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

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INTRODUCTION AND SUMMARY

The Committee on Finance has scheduled a public hearing on September 15, 2011, entitled "Tax Reform Options: Promoting Retirement Security." 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 and a discussion of relevant background and economic data.

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"), in the case of employees, or the Self-Employment Contributions Act ("SECA"), 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.

B. Tax-favored employer-sponsored retirement plans

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 under sections 401(a) and 403(a), tax-deferred annuities under section 403(b), governmental eligible deferred compensation plans under section 457(b), SIMPLE IRAs under section 408(p), and simplified employee pensions ("SEPs") under section 408(k). These plans afford employers flexibility in the design and structure of the retirement plans they adopt, subject to the

[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-44-11), September 13, 2011. This document can be found on our website at www.jct.gov.

requirements applicable to each type of plan under the Internal Revenue Code (the "Code") and, in some cases, under the Employee Retirement Income Security Act of 1974 ("ERISA").

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 of two general types: defined contribution plans, under which benefits are based on a separate account for each participant, and defined benefit plans, under which benefits are determined under a plan formula, rather than an actual account balance or plan assets. 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 under section 401(k) or an employee stock ownership plan ("ESOP").

Defined contribution plans may provide for various types of employer and employee contributions. Defined benefit plans are generally funded by employer contributions, but, in some cases, particularly governmental defined benefit plans, also provide for employee contributions.

Contributions under a defined contribution plan and benefits under a defined benefit plan are subject to specific limits under the Code. An employer's deduction for contributions to each type of plan is also subject to specified limits. The Code also contains rules governing the time when distributions from different types of plans can be made and, under some plans, the form in which distributions must be offered. Subject to these rules, plans may also provide for distributions at various times and in various forms.

Charitable organizations tax-exempt under section 501(c)(3) and educational institutions of State or local governments (including public schools) 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.

Qualified retirement plans are subject to various participant protection requirements, which generally have parallels under ERISA. These include, for example, an exclusive benefit requirement, vesting requirements and protection of accrued benefits (which vary with the type of plan and type of contribution), restrictions on assignment or alienation, and qualified joint and survivor annuity and qualified preretirement survivor annuity requirements. Qualified retirement plans are also generally subject to nondiscrimination requirements to assure that qualified retirement plans achieve the goal of retirement security for both lower and higher paid employees.

C. Taxation of distributions

Distributions from qualified retirement 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). Qualified distributions from a designated Roth account are excluded from income, as is net unrealized appreciation on a lump sum distribution of employer securities. 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.

Subject to certain limitations, distributions from a qualified retirement 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.

A qualified retirement 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.

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 2011), plus an additional $1,000 (for 2011) 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. Distributions before age 59½ that are includible in income are also subject to an additional 10 percent early withdrawal tax unless an exception applies. IRA distributions generally can be rolled over to another IRA or qualified retirement plan; however, a distribution from a Roth IRA can be rolled over only to another Roth IRA or a designated Roth account.

Similar to qualified retirement plans, IRAs are subject to minimum distribution requirements, except that distributions from a Roth IRA are not required during the IRA owner's lifetime.

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.

II. 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.

III. Data Relating to Qualified Retirement Plans

The Current Population Survey shows that, in 2008, 43.6 percent of civilian 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.

IV. Data Relating to Individual Retirement Accounts

Annual amounts rolled over to IRAs from employer-sponsored plans dwarf annual IRA contributions. Data on IRA contributions indicates 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 premiums[2] and reimbursements for medical care,[3] employer-provided dependent care assistance up to $5,000 a year,[4] and certain fringe benefits such as qualified transportation fringes.[5] These exclusions do not apply to self-employed individuals unless specifically provided for. For example, for purposes of the exclusion for dependent care assistance, a self-employed individual is treated as an employee. In some cases, a comparable alternative tax benefit may be provided to a self-employed individual,

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[2] Section 106. All references in this document are to the Internal Revenue Code of 1986 unless otherwise specified.

[3] Section 105(b).

[4] Section 129.

[5] Section 132.

for example, the above-the-line deduction for health insurance premiums paid by a self-employed individual (section 162(l)).

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),[6] as well as income tax withholding.[7] Net compensation of a self-employed individual is subject to tax under the Self-Employment Contributions Act ("SECA").[8]

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., the individual's right is 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 (section 401(a) or 403(a)), a tax-sheltered annuity plan (section 403(b)), and an eligible deferred compensation plan of a State or local government employer (section 457(b)). As discussed below in Part I.B.1, under tax-favored deferred compensation arrangements, 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.

3. Tax treatment of nonqualified deferred compensation[9]

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.[10] The amount included in income results in "basis," and later payments of the deferred compensation

[6] Sections 3101-3128.

[7] Sections 3401-3404.

[8] Sections 1401-1403.

are taxed as an annuity, i.e., part nontaxable basis recovery and part income.[11] 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.[12] 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.[13]

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.[14]

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

[10] Sections 83, 402(b), and 403(c).

[11] Section 72.

[12] Section 409A.

[13] Section 457(f).

[14] Section 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 the need to provide 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 provides rules as to protections that must be afforded to employees to ensure that they receive the benefit promised under the plan, and parallel rules generally apply under the ERISA. However, subject to these rules, an employer that chooses to maintain a retirement plan has a great deal of flexibility in deciding the structure of the plan and the level of benefits, as permitted under the various types of plans available, as discussed below.

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.

The most common type of tax-favored plan is a qualified retirement plan,[15] which may be a defined benefit plan or a defined contribution plan. A defined contribution plan may include a qualified cash or deferred arrangement,[16] which offers an employer great flexibility in designing

[15] Section 401(a).

[16] Section 401(k).

a retirement program for its employees. Another option is a qualified annuity plan,[17] which is similar to and subject to requirements similar to those applicable to qualified retirement plans.

Additional options are available to certain tax-exempt or governmental employers, including tax-deferred annuities[18] and eligible deferred compensation plans,[19] which are sometimes offered in lieu of a section 401(k) plan. Certain small employers have the option of maintaining a SIMPLE IRA plan[20] or a simplified employee pension ("SEP"),[21] as discussed in Part I.D.2, which are funded through direct contributions by the employer to an IRA established for each employee.

2. Qualified retirement plans and annuities

<u>**In general**</u>

A plan of deferred compensation that meets the qualification requirements of section 401(a) of the Code (a "qualified retirement plan) is accorded special tax treatment under present law. 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.[22] Contributions to a qualified retirement plan (other than salary reduction 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 in order for favorable tax treatment to apply. These requirements include, for example, vesting requirements, limits on contributions, and nondiscrimination requirements that are intended to ensure that the qualified retirement plan covers a broad group of employees.[23] In

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[17] Section 403(a).

[18] Section 403(b).

[19] Section 457(b).

[20] Section 408(p).

[21] Section 408(k).

[22] Under sections 401(c) and 404, a self-employed individual is treated as an employee for purposes of the qualified retirement plan rules and can deduct contributions to a plan.

[23] 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.

addition, the assets of the plan must be held in a trust or custodial account for the exclusive benefit of plan participants. Certain of these rules are discussed in more detail below.

Qualified annuity plans under section 403(a) of the Code are similar to qualified retirement plans under section 401(a), are generally subject to the same requirements, and receive comparable tax-favored treatment. However, plan assets are invested in annuity contracts rather than held in a trust or custodial account.

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

Defined contribution plans

General description and rules

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.

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 (discussed below). 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 $49,000 (for 2011) or the employee's compensation.[24] 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.

Defined contribution plans often provide for loans to participants, subject to certain conditions, discussed in Part I.C.5. 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

[24] Section 415(c).

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.

The deduction for employer contributions to a defined contribution plan for a year is generally limited to 25 percent of the participants' compensation.[25] For this purpose, a participant's compensation in excess of $245,000 (for 2011) 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.[26]

Types of defined contribution plans

Defined contribution plans fall into three general types: profit-sharing plans, stock bonus plans, and money purchase pension plans. A plan must designate the type of plan it is intended to be.

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 participants 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 minimum funding requirements,[27] and the employer is generally subject to an excise tax if it fails to make the contributions required under the plan.[28]

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[25] Section 404.

[26] Section 4972.

[27] Section 412. Plans maintained by governmental employers or churches are generally not subject to the minimum funding requirements.

[28] Section 4971.

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. A money purchase plan can provide the same forms of distribution as other defined contribution plans, but must also provide an annuity payable for the life of the participant or, in the case of a married participant, an annuity payable for the life of the participant with a survivor's annuity payable to the spouse after the participant's death.

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 employee stock ownership plan (an "ESOP"), discussed below.

Section 401(k) plans

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.[29] Thus, such arrangements are subject to the rules generally applicable to qualified defined contribution plans. In addition, special rules apply to such arrangements.[30]

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 $16,500 (for 2011) or, if less, the employee's compensation.[31] 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.[32] As a result, the dollar limit on elective deferrals is increased for an individual who has attained age 50 by $5,500 (for 2011). An employee's elective deferrals must be fully vested.

Special nondiscrimination tests apply to elective deferrals, matching contributions, and after-tax employee contributions, as discussed in Part I.B.5.

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 59-½ 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.[33] However, a section 401(k) plan is permitted to include a "qualified Roth contribution program" that permits a participant to elect

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[29] Certain pre-ERISA money purchase plans and rural cooperative plans may also include a qualified cash or deferred arrangement. In addition, certain small employers may adopt a SIMPLE section 401(k) plan similar to a SIMPLE IRA plan discussed in Part I.D.2.

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

[31] Section 402(g).

[32] Section 414(v).

[33] Elective deferrals, including designated Roth contributions are subject to FICA tax.

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 treated as any other elective deferral for certain purposes, including the restrictions on distributions discussed above. Certain distributions from a designated Roth account ("qualified" distributions) are excluded from income, even though they include earnings not previously taxed.

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.

