees to understand their retirement benefits, particularly when employees change jobs. On the other hand, many employers already have plans and are familiar with the present-law rules applicable to their plans. Converting a present-law arrangement to a new type of plan would involve administrative costs, which some employers may not view as commensurate with simplification benefits.

By reducing the complexity associated with ADP and ACP nondiscrimination testing and reducing the related compliance costs associated with a plan, the proposal would arguably make employers more likely to offer retirement plans, thus increasing coverage and participation. Others argue that the present-law section 401(k) safe harbors already provide a simplified method of satisfying the nondiscrimination requirements without the need to run the ADP and ACP tests. Some also point out that the proposal would allow a greater differential in the contribution rates for highly and nonhighly compensated employees than the present law rules for section 401(k) plans and therefore provides less incentive for employers to encourage participation by lower-paid employees.

4. Expand the saver's credit

Description

The President's budget proposals for fiscal years 2010 and 2011 included a proposal to make the saver's credit fully refundable and for the credit to be deposited automatically in an employer-sponsored retirement plan account or IRA to which the eligible individual contributes. In addition, in place of the current credit ranging from 10 percent to 50 percent for qualified retirement savings contributions up to \$2,000 per individual, the proposal would provide a credit of 50 percent of such contributions up to \$500 (indexed for inflation) per individual. The income threshold for eligibility would be increased to \$65,000 for married couples filing jointly, \$48,750 for heads of households, and \$32,500 for singles and married individuals filing separately, with the amount of savings eligible for the credit phased out at a five-percent rate for AGI exceeding those levels.

¹⁶¹ A more detailed analysis of this proposal is provided at Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2009 Budget Proposal*, JCS-1-08, March 2008, p. 20.

Analysis¹⁶²

The present-law saver's credit is intended to encourage low-income taxpayers to save, but many have criticized its effectiveness. Criticism has focused on the low use of the credit, owing to (1) its lack of refundability, (2) the complexity of the credit rate structure combined with taxpayer uncertainty regarding eligibility, (3) lack of awareness of the credit, and (4) the relatively low AGI thresholds for eligibility. By making the credit refundable and raising the income eligibility limits, the proposal is expected to increase utilization of the credit. Also, the revised structure should make it easier for most taxpayers to have a better sense of the amount of credit for which they will be eligible, which could increase savings and subsequent use of the credit to the extent that existing uncertainty limits the effectiveness of the credit at stimulating saving.

Some taxpayers could be worse off under the proposal, as the amount of contributions eligible for the credit is reduced to \$500 per individual, rather than present law's \$2,000 limit. Thus, for example, an individual eligible for the 20-percent credit under present law is potentially eligible for a credit of \$400 (20 percent of \$2,000), while under the proposal the maximum credit is 50 percent of \$500, or \$250. To the extent that the main purpose of the saver's credit is to encourage small amounts of retirement saving for those who might not otherwise do any saving, such a reorientation of credit resources might be appropriate.

The proposal to deposit the credit into the retirement savings account of the taxpayer may also increase retirement savings. However, additional complexities could result for employers if they are required to set up mechanisms to accept the deposit of the tax credit to an employer plan. The administrative costs of such mechanisms may be disproportionately large for small employers and small credit amounts.

5. Automatic enrollment payroll deduction IRA program

Description

The President's Budget Proposals for fiscal years 2010 through 2013 include a proposal for mandatory automatic enrollment payroll deduction IRA programs. Under the proposal, any employer that does not sponsor a qualified retirement plan, SEP, or SIMPLE IRA plan for its employees (or sponsors a plan and excludes some employees) is required to offer an automatic enrollment payroll deduction IRA program with a default contribution to a Roth IRA of three percent of compensation under which three percent of compensation is deducted from each employee's cash wages and contributed to an IRA unless the employee makes an affirmatively election of no IRA contribution or elects a different contribution amount. An employer is not required to offer the program if the employer has been in existence less than two years or has 10 or fewer employees. The proposal includes other provisions designed to limit administrative

¹⁶² A more detailed analysis of this proposal is provided at Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal*, JCS-2-10, August 2010, p. 129.

burdens and ERISA liabilities on employers, such as allowing all contributions to be made to a single IRA trustee or custodian designated by the employer.

Analysis¹⁶³

The automatic payroll deduction IRA proposal does not by itself change present law with respect to tax-favored employer-sponsored retirement plans but, instead, requires employers that do not sponsor such plans to assist employees in saving for retirement through payroll deduction using IRAs. This has the effect of giving individuals the opportunity to save for retirement through the workplace, even if the employer does not sponsor a retirement plan. Advocates of the proposal point out that the use of automatic enrollment has increased employee participation in section 401(k) plans and argue that automatic contributions to IRAs would as well, particularly among by low and middle income employees. The structure of an automatic IRA program also simplifies the retirement plan participation process for employees by eliminating the need for employees to make decisions as to the rate of contribution or the investment of the contributions. However, others point out that there is also evidence that lower-income and middle-income employees participating in present law section 401(k) plans with automatic enrollment are the most likely to remain at the default contribution rate rather than electing a higher contribution rate. Advocates of the proposal respond that many who remain at the default rate might not have elected to participate at all without the automatic feature.

Advocates for the proposal also argue that some employers may be interested in adopting a qualified retirement plan (or SEP or SIMPLE IRA plan), but have not done so because of inertia. An automatic payroll deduction IRA program requirement may prompt the adoption of a plan by such an employer, in part through interaction with service providers that offer employer-sponsored retirement plans. Some have argued that, because the proposal is designed to relieve employers of many of the burdens associated with sponsoring a qualified plan, small businesses may decide to limit employees' opportunity to save for retirement on a tax-favored basis to their ability to contribute to the automatic IRA program. Others have noted, however, that the desire of small business owners to take advantage of the greater tax-deferred savings, including the option of making employer contributions, offered under a qualified plan reduces the likelihood of this result.