ESOPs

An ESOP is a defined contribution plan that is designated as an ESOP and is designed to invest primarily in stock of the employer.[34] 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. An ESOP that borrows funds to acquire employer securities generally is referred to as a "leveraged ESOP." In addition, higher employer deductions are available in the case of an ESOP. For example, in some circumstances, additional deductible contributions may be made to pay interest on a leveraged ESOP loan and dividends paid on employer stock held within an ESOP may be deductible.

Defined benefit plans

Under a defined benefit plan, benefits are determined under a plan formula, rather than based on an actual account balance or plan assets. Traditionally, benefits under a defined benefit plan have been expressed as a life annuity commencing at normal retirement age (as designated under the plan), with accruals for each year of service expressed as a percentage of compensation (generally the participant's highest average compensation for a period of years). However, the past 25 years have seen the development and growth of hybrid defined benefit plans, such as cash balance plans, under which a participant's benefit is expressed as a hypothetical account balance. For example, accruals under a cash balance plan are expressed as hypothetical contributions to the account (or "pay credits") with a right to future hypothetical earnings (or "interest credits").

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[34] Section 4975(e)(7). Participant accounts in other types of defined contribution plans can also be invested in employer stock.

Defined benefit plans are generally funded by employer contributions, in an amount determined on an actuarial basis to be needed to provide the benefits under the plan. Defined benefit plans (other than, generally, those maintained by governmental employers or churches) are subject to minimum funding requirements,[35] and the employer is generally subject to an excise tax if it fails to make the required contributions to the plan.[36] However, some defined benefit plans (including most governmental defined benefit plans) also require employee contributions. Employee contributions to defined benefit plans are generally made on an after-tax basis, except in the case of employee contributions to a State or local government plan that are "picked up" by the employer.[37]

Defined benefit plans may not provide for in-service distributions except at normal retirement age (or age 62, if earlier) or in the case of plan termination. Defined benefit plans must allow participants who have terminated employment and reached normal retirement age to receive distributions and often provide for distributions on early retirement or other severance from employment before normal retirement age.

Defined benefit plans, including hybrid plans, must provide benefits in the form of an annuity payable for the life of the participant or, in the case of a married participant, an annuity payable for the life of the participant with a survivor's annuity payable to the spouse after the participant's death. A defined benefit plan may also allow benefits to be paid in various optional forms that are the actuarial equivalent of the life annuity (including lump sums[38]), but may provide subsidized early retirement benefits or other retirement-type subsidies.

Annuity distributions from a defined benefit plan for a year cannot exceed the lesser of $195,000 (for 2011) or the employee's average compensation for the three consecutive years of highest compensation for the employee.[39] The dollar limit is reduced if distributions begin before age 62 and increased if distributions begin after age 65. An actuarially adjusted limit applies to a form of benefit other than an annuity, such as a lump sum.

The deduction limit for employer contributions to a defined benefit plan for a year depends on whether the plan is a single-employer plan or a multiemployer plan.[40] The deduction limit for a single-employer plan is generally the excess of (1) the sum of the plan's funding target

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[35] Sections 412 and 430-432. The minimum funding requirements depend on whether the plan is maintained by a single employer, i.e., a "single-employer" plan, or is a multiemployer plan, i.e., a plan maintained pursuant to collective bargaining agreements with two or more employers, to which the employers are required to contribute.

[36] Section 4771.

[37] Section 414(h)(2).

[38] Special actuarial assumptions apply in determining lump sums.

[39] Section 415(b).

[40] Section 404.

(the present value of benefits earned under the plan in previous years), normal cost (the present value of the benefits expected to be earned during the year plus plan expenses) and a "cushion" amount, over (2) the value of plan assets. The cushion amount is the sum of 50 percent of the plan's funding target and the amount by which the funding target would increase if certain expected future compensation or benefit increases were taken into account. The deduction limit for employer contributions to a multiemployer plan is generally the excess of (1) 140 percent of the plan's current liability (the present value of all benefits earned under the plan), over (2) the value of plan assets. However, the deduction limit is never less than the contribution required under the minimum funding rules applicable to the plan. Special deduction rules apply 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.[41]

3. 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). 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 and catch-up contributions under a section 401(k) plan. 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. Moreover, additional elective deferrals are permitted 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.

Section 403(b) plans are generally subject to the minimum coverage and nondiscrimination rules that apply to qualified defined contribution plans as discussed in Part I.B.5.[42] However, pretax 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

[41] Section 4972.

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

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

Section 457 provides special rules with respect to deferred compensation arrangements of State and local government and tax-exempt employers.[43] Amounts deferred under an "eligible" plan under section 457(b) (a "section 457(b)" plan) are not currently included in income.[44] 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).[45]

Deferrals under a governmental section 457(b) plan are subject to the same limits as elective deferrals and catch-up contributions under a section 401(k) plan or a section 403(b) plan, i.e., $16,500 (for 2011) plus, if applicable, catch-ups of $5,500 (for 2011), or, if less, the employee's compensation. However, the section 457(b) 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, a special catch-up limit applies under section 457(b) for the last three years before a participant reaches normal retirement age.

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.

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[43] Section 457 does not apply to certain plans, including qualified retirement plans and section 403(b) plans.

[44] Deferrals under a section 457(b) plan are subject to FICA tax.

[45] 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.

4. Qualification requirements with parallel ERISA provisions

The Code and ERISA

Retirement plans are also subject to regulation under ERISA. The ERISA rules generally relate to the rights of plan participants, reporting and disclosure, and the obligations of plan fiduciaries. Some of the Code and ERISA provisions applicable to qualified retirement plans are identical or very similar. For purposes of plan qualification, section 401(a) includes, for example, the following qualification requirements that are also provided as similar participant protections under ERISA: an exclusive benefit requirement under section 401(a) and 401(a)(2) (section 404(a)(1) of ERISA); vesting and related requirements under sections 401(a)(7) and 411 (section 203 and 204 of ERISA); limitations on plan age and service requirements for participation under sections 401(a)(3) and 410(a) (section 202 of ERISA); anti-assignment and anti-alienation requirements under section 401(a)(13) (section 206(d) of ERISA); and qualified joint and survivor annuity ("QJSA") and qualified preretirement survivor annuity ("QPSA") requirements under sections 401(a)(11) and 417 (section 205 of ERISA).[46]

Exclusive benefit requirement

Under the exclusive benefit requirement, a qualified retirement plan must be maintained for the exclusive benefit of employees, and the assets of the plan must be held in a trust (or custodial account) for the exclusive benefit of employees and their beneficiaries. In particular, the trust (or account) terms must prohibit the diversion of assets for purposes other than the exclusive benefit of employees and their beneficiaries.

Vesting and related requirements

Vesting generally

The vesting and related requirements generally provide protection for the participant's accrued benefit and optional forms of benefit, including subsidized optional forms of benefit. In the case of a defined contribution plan, a participant's accrued benefit is the balance of his or her account under the plan. Generally, distributions to a participant or beneficiary from a defined contribution plan simply reduce the participant's account balance.

In the case of a defined benefit plan, a participant's accrued benefit is the portion of the normal retirement benefit (i.e., the annuity payable at normal retirement age[47] under the plan's

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[46] These provisions (other than the exclusive benefit requirement) generally do not apply to governmental plans within the meaning of section 414(d) (which includes certain plans maintained by Indian Tribal governments), which are not subject to ERISA and certain church plans that are also not subject to ERISA. However, under section 411(e), the pre-ERISA vesting requirements apply to these plans for purposes of plan qualification. Further, other than the exclusive benefit requirement, these qualification requirements do not apply under the Code to section 403(b) plans and section 457(b) plans. However, in some cases, a section 403(b) plan maintained by a nongovernmental tax-exempt organization may be subject to the provisions through ERISA.

[47] Under section 411(a)(9), which defines normal retirement age, 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

benefit formula, based on the participant's compensation and years of service) that has accrued under the accrual method provided under the plan.

A defined benefit plan is permitted to provide a wide variety of optional forms of distribution with respect to the accrued benefit but each form of distribution must provide distributions that are not less than the actuarial equivalent of the accrued benefit, or an impermissible forfeiture will occur.[48] A defined benefit plan may provide for a subsidized early retirement benefit or other retirement type subsidies, the right to which is not required to vest or accrue in accordance with the vesting schedules or anti-backloading requirements described below. For example, a plan with a normal retirement age of 65 might provide for payment of a participant's accrued benefit at age 55 without actuarial reduction for early commencement but conditions entitlement to this subsidized early retirement benefit on retirement from service with the employer after attaining age 55 with at least 30 years of service.

Vesting schedules

Generally, an employee's accrued benefit payable at normal retirement age must become nonforfeitable (i.e., vested) after the completion of a specified number of years of service in accordance with a vesting schedule.[49] The Code limits the vesting schedules that can be provided under a plan for a participant's accrued benefit derived from employer contributions.

In the case of a defined contribution plan, the plan can use one of two alternative minimum vesting schedules. Under the first vesting schedule, the participant's accrued benefit derived from employer contributions must become 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 accrued benefit derived from employer contributions must become vested ratably over the period from two to six years of service.

In the case of a defined benefit plan (other than a hybrid plan), the plan can also use one of two vesting schedules.[50] Under the first vesting schedule, the participant's accrued benefit derived from employer contributions must become 100 percent vested upon completion of no

of the time the participant commenced plan participation. Treas. Reg. sec. 1.401(a)-1(b)(2) provides rules as to the earliest permitted normal retirement age that a plan may specify.

[48] Section 401(a)(25) requires the assumptions for determining actuarial equivalence to be specified in the plan in a manner that precludes employer discretion. A defined benefit plan may also provide for permitted ancillary benefits, which are not part of the participant's accrued benefit, such as disability or death benefits. Ancillary benefits are not subject to the vesting requirements, including the requirement that the ancillary benefit not be eliminated or reduced by a plan amendment.

[49] Section 411(a)(3) provides certain permitted forfeitures for accrued benefits that are otherwise 100 percent vested, including, for example, forfeiture upon the participant's death or withdrawal of mandatory employee contributions and suspension of benefits upon reemployment.

[50] Under section 411, additional vesting rules apply in the case of a defined benefit plan. In general, there are also rules to prevent back-loaded rates of accrual.

more than five years of service ("five year cliff vesting"). Under the second vesting schedule, the participant's accrued benefit derived from employer contributions must become vested ratably over the period from three to seven years of service. Under a hybrid plan, the participant's accrued benefit must be 100 percent vested after completion of three years of service

The plan may always provide for the employer-provided portion of the accrued benefit to become fully vested after fewer years of service than under one of the required vesting schedules or become immediately vested when accrued.

Accrued benefits attributable to employee after-tax contributions and pretax elective deferrals must be nonforfeitable at all times,[51] and special rules apply in the case of certain nonelective contributions under a section 401(k) plan and employer matching contributions with respect to elective deferrals (described in more detail in Part I.B.5 below).

Related vesting requirements

The vesting rules also prohibit distribution of an employee's accrued benefit (an "involuntary" distribution) without consent before the later of the time the participant has attained normal retirement age under the plan or attained age 62.[52] An exception generally allows a lump sum distribution without the employee's consent if the present value of the employee's accrued benefit at the time of the distribution is not more than $5,000 ("mandatory cashout"). Further, the present value of any form of payment of the participant's accrued benefit (other than certain single life and joint and survivor annuity forms) generally must be at least the actuarial equivalent of the employee's accrued benefit calculated determined using the interest and mortality assumptions described in section 417(e).[53] Amendments that reduce the employee's accrued benefit (whether or not vested) or eliminate optional forms of benefit, or eliminate or reduce early retirement benefits or retirement-type subsidies, with respect to the employee's accrued benefit generally are prohibited. Amendments are permitted only to reduce future rates of accrual, eliminate optional forms of benefits, or eliminate or reduce early retirement benefits or retirement-type subsidies, with respect to future accruals. Anti-backloading rules apply to defined benefit plans and limit the extent to which rates of accrual with respect to an employee's accrued benefit can be higher for later years of service. Reductions in an

[51] Sections 411(a)(1) and 401(k). Section 411(c) provides rules for determining the portion of any accrued benefit under a defined benefit plan that is attributable to mandatory employee contributions.

[52] Section 411(a)(11) and Treas. Reg. sec. 1.411(a)-11. The regulations also provide that no consent is valid unless, prior to consenting, the participant has received a general description of the optional forms of benefit under the plan and is informed of the right, if any, to defer distribution.

[53] Treas. Reg. sec. 1.411(a)-11 (d) and Treas. Reg. sec. 1.417(e)-1(d). A special rule is provided in section 411(a)(13)(A) for valuing the accrued benefit for certain hybrid plans.

employee's rate of accrual under a defined benefit plan, or rate of allocation under a defined contribution plan, due to increasing age generally are also prohibited.[54]

Anti-assignment and anti-alienation

Benefits under the plan must be prohibited from being assigned or alienated.[55] For example, a plan cannot provide for alienation of a participant's accrued benefits for bad behavior, such as embezzling funds from the employer.[56] There are exceptions specified under section 401(a)(13) which include, for example, complying with qualified domestic relations orders ("QDROs"),[57] voluntary revocable assignments of 10 percent of any benefit payment, use by a participant of his or her accrued benefit as security for a plan loan, and certain judgments or settlements for crimes against the plan or fiduciary violations.

Participation requirement

A plan generally cannot delay participation in the plan based on attainment of age or completion of years of service beyond the later of completion of one year of service (12 month period with at least 1,000 hours of service) or attainment of age 21.[58] 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. A plan cannot exclude an employee from participation (on the basis of age) who has attained a specified age. [59]

QJSA and QPSA requirements

Pension plans (defined benefit plans and money purchase pension plans) must comply with certain requirements that provide certain benefits to the spouse of a married participant. In particular, pension plans must provide that the normal form of benefit under the plan is a qualified joint and survivor annuity ("QJSA") whenever distributions are permitted under the plan to commence to an employee.[60] For a single employee, a QJSA is a life annuity, and, for a married employee, a QJSA generally is a life annuity for the employee with at least a 50 percent

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[54] Sections 411(b)(1)(H) and 411(b)(2). Special rules apply for purposes of determining whether a cash balance plan satisfies this requirement. For example, the rate of hypothetical earnings under a hybrid plan cannot exceed a market rate return.

[55] Sec. 401(a)(13).

[56] *Guidry v. Sheet Metal Workers National Pension Fund*, 493 U.S. 365 (1990).

[57] Section 414(p) provides rules for QDROs.

[58] Sec. 401(a)(1).

[59] Sec. 410(a)(2).

[60] Under section 401(a)(14), a plan is only required to provide for the commencement of benefits at the later of attainment of normal retirement age or severance from employment with the employer. The plan may permit the participant to elect to defer benefits beyond that time, subject to the minimum distribution requirements discussed in Part I.C.3.

survivor annuity for the employee's spouse.[61] The accrued benefit must be paid in the form of a QJSA unless, after receiving a notice explaining the relative value of the QJSA to other forms of distribution, the employee elects another form of distribution and the employee's spouse provides notarized consent to the alternative form of distribution elected as well as to any other beneficiary designated by the employee with respect to the alternative form of distribution.

If a married employee dies before beginning the payment of benefits, the plan must offer a survivor benefit for the spouse in the form of a qualified pre-retirement survivor annuity ("QPSA"), which is a survivor annuity for the spouse that is at least 50 percent of the employee's accrued benefit. Notarized spousal consent by the employee's spouse is also required for the employee to waive the QPSA or elect a different beneficiary or a different form of survivor benefit.

In the case of a defined benefit plan, the other forms of benefit offered to a married participant under the plan are not permitted to be actuarially more valuable than the QJSA immediately payable at the time of the distribution. Finally, the QJSA and QPSA requirements only apply if the actuarial present value of the employee's accrued benefit at the time of the distribution (calculated using the same actuarial assumptions) is more than $5,000.

In the case of a profit-sharing plan or stock bonus plan, including a section 401(k) plan, the plan is generally not required to satisfy the QJSA and QPSA requirements unless the participant elects an annuity form of distribution.[62] However, in addition, in order for the QJSA and QPSA requirements to not apply, the spouse must be the beneficiary of the employee's account balance after the employee's death unless the spouse consents in writing to a different beneficiary. Nevertheless, before the employee's death, the employee may withdraw the entire account balance without spousal consent.

5. Nondiscrimination requirements for qualified retirement plans

<u>Prohibition against discrimination in favor of highly compensated employees</u>

<u>General rules</u>

Under the nondiscrimination requirements, the coverage, and contributions or benefits provided to employees under a qualified retirement plan must not discriminate in favor of highly compensated employees.[63] For purposes of these nondiscrimination requirements, an employee generally is treated as highly compensated if the employee (1) was a five-percent owner of the

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[61] The plan generally must provide two joint and survivor annuity options for married participants, with survivor annuity rates (as a percentage of the annuity during the participant's lifetime) between 50 and 74 percent and between 75 and 100 percent.

[62] Section 401(a)(11)(B)(iii).

[63] Sections 401(a)(3) and (4). A qualified retirement plan of a governmental employer is not subject to the nondiscrimination requirements. Under section 403(b)(1)(D) and (b)(12), a section 403(b) plan of a nongovernmental tax-exempt employer (other than a church) is generally also subject to these requirements.

employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of $110,000 (for 2011).[64] The nondiscrimination requirements are designed to help ensure that qualified retirement plans achieve the goal of retirement security for both lower and higher paid employees.

Nondiscriminatory plan coverage

Whether plan coverage of employees is nondiscriminatory[65] is determined by calculating the plan's ratio percentage, which is the ratio of the percentage of nonhighly compensated employees[66] covered under the plan over the percentage of highly compensated employees[67]covered. Under section 410(b), a ratio percentage of 70 percent or greater is deemed nondiscriminatory. If, however, the ratio percentage is less that 70 percent, a multi-part test applies. First, the plan must cover a group of employees that is reasonable and established under objective business criteria (such as hourly or salaried employees) ("reasonable classification requirement"), and the plan's ratio percentage must meet a specific standard under the regulations. In addition, the average benefit percentage test must be satisfied. Under the average benefit percentage test, the average rate of allocation or accruals of all nonhighly compensated employees (taking into account all plans of the employer) must be at least 70 percent of the average accrual or allocation rate of all highly compensated employees. Employees who have not satisfied the minimum age and service conditions under the plans,[68] certain nonresident aliens, and certain collectively bargained employees are generally excluded when calculating ratio percentages and the average allocation or accrual rates for the average benefit percentage.

Nondiscriminatory plan benefits or allocations

It is generally not discriminatory to provide the same rate of employer contributions or accruals, expressed as a percentage of compensation,[69] to highly compensated and nonhighly

[64] Section 414(q). Further, at the election of the employer, employee's who are highly compensated based on the amount of the employee's compensation may be limited to any employee who had compensation for the preceding year in excess of $110,000 (for 2011) and was in the top 20 percent of employees by compensation for such year.

[65] These rules are generally referred to as the minimum coverage requirements.

[66] For these purposes, the aggregation rules of section 414(b), (c), (m) and (o) apply as well as the leased employee rules of section 414(n). These control group rules and leased employee rules generally also apply for determining the employer for the qualification requirements under section 401(a). Further the separate rules for separate lines of business under section 414(r) may apply but generally only for purposes of applying the nondiscrimination requirements.

[67] A nonhighly compensated employee is an employee other than a highly compensated employee.

[68] As discussed earlier in Part I.B.4, qualified retirement plans may impose an age condition up to age 21 and a service condition up to one year in order for an employee to be eligible to participate in the plan. The employer also generally has the option of testing the benefits and coverage of employees under age 21 or having less than one year of service separately from employees over age 21 with at least of a year of service.