Some argue that the ultimate success of an automatic payroll deduction IRA program is not only how much money employees contribute to IRAs through the program, but how much is retained as savings for use in retirement. Historically, there have been significant amounts of early withdrawals from IRAs, even when an exception to the additional 10-percent tax has not applied. Others respond that, with respect to automatic contributions to an IRA, in contrast to an employer-sponsored plan, there is no natural withdrawal event from an IRA, such as termination from employment, which is likely to precipitate a withdrawal. Thus, inertia also may help keep the funds in the IRA.

¹⁶³ A more detailed analysis of this proposal is provided at Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal*, JCS-3-11, June 2011, p. 9.

DOL has found numerous instances where employers have deducted amounts from an employee's pay for contribution to a section 401(k) plan but failed to contribute the amount to the plan. In the case of a section 401(k) plan, such failure can result in excise taxes, civil penalties, and even criminal prosecution. As a result, some argue that it is important that any mandatory automatic payroll deduction IRA program include comparable safeguards to protect employees against potential abuses by employers. Advocates may respond that there are existing State law protections and remedies for employees.

6. Limit the value of exclusions and deductions for pretax employee contributions to defined contribution plans and IRAs

Description

The President's budget proposals for fiscal year 2013 include a proposal that limits the rate at which taxpayers with taxable income in excess of a threshold amount benefit from all itemized deductions, certain exclusions from AGI, as well as certain above-the-line deductions. In general, the proposal limits the benefit of the specified provisions for individuals to 28 percent of the amount of the deduction or the exclusion. A similar limitation applies under the alternative minimum tax. The exclusions and deductions under the proposal that are limited to 28 percent of their value include the exclusion or above-the-line deduction for pretax employee contributions to defined contribution plans and contributions to traditional IRAs, as well as the exclusion for employer-provided health insurance (and the deduction for the cost of health insurance for self-employed individuals) and the exclusion for tax-exempt state and local bond interest.

The result of this limitation on contributions is illustrated as follows: assume that a taxpayer in the 35-percent income tax bracket for 2012 makes a \$22,500 contribution to a section 401(k) plan. Under present law, the \$22,500 contribution will result in a \$7,875 tax savings, or 35 percent of \$22,500. Under the proposal, the same \$22,500 contribution by the same 35-percent bracket taxpayer would result in a tax savings of only \$6,300 (28 percent of \$22,500), thus raising his tax liability by \$1,575 (or seven percent (35 percent minus 28 percent) of his \$22,500 contribution).

Analysis¹⁶⁴

This proposal would reduce the tax subsidy for pretax employee elective contributions to tax-favored employer-sponsored retirement plans and deductible contributions to traditional IRAs. Taxpayers can still receive a tax deduction equal to 28 percent of the contribution, but the tax savings would be reduced for taxpayers with a marginal tax rate above 28 percent. Some might argue that this results in partial double taxation because when amount are distributed from the plan there is no credit for this earlier partial income inclusion. It is possible that taxpayers

¹⁶⁴ The President's budget proposals for fiscal year 2012 included this proposal, but only with respect to itemized deductions. A detailed analysis of the fiscal year 2012 proposal is provided at Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal*, JCS-3-11, p. 528.

subject to this limitation will reduce their rate of retirement savings as a result of the limitation, which increases the price of saving in this form. Some predict that the proposal may cause higher-income taxpayers to take greater advantage of the opportunity to make contributions to a designated Roth account under a section 401(k) plan or to a Roth IRA, in lieu of a pretax or deductible contribution. Some also argue that plan sponsors may provide greater matching and nonelective contributions to all plan participants under the relevant tax-favored retirement plan, which is likely to increase retirement savings for lower-income and middle-income taxpayers.

7. Multiple-employer plans

Description

As discussed above, multiple-employer plans are most commonly maintained by a group of associated employers, such as businesses in the same industry. Interest has developed recently in the use of multiple-employer plans that would be available to unaffiliated employers (sometimes called “open” multiple-employer plans) as a means of expanding defined contribution plan coverage, particularly for small employers. These plans are suggested as offering economies of scale and simpler plan administration and, thus, a less expensive vehicle for small employers to provide a tax-favored retirement plan for their employees. As interest in multiple-employer plans as a vehicle for new defined contribution plan establishment by small employers has risen, certain obstacles to such establishment have been identified and proposals to remove these obstacles have developed.¹⁶⁵

Proponents of multiple-employer plans suggest that potential participating employers are concerned that qualification failures under the Code with respect to a portion of the plan covering employees of another employer could cause the entire multiple-employer plan to be disqualified. Thus, there are recommendations that a mechanism be provided to assure qualified status with respect to the portion of the plan covering employees of compliant employers.¹⁶⁶ Similarly, proposals include rules under which an employer maintaining a multiple-employer plan can insulate itself from fiduciary responsibility under ERISA for the acts or omissions of other employers.¹⁶⁷ Proposals include the ability to force the spinoff from a multiple-employer

¹⁶⁵ There have also been proposals that suggest the use of multiple-employer plans in the context of broader reforms. Some of these are described in a report by the Government Accountability Office, *Private Pensions, Better Agency Coordination Could Help Small Employer Address Challenges to Plan Sponsorship*, GAO-2-326, March 2012, pp. 30 - 32.

¹⁶⁶ H.R. 1534, the Small Businesses Add Value Act of 2011 (Reps. Kind and Rechart), directs the Secretary of the Treasury to issue regulations under which a multiple-employer plan may be treated as satisfying the Code qualification requirements despite violation of those requirements by one or more other participating employers. (H.R. 1534 also provides a safe harbor nondiscrimination test for a multiple-employer section 401(k) plan in which small employers participate.) H.R. 4050, the Retirement Plan Simplification Act of 2012 (Rep. Neal), includes a similar directive to the Secretary of the Treasury. Senator Kohl has announced the intent to introduce a bill with Senator Enzi and others that contains a similar provision, as well as other favorable rules for multiple-employer plans. See Press Release by the United States Senate Committee on Aging, *Kohl Announces Plans for Bipartisan Legislation Making it Easier for Small Businesses to Offer Retirement Plans*, March 7, 2012.