[69] Compensation must be nondiscriminatory in accordance with section 414(s).

compensated employees.[70] For this purpose, compensation generally is limited to $275,000 per year (for 2011). In calculating an employee's accrual or allocation rate, credit may be given for the employer paid portion of social security taxes or benefits.[71]

Treasury regulations provide detailed rules for determining whether a plan satisfies the nondiscrimination requirements.[72] Under the regulations, the amount of contributions or benefits provided under the plan, and the benefits, rights and features offered under the plan must all be tested to ensure they are not discriminatory.[73] There are three general approaches to testing the amount of benefits under qualified plans: (1) design-based safe harbors under which the plan's benefit or allocation formula satisfies certain uniformity standards;[74] (2) a general test;[75] and (3) cross-testing of equivalent accruals or allocations.[76] Elective deferrals, matching contributions, and after-tax employee contributions are subject to special testing rules.

The general test is generally satisfied by measuring the rate of accrual or allocation of each highly compensated employee to determine if the group of employees with the same or higher rate of accrual or allocation[77] is a nondiscriminatory group. This test generally is satisfied if the ratio percentage of highly compensated and nonhighly compensated employees with the same or a higher allocation rate or accrual rate as the rate of the highly compensated employee satisfies the minimum coverage requirements (using, if the ratio percentage is less than 70 percent, a simplified nondiscrimination standard which includes disregarding the reasonable classification requirement, but requires satisfaction of the average benefit percentage test).

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[70] Section 401(a)(5)(B). For purposes of plan qualification, it is generally not considered discriminatory to provide greater benefits to nonhighly compensated employees.

[71] See sections 401(a)(5)(C) and (D) and 401 (l) and Treas. Reg. secs. 1. 401(a)(4)-7 and 1.401(l)-1 through -6 for rules for determining the amount of credit which may be given for the employer paid portion of social security taxes or benefits. This credit is referred to generally as permitted disparity.

[72] Treas. Reg. secs. 1. 401(a)(4)-1 through 13.

[73] See Treas. Reg. sec. 1.401(a)(4)-1. The timing of plan amendments must also not have the effect of discriminating significantly in favor of highly compensated employees.

[74] Treas. Reg. secs. 1.401(a)(4)-2(b) and 3(b).

[75] Treas. Reg. secs. 1.401(a)(4)-2(c) and 3(c)

[76] Treas. Reg. sec. 1.401(a)(4)-8.

[77] An employee's allocation rate generally is the amount of employer contribution allocated to an employee's account for the plan year expressed as a percentage of the employee's compensation for the plan year. An employee's accrual rate generally is the amount of the annual payments under the employee's accrued benefit payable at normal retirement age (or other testing age prescribed under the regulations) expressed as a straight life annuity divided by the employee's years of service, expressed as a percentage of average annual compensation. Allocation and accrual rates are then permitted to be increased by a factor to reflect permitted disparity. If the defined benefit plan provides subsidized optional forms of benefit, the accrual rate for the most valuable benefit under the plan available to each employee is also calculated and tested.

Cross-testing involves the conversion of allocations[78] or accruals to actuarially equivalent accruals or allocations, with the resulting equivalencies tested under the general test.

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

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.[79] Generally, this is an objective mathematical test that compares the average rate of deferral for highly compensated employees to all nonhighly compensated employees. This test generally allows the average deferral rate for highly compensated employees to exceed the average deferral rate for nonhighly compensated employees but not by more than a calculated percentage. The permissible deviation of the average deferral rate of the nonhighly compensated employees from the average deferral rate of highly compensated employees is the greater of 125 percent, or the lesser of (i) two percentage points or (ii) double the average rate. Employer matching contributions and after-tax employee contributions are subject to a similar special annual 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.[80]

If either test is not satisfied, a mechanism is provided under the Code and regulations for the employer to make immediately vested additional contributions to 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 (a

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[78] Cross-testing of allocations under a defined contribution plan is permitted only if certain threshold requirements are satisfied.

[79] Section 401(k)(3). The ADP test does not apply to section 403(b) plans. Instead all employees of the employer (whether governmental or tax-exempt) generally must be permitted to make elective deferrals of more than $200 each year, referred to as the" universal availability requirement." For an employee, this requirement may be satisfied through eligibility under another plan such as a 401(K) plan. Certain categories of employees are permitted to be excluded in determining all employees of the employer.

[80] Section 401(m)(2). The ACP test also applies to section 439b) plans of nongovernmental employers (other than churches).

"safe harbor" section 401(k) plan).[81] A plan generally satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement (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) or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement. 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.

Another safe harbor applies for 401(k) plans that provide for automatic enrollment, including automatic increases in the deferral rate. Under this 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. The amount of the safe harbor nonelective contribution is the same three percent nonelective contribution. However, the matching and nonelective are allowed to become 100 percent vested only after two years of service (rather than being immediately vested).

Top heavy rules

The top-heavy rules limit the extent to which accumulated benefits or account balances can be concentrated with key employees by specifying minimum accruals or allocation that must be provided to employees who are not key employees if the plan is top-heavy. In contrast to the other nondiscrimination requirements which are designed to test annual rates of accrual or allocation of highly compensated employees when compared to the rates of nonhighly compensated employees, the top-heavy rules test the portion of the total plan benefits or allocations that have accumulated for the benefit of key employees as a group. A key employee is an officer with annual compensation greater than $160,000 (for 2011), 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 all 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 of the accounts for all employees.

For a defined benefit plan, the top heavy minimum accrual for a year for a non-key employee is an accrual necessary for the non-key employee's accrued benefit to equal the lesser of 20 percent, or two percent multiplied by years of service, of the employee's average high five consecutive years of compensation. For a defined contribution plan, the top heavy minimum

[81] Section 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.

allocation for the year is three percent of compensation. Minimum vesting for top heavy plans is the three year cliff, or two to six year graduated, vesting that applies generally to defined contribution plans.

C. Taxation of Distributions

1. Inclusion in income

Background

Qualified retirement plans have the advantage of deferring tax on certain contributed amounts and their earnings (or accrued benefits under a defined benefit plan) until the amounts are actually distributed. The same tax deferral also applies to amounts contributed to section 403(b) plans and governmental section 457(b) plans. Upon distribution, the taxation of received amounts will vary depending on individual circumstances, including the tax bracket of the recipient, whether the distribution is made in-service or after the employee has separated from service, and whether the distribution is payable in the form of an annuity or as a lump sum.

Taxation under section 72

Distributions from qualified retirement plans, section 403(b) plans, and governmental section 457(b) plan are generally includible in gross income as ordinary income in the year in which distributed in accordance with the rules of section 72.[82] Section 402, however, provides certain explicit exceptions to this general rule for rollovers of distributions to other eligible retirement plans, and certain distributions of employer securities.

The part of any distribution that represents the plan 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.[83]

Qualified distributions from designated Roth accounts

A qualified distribution from a participant's designated Roth account is not includible in the participant's gross income, even though the distribution includes 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)

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[82] Sections 72, 402(a)(1), 403(b)(1) and 457(a). Generally, governmental section 457(b) plans do not provide for after-tax contributions so participants do not have investment in the contract and section 72 does not apply to the distribution. However, effective as of 2011, a governmental section 457(b) plan may allow employees to make designated Roth contributions, which will result in investment in the contract.

[83] Generally, under the provisions of section 72(e)(8)(B), if the distribution is not received as an annuity, the portion of any distribution that is a recovery of basis is determined by multiplying the amount of the distribution by the ratio of the employee's investment in the contract over the participant's entire account balance (or value of the accrued benefit in the case of a defined benefit plan). If after tax employee contributions are separately accounted for under a defined contribution plan, the basis recovery rules can be applied separately with respect to distributions from such separate account. If distributions under a qualified plan or section 403(b) plan are being made in the form of annuity payments, section 72(d) provides a mandatory simplified rule for determining the portion of each payment that is a recovery of basis.

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.

Net unrealized appreciation

If employer securities are distributed by a qualified retirement plan and either the distribution is a lump sum distribution or the employer securities are attributable to after-tax employee contributions, the net unrealized appreciation in the securities is excluded from the recipient's gross income.[84] Net unrealized appreciation is defined as the excess of the market value of the securities at the time of distribution over the cost or other basis of the securities to the trust.[85] In other words, it is the amount the value of the securities increased while held by the qualified retirement plan. The basis of the employer securities after distribution does not include the amount of net unrealized appreciation excluded from gross income.[86]

The exclusion for net unrealized appreciation is not available when the distribution is rolled over into another eligible retirement plan.[87] When the securities are received as part of a lump sum distribution, the recipient may elect not to exclude net unrealized appreciation.[88]

2. Early distributions

The Code imposes restrictions on the timing of distributions from qualified retirement plans. These restrictions are designed to help ensure that distributions from qualified retirement plans are used for retirement; not taken too early so that they are depleted prior to retirement or taken too late so that they are primarily a means of estate planning.

Generally, a distribution from a qualified retirement plan or section 403(b) plan prior to the employee attaining age 59½ is subject to an additional tax equal to 10 percent of the amount of the distribution that is includible in gross income unless an exception applies.[89] The 10

[84] Section 402(e)(4). Under section 402(e)(4)(E), for purposes of this exclusion for net unrealized appreciation, employer securities include shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form including of a parent or subsidiary of the employer. See section 402(e)(4)(D) for the definition of a lump sum distribution.

[85] Treas. Reg. sec. 1.402(a)-1(b)(2) provides rules for determining the cost or other basis of employer securities to the trust.

[86] Under Treas. Reg. sec. 1.402(a)-1(b)(1), when employer securities with net unrealized appreciation are sold or exchanged, any gain is treated as long-term capital gain up to the amount of the net unrealized appreciation (regardless of how long the securities were held by the taxpayer). Any gain in excess of the amount of net unrealized appreciation is long-term or short-term gain, depending on how long the taxpayer held the securities after distribution.

[87] Section 402(e)(4)(A).

[88] Section 402(e)(4)(B).

[89] Section 72(t).

percent tax is in addition to the taxes that would otherwise be due on distribution. The exceptions to the 10 percent additional tax generally include distributions due to death or disability; distributions made in the form of certain periodic payments; distributions made subsequent to the employee's separation from service after attaining age 55; distributions made on account of a tax levy on the plan; distributions made to an alternate payee pursuant to a qualified domestic relations order; distributions to the extent that they do not exceed the amount allowable as a deduction under section 213 to the employee for amounts paid during the taxable year due to medical care (determined without regard to whether the employee itemizes deductions for such year); or distributions made to a member of a reserve unit called to active duty for 180 days or longer. There is also an exception for a distribution of dividends described in section 404(k) paid with respect to stock help by an ESOP.

3. Minimum distribution requirements

In general

All qualified retirement plans, section 403(b) plans, and section 457(b) plans must meet certain minimum distribution requirements.[90] The purpose of the minimum distribution rules is to try to ensure that qualified retirement plans are used to aid in retirement, not estate planning. Failure to satisfy the minimum distribution requirements can result in a 50 percent penalty with respect to the amount of the underpayment.[91] Individuals, may, however, request that the penalty be waived if the shortfall was due to a reasonable error and reasonable steps are taken to remedy the shortfall.[92]

Pre-death distributions

To meet the minimum distribution requirements for pre-death distributions, (1) an employee's entire interest must be distributed to the employee no later than the required beginning date, or (2) the distribution must begin no later than the required beginning date and must be distributed over (a) the life of the participant, (b) over the lives of the participant and his or her designated beneficiary, (c) over a period not extending beyond the life expectancy of the participant, or (d) over a period not extending beyond the joint life and last survivor expectancy of the participant and his or her designated beneficiary.[93]

[90] Section 401(a)(9). There are special rules for governmental plans and certain annuity contracts.

[91] Section 4974.

[92] Treas. Reg. sec. 54.4974-2, Q&A-7(a). Automatic waivers are also available in certain limited circumstances when the participant's death occurs prior to the date of required distribution.

[93] Treas. Reg. sec. 1.401(a)(9)-2, A-1(a).

Required beginning date

The required beginning date is, generally, April 1 of the calendar year following the later of the calendar year in which the participant attains the age of 70½ or the calendar year in which the participant retires.[94]

Amount of required distribution

The minimum amount that must be distributed during a participant's lifetime is generally determined based on a uniform lifetime table developed by the Department of the Treasury and promulgated in regulations. The uniform lifetime table, which is redetermined annually, is based on the joint life expectancies of an individual and a hypothetical survivor who is ten years younger.

For defined contribution plans, the amount of the annual required minimum distribution generally is determined by dividing the participant's account balance by a life expectancy factor for the participant's age for each calendar year. For this purpose, the account balance is determined as of the last valuation date in the calendar year immediately preceding the calendar year in which the distribution is required, increased to reflect any contributions or forfeitures attributable to that year and decreased to reflect any distributions.[95] The divisor is generally determined using the factor in the uniform lifetime table provided in Treasury regulations.[96] However, if the participant's designated beneficiary is the participant's spouse and the spouse is more than 10 years younger than the participant, the joint life and last survivor expectancy of the couple is the divisor.[97]

For defined benefit plans, distributions of the participant's entire interest under the plan must generally be paid either in the form of periodic annuity payments for the participant's life (or the joint lives of the participant and beneficiary) or over a period certain that does not exceed the maximum length of the period determined under the uniform lifetime table for the calendar year containing the annuity starting date.[98] Increases in payments are only permitted in certain limited circumstances, including cost of living adjustments and increases pursuant to plan

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[94] Section 401(a)(9)(C). For 5-percent owners, the required beginning date is April 1 of the calendar year following the calendar year in which the participant attains the age of 70½. When a participant (other than a 5-percent owner) retires in a calendar year after the calendar year in which he or she turns 70½, a defined benefit plan is required to actuarially increase the participant's accrued benefit to take into account any time period after age 70½ during which the employee was not receiving benefits under the plan.

[95] Treas. Reg. sec. 1.401(a)(9)-5, A-3.

[96] Treas. Reg. sec. 1.401(a)(9)-9, A-2.

[97] This rule may not apply if the spouse is not the participant's sole beneficiary. However, see the special rule for separate accounts. See Treas. Reg. sec. 1.401(a)(9)-8, Q&A-2(a).

[98] Treas. Reg. sec. 1.401(a)(9)-6, Q&A-1.

amendments. Variable annuities and certain other regular increases, as well as changes in the form of payment, are permitted if certain conditions are satisfied.[99]

Minimum required distributions must satisfy the incidental benefit requirement and so must be primarily for retirement benefits. Special rules, therefore, apply to distributions in the form of a joint and survivor annuity with a nonspouse beneficiary.

Post-death distributions

If distributions begin before the participant's death, but the participant's entire interest has not been distributed prior to death, the remaining interest must be distributed at least as rapidly as under the method of distribution being used at the date of death.[100] For purposes of determining the rate of post-death distributions, distributions generally are deemed to have not started before the participant's required beginning date even if payments were actually made prior to that date.[101]

If the participant dies before the participant's required beginning date, distributions must follow one of two rules. The first rule, known as the five-year-rule, requires the participant's entire interest to be distributed by December 31 of the calendar year containing the fifth anniversary of the date of the participant's death.[102] The second rule is known as the life-expectancy method. Under the life-expectancy method of making post-death distributions, any portion of a participant's interest that is payable to or for the benefit of a designated beneficiary must be distributed beginning within one year of the participant's death. The distribution must be made over the life of the designated beneficiary or over a period not extending beyond his or her life expectancy.[103] If the designated beneficiary is not the participant's spouse, distributions must begin no later than December 31 of the calendar year immediately following the calendar year in which the participant died. Under a special rule for designated beneficiaries who are surviving spouses of participants, however, surviving spouses may begin receiving distributions on or before the later of December 31 of the calendar year immediately following the participant's death or December 31 of the calendar year in which the deceased participant would have attained age 70½.[104] The regulations provide rules parallel to the rules for pre-death distributions for defined contribution plans and defined benefit plans for determining the amount of each annual required distribution.

[99] Treas. Reg. sec. 1.401(a)(9)-6, Q&A-13 and 14.

[100] Section 401(a)(9)(B)(i).

[101] Treas. Reg. sec. 1.401(a)(9)-2, Q&A-6(a).

[102] Treas. Reg. sec. 1.401(a)(9)-3, A-2.

[103] Treas. Reg. sec. 1.401(a)(9)-3, A-1(a).

[104] Treas. Reg. sec. 1.401(a)(9)-3, A-3(a).

4. Rollovers

General rule

A distribution from a qualified retirement plan, section 403(b) annuity, or a governmental section 457(b) plan that is an eligible rollover distribution may be rolled over to an eligible retirement plan. 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 certain exceptions which include certain periodic payments, required minimum distributions, and hardship distributions.[105]

Eligible retirement plans include qualified retirement plans, section 403(b) plans, governmental section 457(b) plans, and IRAs. However, only a Roth IRA or designated Roth account is an eligible retirement plan with respect to distributions from a designated Roth account.

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).[106]

Direct rollovers

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. 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.

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.[107] 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

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[105] Section 402(c)(4). Treas. Reg. sec. 1.402(c)-1 identifies certain other payments that are not eligible for rollover which include, for example, certain corrective distributions, loans that are treated as deemed distribution under section 72(p), and dividends on employer securities as described in section 404(k).

[106] Section 402(c)(11).

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

percent withheld will remain taxable unless the participant substitutes funds within the 60 day period.[108]

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.

<u>Roth conversions</u>

Distributions from qualified retirement plans, 403(b) annuities, and governmental 457(b) plans may be rolled into a Roth IRA even though the distribution is not from a designated Roth account.[109] Distributions from these plans that are rolled over into a Roth IRA and that are not distributions from a designated Roth account must be included in gross income.

<u>Required notice</u>

Plan administrators are required to provide a written explanation of the plan's distribution options, including direct rollover provisions and mandatory withholding requirements. The notice must be provided to participants within a reasonable time before the distribution is made (generally, between 30 and 180 days before distribution). The notice must explain the direct rollover rules, the mandatory withholding rules, options for sixty-day rollover, and, if applicable, special taxation rules. The Internal Revenue Service has a model notice that can be used to help plan administrators meet these requirements. Failure to provide notice can subject the administrator to a fine of $10 per employee, not to exceed $5,000, and may have the potential to lead to plan disqualification. Notices must be provided individually to each distributee, but may be delivered electronically.

5. Plan loans

<u>In general</u>

Qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans generally are permitted, but are not required, to offer plan loans to participants.

Section 72(p) requires that plan loans comply with certain conditions so that the loan is not treated as a taxable distribution to the participant.[110] Generally, loans that do not satisfy all

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[108] 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.

[109] Section 408A(e). The Small Business Jobs Act of 2010 (Pub. L. No. 111-240) provides special rules for in-plan Roth conversions.

[110] Section 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). In addition to the loan requirements discussed below, there are special rules for the interest rate that can be charged to an employee who leaves for military service.

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.

Maximum loan amount

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.[111]

Repayment terms

Generally, a plan loan is treated as a deemed distribution unless it provides for repayment within five years of the loan date[112] and for substantially equal payments of both principal and interest at least no less frequently than quarterly over the term of the loan.[113]

Deemed distributions and plan loan offsets

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 operate so 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 under section 72(p), a loan offset amount can be an eligible rollover distribution. A plan is not, however, required to offer a direct

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[111] Section 72(p)(2)(A). All employers in the controlled or affiliated group are treated as one employer for purposes of determining the maximum loan limits. Deemed distributions are generally treated as outstanding loans for purposes of determining the maximum loan amount.

[112] Section 72(p)(2)(B). There is an exception to the five-year rule for loans used to purchase the participant's principal residence and in the case of military service. Plans may suspend repayment of a loan while the participant is performing services in the uniformed services of the United States. Under Treas. Reg. sec. 1.72(p)-1, Q&A-9(b) and (c), 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).

[113] Section 72(p)(2)(C). 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.

rollover with respect to the loan offset amount and the amount is generally not subject to mandatory 20 percent withholding.

6. 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.[114] 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.[115] 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.[116] There are, however, regulatory safe harbors whereby the requirements may be deemed to have been met.[117] 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.

[114] Section 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.

[115] Section 457(b) plans may provide for distributions in the case of an unforeseeable emergency. Section 457(d)(1)(iii).