¹⁶⁷ H.R. 4050 also directs the Secretary of Labor to issue regulations establishing conditions under which an employer participating in a multiple-employer plan is not liable under ERISA for the acts or omissions of one or

plan of the portion of the plan covering the employees of noncompliant employers. Finally, there are recommendations to allow simplified ERISA disclosure obligations for employers participating in multiple-employer plans, including annual reporting, summary plan descriptions, and participant benefit statements.

More fundamentally, although the Code allows a multiple-employer plan to be maintained by unaffiliated employers, ERISA is less clear on this issue. Under ERISA, employee benefit plans must be sponsored by an employer, by an employee organization, or by both. The definition of employer is any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan, and includes a group or association of employers acting for an employer in such capacity.¹⁶⁸ It is not clear that a group or association of employers that are treated as the employer under this ERISA definition may be completely unaffiliated.¹⁶⁹ Thus, at least one proposal would clarify that a defined contribution plan does not fail to be treated as employee pension benefit plan merely because it is maintained by two or more unaffiliated employers.¹⁷⁰

Analysis

To the extent that multiple-employer plan proposals reduce the cost of retirement plan maintenance and simplify plan administration, the proposals may expand retirement plan adoption and continuance among small employers, thus expanding employment-based savings opportunities to more individuals. However, some argue that use of standardized plan documents with third party plan administration and participation in pooled investment trusts are already available to small employers and that these options may already offer small employers reduced cost, economies of scale, and simplified plan administration. Because so many of the rules for multiple-employer plans apply separately to the benefits of each employer's employees, there may not be as many economies of scale as some advocates of these proposals suggest.

Multiple-employer plan proposals are generally designed to allow employers that participate in these plans to insulate themselves from liability arising from the actions of other participating employers. Advocates argue that this serves to reward and protect employers participating in these plans who are complying with the requirements of the Code and ERISA from the consequences of the actions of noncompliant employers. Others raise concerns that it may be difficult to design rules that provide this insulation from liability for employers and still adequately insure the qualification of the plan and protection for employees. Also it may be

more another participating employers. The bill provides that the regulations may require that the portion of the plan attributable to such other employers be spun off and maintained by the other employers.

¹⁶⁸ ERISA sec. 3(5).

¹⁶⁹ See Testimony of Phyllis C. Borzi, Assistant Secretary of Labor, Employee Benefits Security Administration, before the Special Committee on Aging, United States Senate, March 7, 2012, in which she raises concerns about some claims made by promoters of open multiple-employer plans regarding the ERISA reporting and fiduciary obligations of employers participating in these plans.

¹⁷⁰ See H.R. 1534.

difficult to develop rules for multiple-employer plans that maintain economies of scale and provide this type of insulation from liability.

III. ECONOMIC ISSUES RELATING TO RETIREMENT PLANS

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 difference between an idealized income tax and an idealized consumption tax boils down to only one factor: an income tax, but not a consumption tax, burdens (taxes) income from savings – more specifically, the risk-free “return to waiting.”¹⁷¹

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.¹⁷² The existence of IRAs and other tax-advantaged forms

¹⁷¹ 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.

¹⁷² 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.

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.¹⁷³ 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 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 (deductible IRAs)

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.

A cash-flow consumption tax is similar to the treatment of deductible IRAs under present law. 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.

¹⁷³ 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.

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). 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.

Tax prepayment approach to consumption taxation (Roth IRAs)

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" approach¹⁷⁴ 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 of Hall-Rabushka flat tax¹⁷⁵ and the Bradford X-tax.¹⁷⁶

Economic equivalence of deductible and Roth IRAs

The above examples show the same economic result from saving in a Roth or a deductible IRA. In both examples the taxpayer earns a rate of return on deferred consumption equal to the full pre-tax rate of return on saving. Specifically, in both cases \$800 of first period consumption was traded for \$840 in second period consumption. The combination of a deduction for saving and inclusion of all proceeds in the base upon withdrawal from the qualified savings account has the same result as exempting from tax the return on saving.¹⁷⁷

¹⁷⁴ This approach is sometimes described as a "yield exemption" approach.

¹⁷⁵ Robert E. Hall and Alvin Rabushka, *The Flat Tax*, Hoover Institution Press, Stanford, CA, 2nd ed. 1995.

¹⁷⁶ 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.

¹⁷⁷ This result is an analog of the "Cary Brown theorem," which holds that, assuming constant tax rates, permitting an immediate deduction for the cost of a marginal asset that ordinarily would be purchased with after-tax dollars is equivalent to exempting the yield from the asset from tax. Cary Brown, "Business-Income Taxation and Investment Incentives," in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen* 300 (1948). See also Joint Committee on Taxation, "*Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II*," (JCX-63-07), September 4, 2007, page 6 for a related discussion.

Some caveats to this equivalence are warranted.¹⁷⁸ Whether a Roth IRA and a traditional IRA to which deductible contributions are made are in fact economically equivalent depends on there being no difference between the taxpayer's marginal tax rate in the year contributions are made and the marginal tax rate in the year IRA funds are withdrawn. If marginal rates were to decrease over time (because of a legislated reduction in tax rates or because taxpayers fall into lower tax brackets in retirement), a traditional IRA to which deductible contributions are made is more advantageous than a Roth IRA, because the traditional IRA permits taxpayers to defer payment of tax until rates are lower. When marginal tax rates increase over time, a Roth IRA is preferable because the income will be exempted from tax at a higher rate than the rate at which the forgone deduction would have been taken.

The economic equivalence of saving in a Roth IRA or a traditional deductible IRA does not mean that a dollar contributed to a Roth IRA is the economic equivalent of a dollar contributed to a deductible IRA. The reason is that a given dollar that is contributed to a Roth IRA represents an after-tax contribution, and therefore requires a greater reduction in current consumption (since the contribution is not deductible). As a result, an after-tax contribution (such as a Roth IRA) represents more saving than the same dollar contribution to a deductible IRA, which is made with pre-tax dollars. As the above examples showed, a taxpayer in the 20 percent tax bracket must reduce current consumption by \$1,000 to contribute \$1,000 to a Roth IRA, but only by \$800 to contribute \$1,000 to a deductible IRA, because the \$1,000 contribution reduces current tax liability by 20 percent of \$1,000, or \$200.

Present law, which caps the annual contribution to a Roth or a deductible IRA at the same amount of \$5,000 (for 2012), thus effectively sets a higher cap for the Roth IRA, thereby permitting greater amounts of tax-preferred saving to be done in the Roth IRA. For taxpayers not constrained by a cap, the proper economic comparison of the tax benefits of the two types of tax-favored saving for a taxpayer with a 20 percent marginal rate is the comparison of an 80 cent Roth IRA contribution for each dollar contribution to a deductible IRA because each requires the same reduction in current consumption.¹⁷⁹

¹⁷⁸ In addition to the points made in the text, an after-tax contribution to a Roth IRA and a pre-tax (deductible) contribution to a traditional IRA theoretically could also produce divergent results when a taxpayer has the ability to earn systematically higher than normal returns (so-called economic rents), through possession of some unique asset or market position. In that case, the economic returns from exploiting that special situation would ultimately be taxed when the returns (above and beyond the normal returns from investment) were withdrawn from a traditional IRA, but not from a Roth IRA (because all returns from the latter are tax-exempt). This difference reflects the fact that, at least in theory, only normal returns are sheltered from tax, in the former case, while in the latter case, all returns are tax-free. This distinction is unlikely, however, to have any practical effect, because of the limitations imposed on the type of investment assets that an IRA may hold and the relatively small-scale investment that IRAs are designed to accommodate. Roth IRAs and other pre-paid forms of consumption tax, such as the Hall-Rabushka flat tax and the Bradford X-tax, which at the individual level are essentially a tax on wage income but not income from savings, all exempt above-normal returns from taxation. Point-of-sale consumption taxes, such as a national retail tax, or a value added tax like that common in much of the rest of the world, will exempt the normal return to saving from tax but capture tax on above-normal returns, similar to cash flow consumed income taxes or deductible IRAs.

¹⁷⁹ The equivalence is easily seen mathematically: the final after-tax value of the contribution to the deductible IRA is given by $C * (1+r)^n * (1-t)$, where C equals the contribution, r the annual rate of return, n the

Effect of retirement plans on saving

Economists disagree as to whether tax-advantaged saving vehicles increase the level of national saving. In fact, economists disagree whether, in practice, an income tax discourages saving. At issue is the extent to which taxpayers change their saving in response to the net, after-tax return to their saving. Some studies have argued that one should expect substantial increases in saving from increases in the net return.¹⁸⁰ Other studies have argued that large behavioral responses to changes in the after-tax rate of return need not occur.¹⁸¹ Empirical investigation of the responsiveness of personal saving to the taxation of investment earnings provides no conclusive results.¹⁸² Some find personal saving responds strongly to increases in the net return to saving,¹⁸³ while others find little or a negative response.¹⁸⁴ Studies of retirement savings incentives follow a similar pattern, with some finding an increase in saving as a result of the incentives,¹⁸⁵ while others find little or no increase as retirement plan savings substitute for other saving.¹⁸⁶

Standard economic theories of saving assume that individuals save during their working years and dissave during retirement in a way that maximizes well-being over their lifetimes. Implicit in this assumption are that individuals have both the cognitive ability and the willpower

number of years the investment is held, and t the tax rate. The final after-tax value of the equivalent Roth IRA contribution is $(1-t) * C * (1+r)^n$. Note that $(1-t) * C$ represents the reduced amount that can be contributed to the Roth IRA since tax must be paid first. The expressions are mathematically equivalent when t is unchanged.

¹⁸⁰ Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," *American Economic Review*, 71, September 1981.

¹⁸¹ David A. Starrett, "Effects of Taxes on Saving," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman (eds.), *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax*, (Brookings Institution), 1988.

¹⁸² 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.

¹⁸³ Michael Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, vol. 86, April 1978.

¹⁸⁴ George von Furstenberg, "Saving," in Henry Aaron and Joseph Pechman (eds.), *How Taxes Affect Economic Behavior*, (Brookings Institution), 1981.

¹⁸⁵ 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.

¹⁸⁶ 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, December, 1994, pp. 1233-1260.

to save and dissave the correct amounts at the correct times throughout their lives. One recent study questions these underlying assumptions of individual behavior in economic models with respect to retirement planning decisions. This 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.¹⁸⁷ Finally, with respect to tax-favored forms of saving, the revenue loss to the Federal government represents a decline in government saving, and thus must be accounted for to determine net national saving.

¹⁸⁷ 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.

IV. DATA RELATING TO QUALIFIED RETIREMENT PLANS

A. General Data on Qualified Retirement Plan Participation

According to the Current Population Survey,¹⁸⁸ in 2008, 42.8 million workers (out of a total of 98.4 million private-sector wage and salary workers aged 25 to 64) participated in a qualified retirement plan. This translates to a participation rate of 43.6 percent. This participation rate was relatively stable over previous years. Participation rates were 45.0 percent, 43.2 percent, and 45.1 percent in 2005, 2006, and 2007, respectively. These rates are about 10 percentage points lower than the rates for employer sponsorship of a plan, indicating that a large percentage of employees participate in an employer plan or IRA if available to them, but some employees do not.