[116] Treas. Reg. sec. 1.401(k)-1(d)(3)(i).

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

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,[118] to which both deductible and nondeductible contributions may be made,[119] and Roth IRAs, to which only nondeductible contributions may be made.[120] 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 2011)[121] 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 2011 ($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

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[118] Section 408.

[119] Section 219.

[120] Section 408A.

[121] The dollar limit is indexed for inflation.

with AGI for the taxable year over certain indexed levels. In the case of an individual who is an active participant in an employer-sponsored plan, the AGI phase-out ranges for 2011 are: (1) for single taxpayers, $56,000 to $66,000; (2) for married taxpayers filing joint returns, $90,000 to $110,000; 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 2011 between $169,000 and $179,000.

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, subject to the same limits as 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 2011 are: (1) for single taxpayers, $107,000 to $122,000; (2) for married taxpayers filing joint returns, $169,000 to $179,000; 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.[122] The amount converted is includible in the taxpayer's income as if a withdrawal had been made,[123] 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.

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[122] 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.

[123] A special rule is provided in the case of a rollover 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.[124] 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.[125]

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.[126] 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.[127] To receive this treatment, the taxpayer must not have claimed a deduction for the amount of the distributed contribution.

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.[128] 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

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[124] Section 408A(d)(6).

[125] Treas. Reg. sec. 1.408A-6.

[126] Sections 4973(b) and (f).

[127] Section 408(d)(4).

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

contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings; amounts that are attributable to a return of contributions to the Roth IRA are not includable 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.

Early distribution tax

Early withdrawals from an IRA, i.e., before age 59½, generally are subject to an additional 10-percent tax to the extent includible in income unless an exception applies.[129] This additional tax applies to distributions from both traditional and Roth IRAs.[130] Exceptions to the additional tax include withdrawals due to death or disability; made in the form of certain periodic payments; used to pay medical expenses in excess of 7.5 percent of AGI; used to purchase health insurance for certain unemployed individuals; used for higher education expenses; used for first-time homebuyer expenses of up to $10,000; or made to a member of a reserve unit called to active duty for 180 days or longer.

Required minimum distributions

Distributions from traditional IRAs generally are required to begin by the April 1 of the year following the year in which the IRA owner attains age 70½. To the extent that the required minimum amount for a year is not distributed, the distributee is subject to an excise tax equal to 50 percent of the difference between the amount distributed for the year and the amount that was required to be distributed.[131] Distributions are required to be made (in accordance with regulations) over the life or life expectancy of the IRA owner, or over the joint lives or joint life

[129] Sec. 72(t). Section 72(t) also governs early distributions from qualified plans and section 403(b) plans.

[130] Because distributions from Roth IRAs attributable to contributions (including conversion contributions) are not includible in gross income and distributions from all Roth IRAs are treated as first attributable to contributions, the early-distribution tax generally will only apply to a distribution from a Roth IRA when only amounts attributable to earnings remain in all Roth IRAs. However, as noted earlier, a special rule applies for withdrawals within five years of a conversion.

[131] Section 4974.

expectancy of the IRA owner and a designated beneficiary.[132] The regulations implement this provision by providing generally that the required minimum distribution is determined by dividing the IRA account balance as of the end of the prior year by a distribution period,[133] generally a number in the uniform lifetime table.[134] This table is based on joint life expectancies 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 expectancy is greater than the uniform life time table), the joint life expectancy of the couple is used. There are special rules in the case of annuity payments from an insurance contract.

If an IRA owner dies after minimum required distributions have begun, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death. The regulations interpret this as allowing payments using a distribution period equal to the remaining years for the beneficiary's life or, if there is no designated beneficiary, a distribution period equal to the remaining years of the IRA owner's life, as of the year of death.[135]

If the IRA owner dies before minimum distributions have begun, then the entire remaining interest must generally be distributed within five years of the IRA owner's death. The five-year rule does not apply if distributions begin within one year of the IRA owner's death and are payable (in accordance with regulations) over the life or life expectancy of a designated beneficiary. For payments over life expectancy, the required minimum distribution for a year is calculated using a distribution period that is determined by reference to the beneficiary's life expectancy.[136] Special rules apply if the beneficiary of the IRA is the surviving spouse.

Roth IRAs are not subject to the minimum distribution rules during the IRA owner's lifetime. However, Roth IRAs are subject to the post-death minimum distribution rules that apply to traditional IRAs.

<u>Rollovers</u>

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.

[132] Treas. Reg. sec. 1.408-8 provides rules for required minimum distributions from IRAs. Generally those rules incorporate by reference the rules in Treas. Reg. sec. 1.401(a)(9)-1 through -9.

[133] Treas. Reg. sec. 1.401(a)(9)-5.

[134] Treas. Reg. sec. 1.401(a)(9)-9.

[135] Treas. Reg. sec. 1.401(a)(9)-5, A-5(a).

[136] Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

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.[137] 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 a distributions from a Roth IRA may only be rolled over tax free to another Roth IRA. However, a distributions from a traditional IRA may be rolled over to a Roth IRA if the distributions in included in gross income in accordance with section 408(d)(1).

<u>Deemed IRAs</u>

Certain types of employer-sponsored retirement plans are permitted to provide IRAs to employees as a part of the plan.[138] 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.[139]

<u>Payroll deduction IRA</u>

Under current law, 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, 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."[140] Congress encouraged the Secretary of the Treasury to "continue his efforts to publicize the availability of these payroll deduction IRAs."[141] In response to that directive, the IRS published Announcement 99-2,[142] which reminds employers of the availability of this option for their employees.

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[137] A trustee to trustee transfer between IRAs is not treated as a distributions 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 rollover a distribution to his or her own IRA.

[138] Sec. 408(q).

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

[140] Pub. L. No. 105-34.

[141] H. Rep. No. 102-220, p. 775 (1997).

[142] 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.

In 1975, the Department of Labor ("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 the Employee Retirement Income Security Act ("ERISA").[143] Interpretive Bulletin 99-1[144] restated and updated the DOL's positions on these programs. 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.[145]

2. Employer retirement plans using IRAs

SIMPLE IRA plan

Under present law, a small business that employs fewer 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 savings incentive match plan for employees ("SIMPLE") retirement plan. A SIMPLE retirement plan is generally a plan under which contributions are made to an individual retirement arrangement for each employee (a "SIMPLE IRA").[146] A SIMPLE retirement plan allows employees to make elective deferrals to a SIMPLE IRA, subject to a limit of $11,500 (for 2011). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions under a SIMPLE retirement plan up to a limit of $2,500 (for 2011).

In the case of a SIMPLE retirement 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 retirement 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

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[143] Labor Reg. sec. 2510.3-2(d).

[144] 64 F.R. 32999, June 18, 1999; Labor Reg. sec. 2509.99-1.

[145] Labor Reg. sec. 2509.99-1.

[146] There is also an option to provide a SIMPLE plan as part of a section 401(k) plan (a "SIMPLE section 401(k)" plan). In the case of a SIMPLE section 401(k) plan, the group of employees eligible to participate must satisfy the minimum coverage requirements generally applicable to qualified retirement plans under section 410(b). A SIMPLE section 401(k) plan does not have to satisfy the ADP or ACP test and is not subject to the top-heavy rules. The other qualified retirement plan rules generally apply.

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.[147] 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 retirement 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.[148]

No contributions other than employee elective contributions, required employer matching contributions, or employer nonelective contributions can be made to a SIMPLE retirement 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 ($49,000 for 2011).[149] 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 2011) 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 retirement 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 ($16,500 for 2011). 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 2011).

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[147] This option is not available for SIMPLE section 401(k) plans.

[148] IRS Notice 98-4, 1998-1 C.B. 269.

[149] Section 408(k).

II. 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 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."[150]

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.[151] The existence of IRAs and other tax-advantaged forms

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[150] See Joseph Bankman and David Weisbach, "The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax," 58 *Stanford Law Review*, 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: Income = Consumption + Change in Wealth. A consumption tax, of course, imposes tax on 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 in turn comprises new investment (or withdrawals of previously-invested capital) and returns on capital, which is a way of saying that, 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.

[151] 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.[152] 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 usually is less than that income), (2) difficulties in making a consumption tax as progressive as an income tax, since the poor consume a larger share of their income immediately, and (3) many difficult transition issues in moving from an income tax system to a consumption tax, including whether and how to tax "old" capital that was created under an income tax system.

Cash flow approach to consumption taxation

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

A cash-flow consumption tax is similar to the treatment of deductible IRAs and defined contribution plans under present law. Using deductible IRAs, taxpayers deduct contributions to qualified accounts in the year they make contributions, earnings on the account are excluded from income, and upon withdrawal taxpayers include in income the entire amount withdrawn. Similarly with defined contribution plans, employer contributions and employee elective contributions are deductible to the employer and generally excluded from the income of the employee, earnings on the account are excluded from income, and upon withdrawal the entire amount withdrawn is included in income.

A full cash-flow consumption tax treats all saving, not just retirement 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.

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[152] 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*, 2nd ed., rev. Arlington VA: 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 effect of cash-flow treatment, as in a deductible IRA or defined contribution plan, is that the taxpayer receives a tax-free return on his savings, assuming the tax rate is the same at the time of deduction (or exclusion) and withdrawal. Specifically, the taxpayer is able to defer consumption from one period to the next and earn the full pretax rate of return on the deferred consumption.

Defined benefit plans also provide cash-flow consumption tax treatment with respect to the employer contributions to the plan, as these contributions are deductible for the employer and excluded from the income of the employee. The earnings on the plan's assets are excluded from income, and upon receipt of benefits the full benefit attributable to the employer contribution is included in income. However, employee contributions to the plans do not receive consumption tax treatment, as these contributions are generally made on an after-tax basis.

The following example illustrates how the cash-flow 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

Another way to implement a consumption tax indirectly is to include in the base only earned income. Taxpayers claim no deduction for savings, but their returns to saving, whether in the form of interest, dividends, rents, royalties, or capital gains, are excluded from the base of the tax and thus are received tax-free. This "tax prepayment" approach[153] treats all savings as coming from after-tax dollars. In terms of the previous example, a taxpayer initially pays tax of $200 on the $1,000 he sets aside from current consumption. When he withdraws the $840 in the following year (the $800 he was able to put in the account plus a five-percent return), none of that is included in the tax base. This tax prepayment approach is similar to that provided under present law for Roth IRAs and to the individual portion of the Hall-Rabushka flat tax [154] and the Bradford X-tax.[155]

[153] This approach is sometimes described as a "yield exemption" approach.

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

[155] 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, Washington, D.C., 2005. See also David F. Bradford, *The X Tax in the World Economy,* AEI Press, Washington, D.C., 2004. See also David F. Bradford, *Untangling the Income Tax,* Harvard University Press, Cambridge, MA, 1986.

Practical 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.[156] Other studies have argued that large behavioral responses to changes in the after-tax rate of return need not occur.[157] Empirical investigation of the responsiveness of personal saving to the taxation of investment earnings provides no conclusive results.[158] Some find personal saving responds strongly to increases in the net return to saving,[159] while others find little or a negative response.[160] Studies of retirement savings incentives follow a similar pattern, with some finding an increase in saving as a result of the incentives,[161] while others find little or no increase as retirement plan savings substitute for other saving.[162] One recent study questions the underlying assumptions of individual behavior in economic models with respect to retirement planning decisions. This study posits that these implicit assumptions are not correct and that effective policy must take into account a correct set of assumptions about individual behavior.[163] With respect to the tax-favored forms of saving, the

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

[157] 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*, (Washington, D.C.: Brookings Institution), 1988.

[158] See Douglas W. Elmendorf, "The Effect of Interest-Rate Changes on Household Saving and Consumption: a Survey," *Finance and Economics Discussion Series*, 96-27, (Washington D.C.: Board of Governors of the Federal Reserve System), 1996.

[159] Michael Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, 86, April 1978.

[160] George von Furstenberg, "Saving," in Henry Aaron and Joseph Pechman (eds.), *How Taxes Affect Economic Behavior*, (Washington, D.C.: Brookings Institution), 1981.

[161] Daniel J. Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification", *Journal of Public Economics*, Volume 87, Issues 5-6, May 2003, pages 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*, Volume 58, Issue 1, September 1995, pages 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), pages 91-112.

[162] 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 (Dec., 1994), pages 1233-1260.

[163] Benartzi, Shlomo and Richard H. Thaler, "Heuristics and Biases in Retirement Savings Behavior," *Journal of Economic Perspectives*, Vol. 21, No. 3 (Summer 2007), pages 81-104.

revenue loss to the Federal government represents a decline in government saving, and thus must be accounted for to determine net national saving.

III. DATA RELATING TO QUALIFIED RETIREMENT PLANS

A. General Data on Qualified Retirement Plan Participation

According to the Current Population Survey,[164] 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.

Table 1.−Participation in Private Qualified Retirement Plans, 2008
Private-Sector Wage and Salary Workers, Aged 25-64

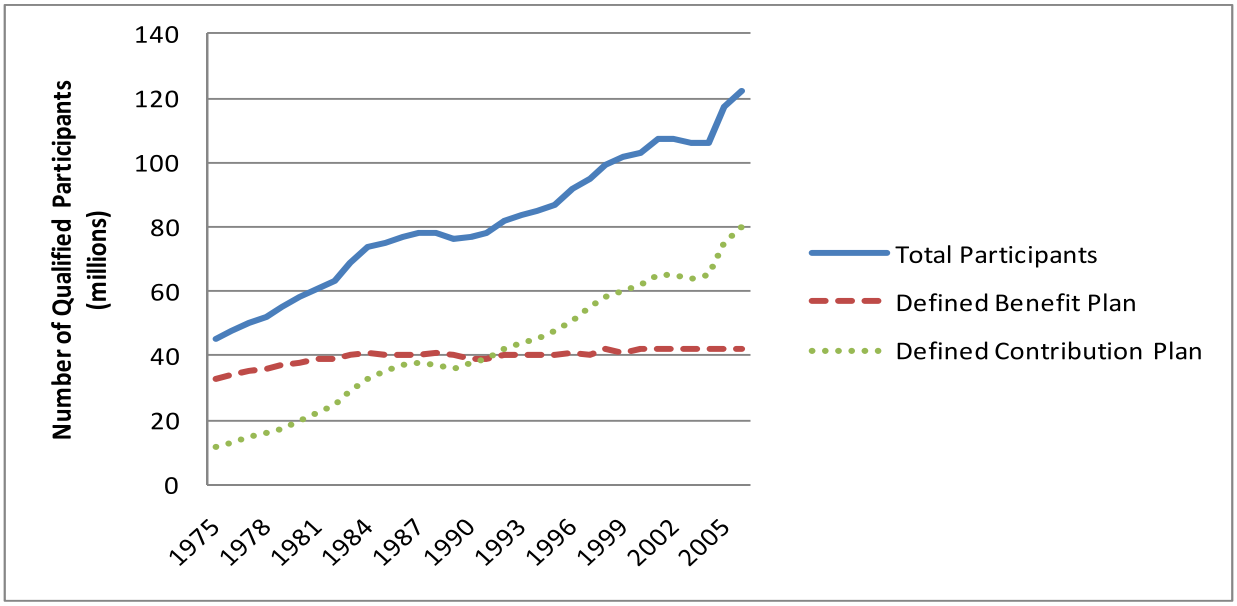
Age	Workers (thousands)	Employer Sponsors a Plan (Percentage)	Employee Participation Rate (Percentage)
2005	72,331	54.9	45.0
2006	74,542	52.6	43.2
2007	74,588	54.8	45.1
2008	72,036	53.2	43.6

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

Figure 1 below shows that the number of participants in defined contribution plans has steadily increased since at least 1975 and up to 2006, while participation rates in defined benefit plans have held steady over this same period.

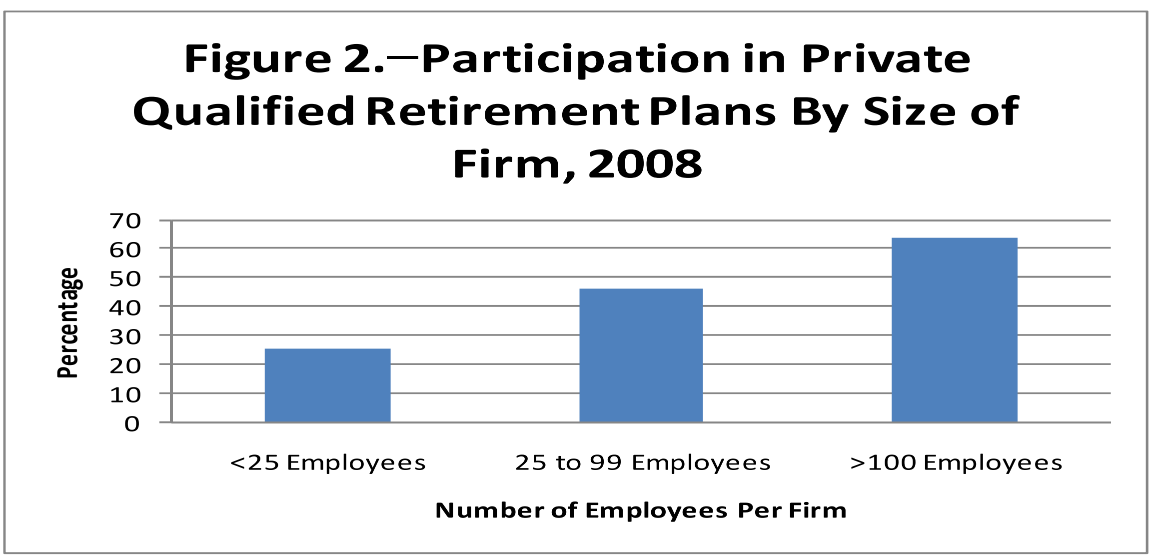
[164] The Current Population Survey is a monthly survey of 50,000 households conducted by the Bureau of the Census for the Bureau of Labor Statistics.

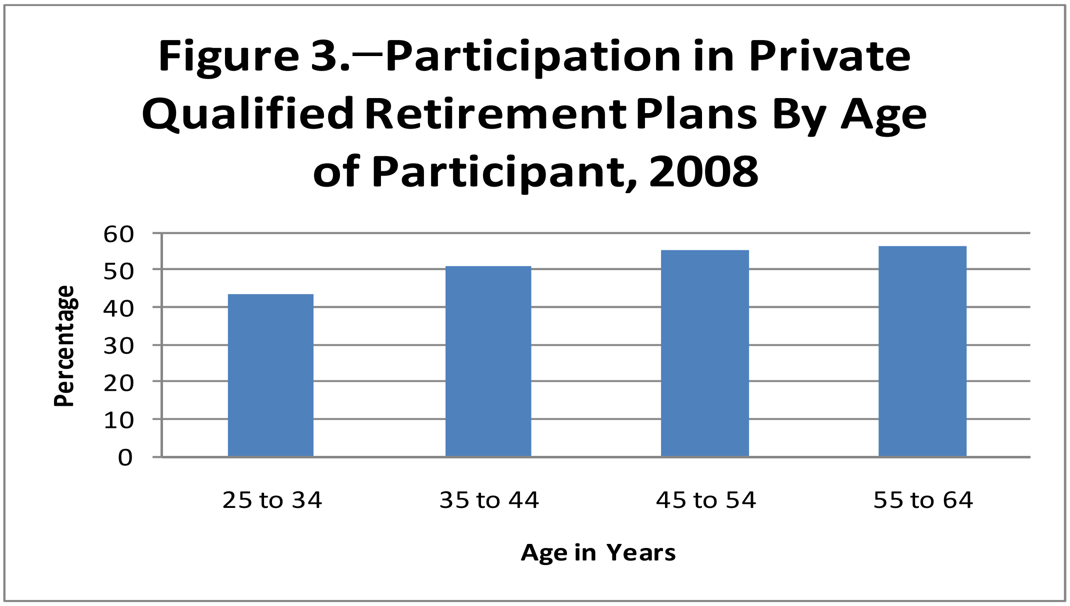
Figure 1.–Number of Private-Sector Qualified Participants by Type of Plan 1975-2006 (millions)