**Table 2.—Participation in Private Qualified Retirement Plans, 2008
Private-Sector Wage and Salary Workers, Aged 25-64**

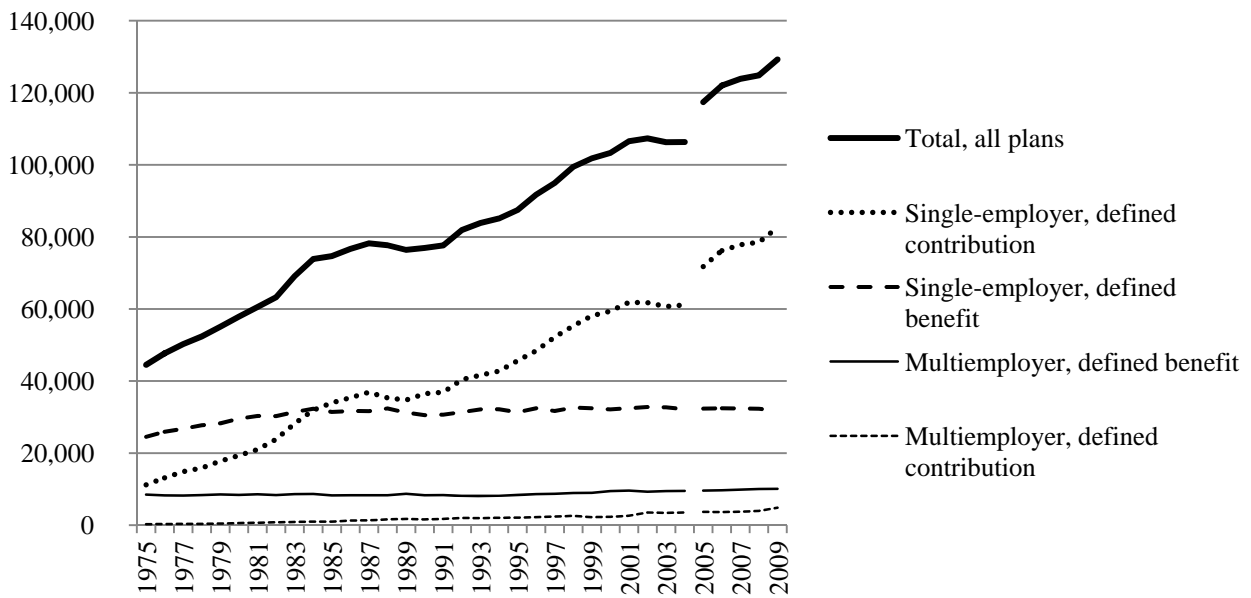
Year	Workers (thousands)	Employer Sponsors a Plan (percentage)	Employee Participation Rate (percentage)
2005	72,331	54.9	45
2006	74,542	52.6	43.2
2007	74,588	54.8	45.1
2008	72,036	53.2	43.6

Source: Congressional Research Service, *Pension Sponsorship and Participation: Summary of Recent Trends, 2009*

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 2009, 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.

¹⁸⁸ The Current Population Survey is a monthly survey of 60,000 households conducted by the Bureau of the Census for the Bureau of Labor Statistics.

Figure 1.—Number of Private-Sector Plan Participants by Type of Plan 1975-2009 (thousands)



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

Note: The break in the data series in 2005 is due to changes in the definition of total participant and active participant beginning with the 2005 Private Pension Plan Bulletin. See the Changes to Participant Counts Appendix for more details. As in previous bulletins, 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.

Note: Excludes plans covering only one participant.

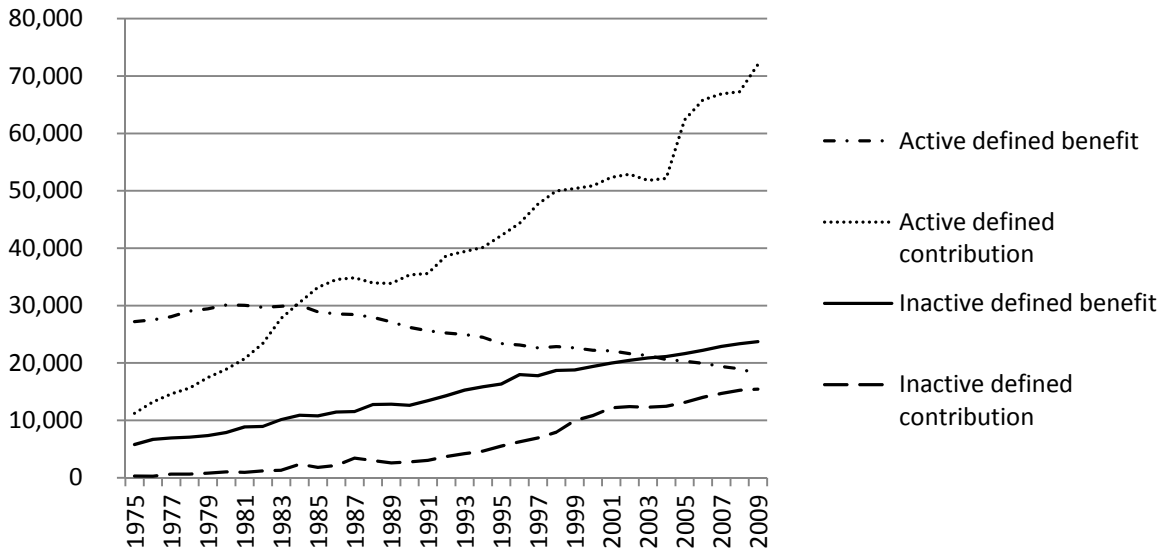
Figure 2 below shows trends from 1975 to 2009 in the number of participants by active and inactive status.¹⁸⁹ The numbers of inactive participants in defined benefit and defined contribution plans both increased over this period, though there are larger numbers of inactive participants in defined benefit plans than defined contribution plans throughout. This implies that the percent of inactive participants in defined benefit plans relative to inactive participants in defined contribution plans decreased. Between 1975 and 2009, 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

¹⁸⁹ 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.

participants are active participants and a decreasing proportion of defined contribution participants are inactive.

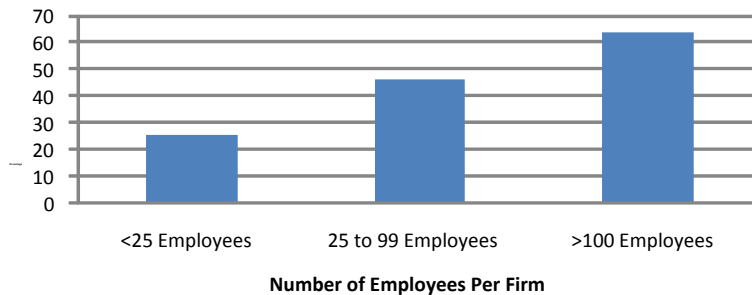
Figure 2.—Number of Private-Sector Participants by Active or Inactive Status and Type of Plan 1975-2009 (thousands)



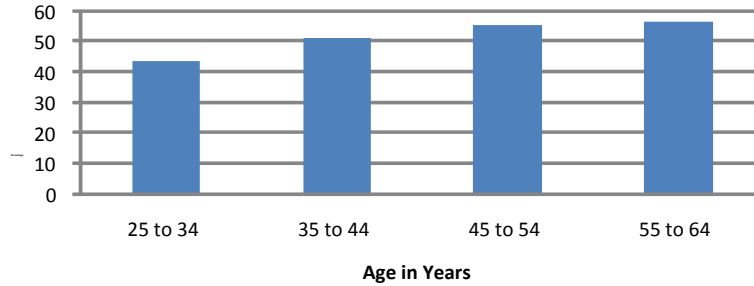
Source: Form 5500 filings with the U.S. Department of Labor.

Participation in qualified retirement plans varies with tenure, firm size and industry. Figures 3, 4, and 5 below, present data from the Current Population Survey in 2008. Participation rates are higher for workers who work in larger firms, for older workers, and for workers with higher incomes.

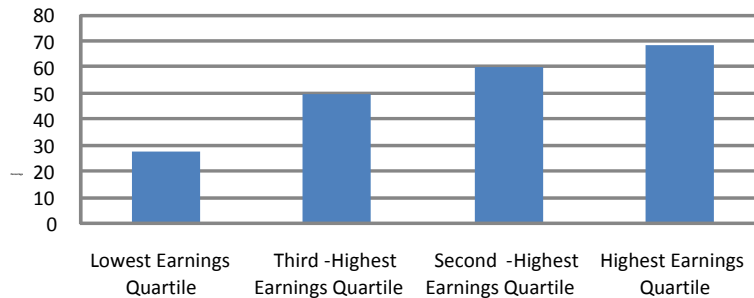
Figure 3.—Percentage Participation In Private Qualified Retirement Plans By Size of Firm, 2008



**Figure 4.—Percentage Participation
In Private Qualified Retirement Plans
By Age of Participant, 2008**



**Figure 5.—Percentage Participation
In Private Qualified Retirement Plans
By Income Quartiles, 2008**



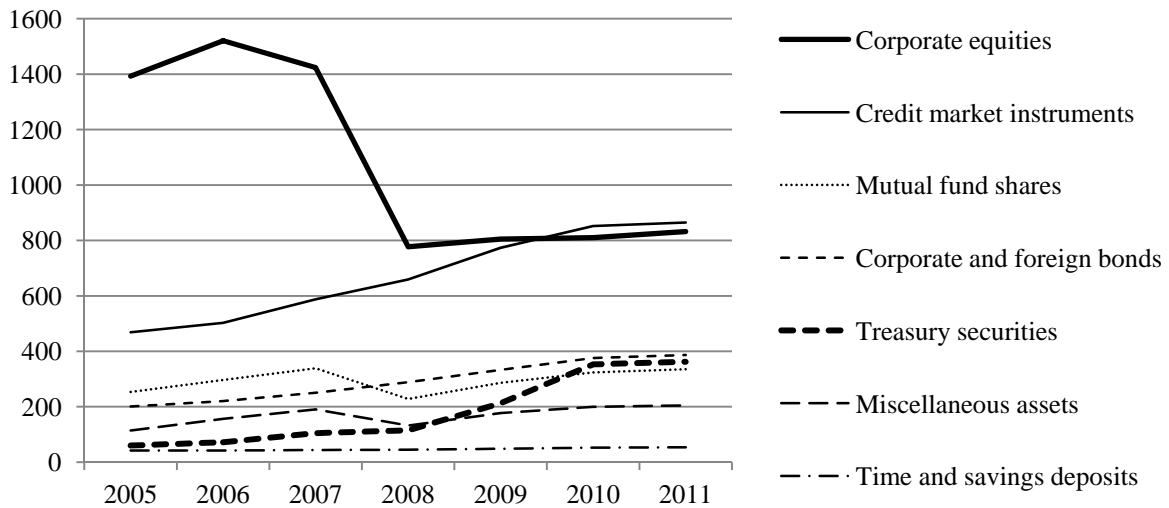
Source: Congressional Research Service, Pension Sponsorship and Participation: Summary of Recent Trends, 2009.

Notes: Includes all private-sector wage and salary workers, aged 25 to 64, employed year-round, full-time.

B. Data on Qualified Retirement Plan Assets

Data from the Board of Governors of the Federal Reserve, Flow of Funds Accounts show the composition of assets held in qualified retirement plans. Figure 6 below shows the majority of assets in private defined benefit plans are held in corporate equities and credit market instruments, with smaller holdings of Treasury securities, time and savings deposits, and corporate and foreign bonds. In 2011, the total value of assets held in private defined benefit plans was \$2318.6 billion. In 2011, 35.9 percent of total assets were in corporate equities and 37.2 percent in credit market instruments. The data show that holdings of credit market instruments increased relatively more than other types of assets between 2005 and 2011. Holdings of corporate equities dropped sharply in 2008. The value of corporate equities in private defined benefit retirement plan assets remains well below 2007 levels.