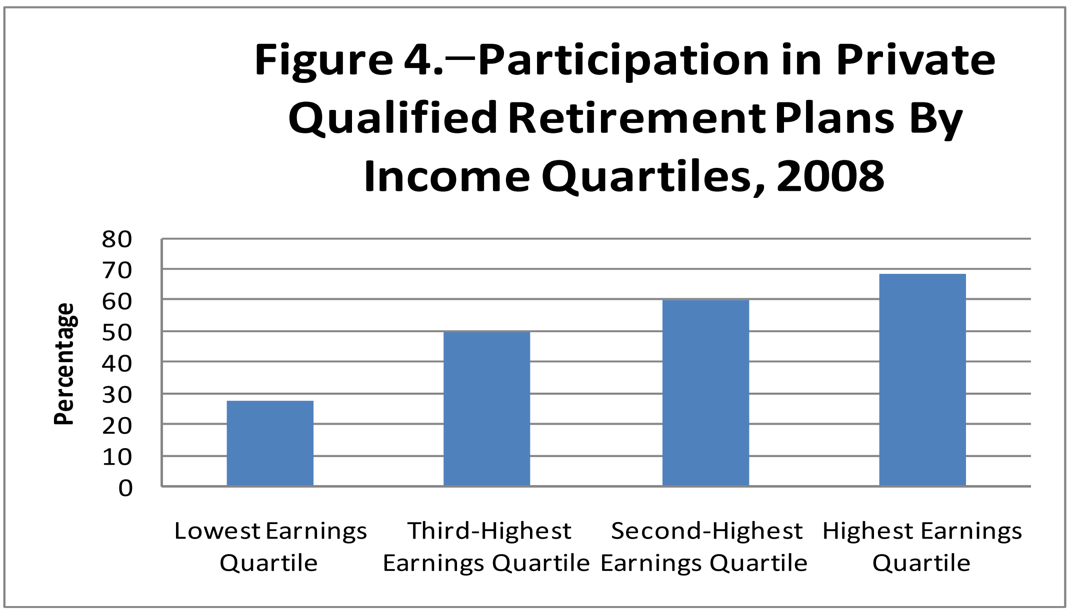


Source: Employee Benefit Research Institute tabulations.

Participation in employer-sponsored qualified retirement plans varies with tenure, firm size and industry. Figures 2, 3, and 4 below, present data from the Current Population Survey in 2008. Participation rates are higher for older workers, for workers who work in larger firms, and for workers with higher incomes. Participation rates are higher in the public sector than in the private sector.





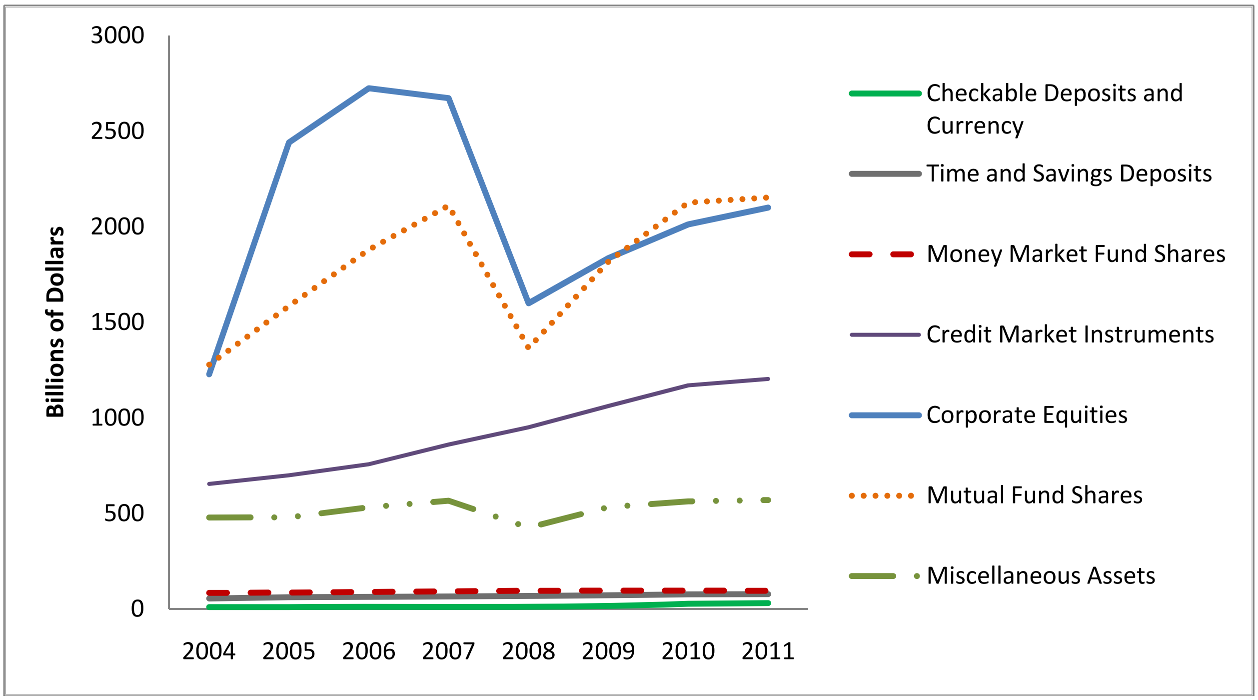


Source: Congressional Research Service, Pension Sponsorship and Participation: Summary of Recent Trends, 2009.
Notes: Includes private-sector wage and salary workers, aged 25 to 64, employed year-round, full-time.

B. Data on Qualified Retirement Plan Assets

Data from the Board of Governors of the Federal Reserve, Flow of Funds shows the composition of assets held in qualified retirement plans. Figure 5 below shows the majority of assets are held in corporate equities and mutual fund shares, with nominal holdings of checkable deposits and currency, time and savings deposits, and money market fund shares. The data show that holdings of corporate equities and mutual fund shares increased relatively more than credit market instruments and other types of assets between 2004 and 2007, with a relatively large drop in 2008. Since 2008, mutual fund shares have regained some of their value to approximately 2007 levels. However, the value of corporate equities in qualified retirement plan assets remains below 2007 levels.

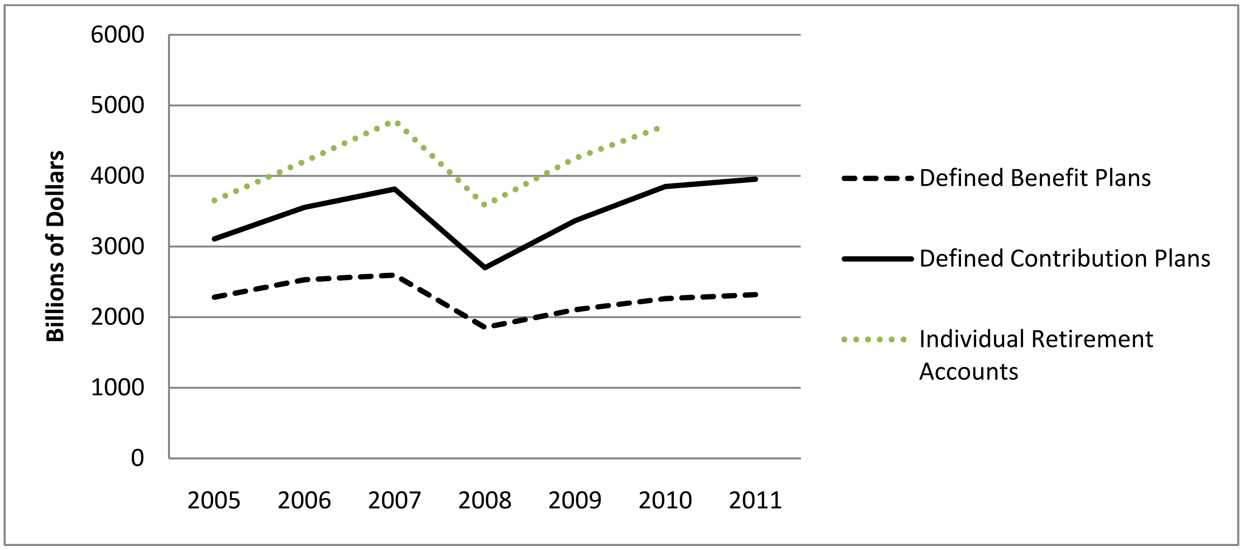
Figure 5.−Composition of Assets Held in Qualified Retirement Plans



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

Figure 6 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.

**Figure 6.−Market Value of Assets Held in Qualified Retirement Plans,
By Type of Plan**



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

IV. DATA RELATING TO INIDIVIDUAL RETIREMENT ACCOUNTS

Individual retirement accounts ("IRAs") are an important element of U.S. personal savings. Table 2, below, shows annual contributions and rollover data for recent years. In 2005, $15.8 billion was contributed to traditional IRAs, and $18.6 was contributed to Roth IRAs.[165] Amounts rolled over from previously saved funds in employer plans – over $231.3 billion in 2005 – dwarf the annual contributions to IRAs.

Table 2.–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).

[165] An additional $14.6 billion was contributed to SEP plans and $8.6 billion to SIMPLE plans.

Table 3 shows the distribution of taxpayer contributions to traditional and Roth IRAs by income class.

Table 3.–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.

Statistics such as those shown in Table 3 are often cited by critics of tax-favored savings arrangements. These critics also observe that IRAs are used primarily by higher income taxpayers who would save for retirement with or without a tax subsidy and that these taxpayers may be simply moving existing savings into tax-favored accounts. 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.[166] As a result of these observations, some believe that IRAs have not been very effective in increasing retirement savings by low income taxpayers.

Figure 6 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.

[166] Victoria Bryant, "Accumulation and Distribution of Individual Retirement Arrangements, 2004," *Statistics of Income Bulletin*, Spring 2008.