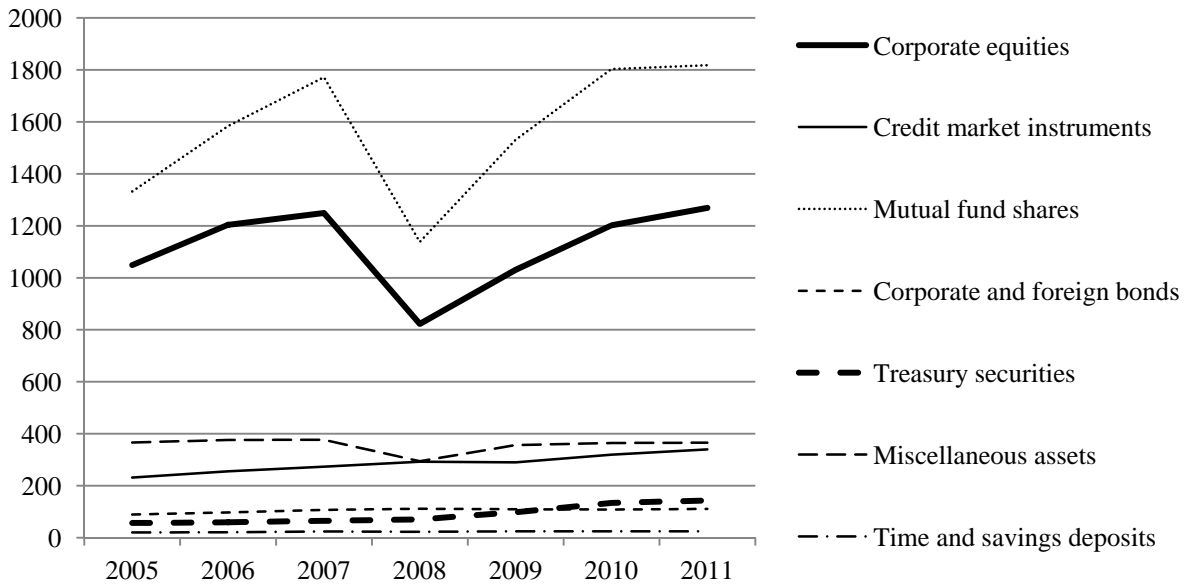
**Figure 6.—Composition of Assets Held in Private Defined Benefit Plans
(billions of dollars)**



Source: Board of Governors, Federal Reserve, Flow of Funds Accounts, 2011.

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 2011, the total value of assets held in defined contribution plans was \$3953.8 billion. In 2011, 46 percent of this total value was held in mutual funds. Corporate equities also represent a significant share of holdings. In 2011, corporate equities constituted 32.1 percent of total holdings. There are smaller holdings of credit market instruments and other miscellaneous assets in private defined contribution plans, and nominal holdings of time and savings deposits and Treasury securities.

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

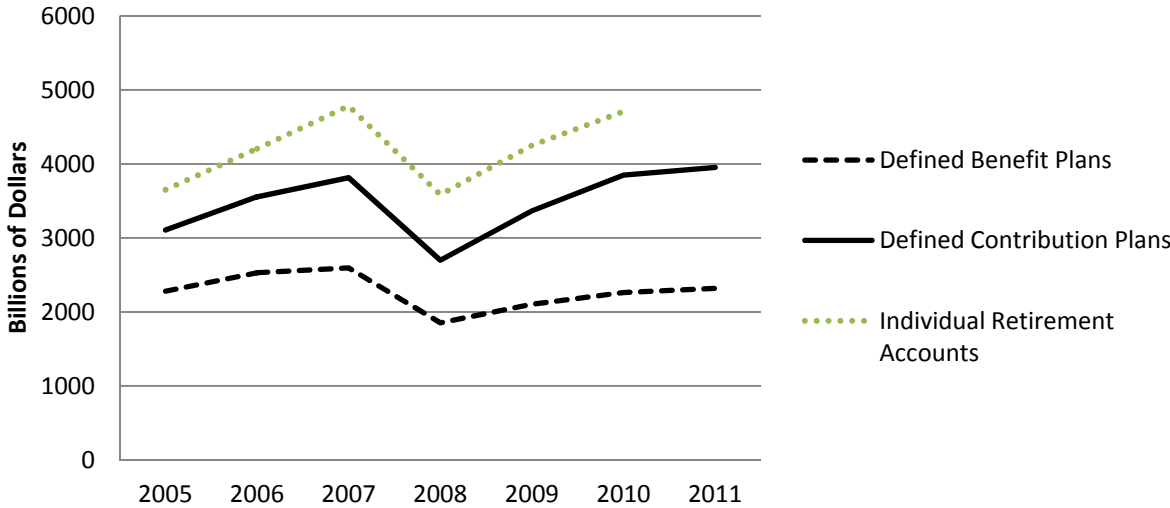


Source: Board of Governors, Federal Reserve, Flow of Funds, 2011.

Figure 8 below shows the market value of assets held in defined contribution plans is consistently higher than those held in defined benefit plans since at least 2005. Market value in both types of plans was relatively stable or increased slightly over the period 2005 to 2007, dropped in 2008, and has largely recovered to 2007 levels since. Assets held in IRAs followed a similar pattern. As of December 31, 2010,¹⁹⁰ total assets held in defined benefit plans was \$2262.0 billion; in defined contribution plans was \$3953.8 billion; and in IRAs was \$4710.0 billion.

¹⁹⁰ This is the most recent year for which data on financial assets held in IRAs is available.

Figure 8.—Market Value of Assets Held in Private Qualified Retirement Plans, By Type of Plan, and IRAs (billions of dollars)



Source: Board of Governors, Federal Reserve, Flow of Funds (2011).
 Note: Data for financial assets held in IRAs is not yet available for 2011.

V. DATA RELATING TO INDIVIDUAL RETIREMENT ACCOUNTS

Individual retirement accounts (“IRAs”) are an important element of U.S. personal savings. Table 3, below, shows annual contributions and rollover data for 2001 to 2005.¹⁹¹ In 2005, individuals contributed \$15.8 billion to traditional IRAs, and \$18.6 billion to Roth IRAs.¹⁹² Amounts rolled over from previously saved funds in employer plans – over \$231.3 billion in 2005 – dwarf the annual contributions to IRAs.

Table 3.—Annual Contributions and Rollover Data (billions of dollars)

Tax Year	Contributions				Roth Conversions	Rollover Contributions
	Traditional IRAs	Roth IRAs	SEP Plans	SIMPLE Plans		
2001	9.2	11.0	10.1	5.5	3.1	187.8
2002	12.4	13.2	10.3	6.3	3.3	204.4
2003	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
2004	12.6	14.7	13.8	7.6	2.8	214.9
2005	15.6	18.6	14.6	8.6	2.6	231.3

Source: Statistics of Income Bulletin (2001-2004) and Joint Committee on Taxation staff calculations (2005).

Note: These data are not available in the Statistics of Income Bulletin after 2004.

¹⁹¹ This is the most recent data available from the Statistics of Income Bulletin published by the IRS.

¹⁹² An additional \$14.6 billion was contributed to SEP plans and \$8.6 billion to SIMPLE plans.

Table 4 shows the distribution of taxpayer contributions to traditional and Roth IRAs by income class.

Table 4.—Contributions to Traditional and Roth IRAs for Primary and Secondary Taxpayers by AGI, Tax Year 2005 (millions of dollars)

Adjusted Gross Income	Traditional IRAs		Roth IRAs	
	Number	Amount	Number	Amount
Less than Zero.....	35	84	48	118
\$0 to \$10,000.....	126	253	312	712
\$10,000 to \$20,000.....	304	710	357	747
\$20,000 to \$30,000.....	441	1,019	432	918
\$30,000 to \$40,000.....	465	1,879	487	1,094
\$40,000 to \$50,000.....	518	1,389	609	1,485
\$50,000 to \$75,000.....	984	2,679	1,448	3,819
\$75,000 to \$100,000.....	669	1,942	1,340	3,859
\$100,000 to \$200,000.....	1,079	3,522	1,651	5,067
\$200,000 and over.....	713	2,707	97	299
Total	5,334	15,495	6,783	18,120

Source: Joint Committee on Taxation staff calculations (2005).

At the end of 2005, over \$3 trillion was held in traditional IRAs in 40.4 million accounts; \$157 billion was held in Roth IRAs in 13.8 million accounts. While contributions to Roth IRAs have outpaced those of traditional IRAs in recent years, the larger balances in traditional IRAs reflect their longer period of existence as well as the effect of rollovers from employer plans.

In studies of the effect of tax-favored savings vehicles on overall savings levels, some researchers find that IRAs lead to increased overall levels of savings, while other researchers find they do not.¹⁹³ While it is true that households that save in one type of savings vehicle are also more likely to save in others, it is unclear the extent to which the existence of IRAs affects

¹⁹³ Gale, William G., and John Karl Scholz, "IRAs and Household Savings," *American Economic Review*, December 1994, vol. 84, issue 5, pp. 1233-60; Venti, Steven F., and David A. Wise, "Government Policy and Personal Retirement Saving," In Poterba, J., ed., *Tax Policy and the Economy*, vol. 6, Cambridge: Massachusetts Institute of Technology Press, 1992, pp. 1-41.

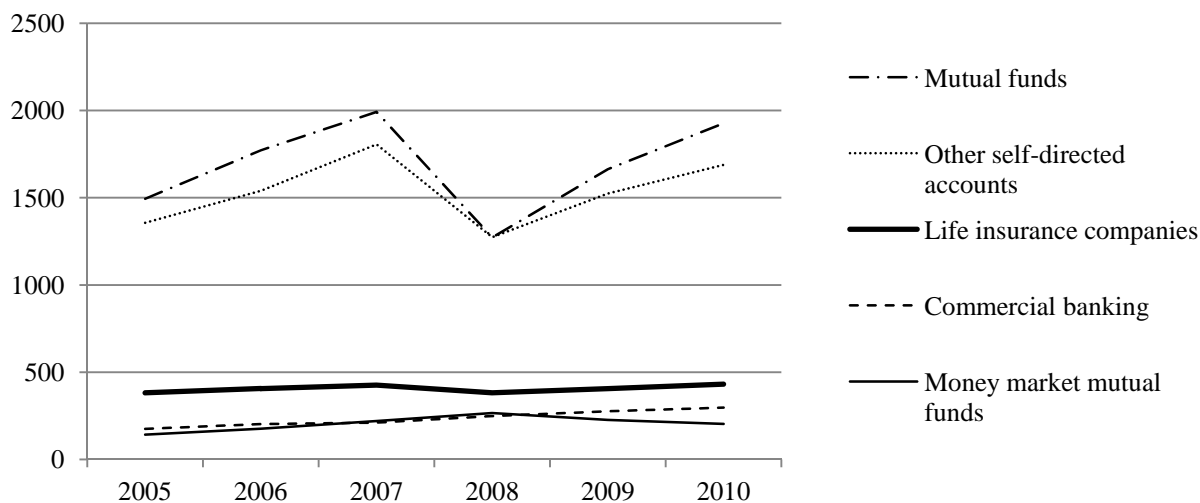
overall savings levels in these various types of households. Some critics of tax-favored savings arrangements such as IRAs question the fairness of such policies, observing that these vehicles, as currently structured, are used disproportionately by higher-income taxpayers relative to lower-income taxpayers.

IRS data show that participation rates for those eligible to contribute to IRAs is close to 30 percent for taxpayers with AGI in excess of \$200,000, while it is below 10 percent for those with AGI less than \$40,000.¹⁹⁴ As a result of these observations, some believe that IRAs have not been very effective in increasing retirement savings by low-income taxpayers.

Figure 8, previously discussed above, shows the market value of assets held in IRAs is consistently higher than those held in defined contribution and defined benefit plans since at least 2005. As with defined contribution and defined benefit plans, the market value of assets held in IRAs increased steadily over the period 2005 to 2007, dropped in 2008, and has largely recovered to 2007 levels since.

According to the data in Figure 9 below, the largest share of assets held in IRAs are in mutual funds and other self-directed accounts. The market value of assets such as life insurance companies, money market mutual funds, and commercial banking are also significant though much smaller than the value of mutual funds and other self-directed accounts.

**Figure 9.—Composition of Assets Held in Individual Retirement Accounts
(billions of dollars)**



Source: Board of Governors, Federal Reserve, Flow of Funds, 2011.

¹⁹⁴ Victoria Bryant, “Accumulation and Distribution of Individual Retirement Arrangements, 2004,” *Statistics of Income Bulletin*, Spring 2008.