1999 Income Tax School

RETIREMENT

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INTRODUCTION

When consulting with clients regarding retirement plan design as well as planning for retirement assets, the advisor must have a thorough understanding of the client's goals and objectives in order to assist the client in making a well-informed and intelligent decision. **In planning for distribution of retirement assets, the advisor must have a thorough understanding of the complex retirement distribution rules.** To say the least, this is a very challenging area of tax law. This chapter will provide a **general overview** of key concepts and considerations.

PLAN DESIGN CONSIDERATIONS

A consideration for many closely held businesses today is determining a retirement plan for the owner as well as the rank-and-file employees. This section discusses some of the most commonly used plans and the types of businesses that typically benefit from the use of a specific plan. The circumstances, goals, and objectives of a particular client's situation will drive this decision.

KEOGH (H.R. 10) PLAN [I.R.C. §401(A)]

A Keogh plan may be established **only** by a sole proprietor, a partnership, or an entity treated as a partnership. For purposes of participation in a qualified plan, a self-employed individual is treated as an employee. There are very few differences between a corporate plan and a Keogh plan. A Keogh plan can be established as **either** a **defined contribution plan** or a **defined benefit plan.** A defined contribution plan is more common and will be the focus of this discussion. A defined contribution plan can be **either** a **profit-sharing plan** or a **money purchase pension plan.**

WHO MUST BE INCLUDED

If a self-employed individual has employees, the employees who meet minimum participation requirements must be allowed to participate. A Keogh plan cannot discriminate in favor of highly compensated employees. The following are the **minimum participation** requirements:

1. The employee has reached age 21.
2. The employee has **at least one year of service** (two years if there is a two-year full vesting provision in the plan). A **year of service** is generally defined as a 12-month period during which the employee has **1,000 or more hours of service** [I.R.C. §401(a)(1)].

The plan may have more liberal participation requirements, but it cannot have more restrictive standards.

This chapter was written by Robert S. Keebler, CPA, MST

Practitioner Note. A minister is not a self-employed person for the purposes of retirement plan coverage.

CONTRIBUTION LIMITATIONS

Contributions are limited to a **percentage** of the participant's qualified compensation. For 1999, the maximum qualified compensation per participant is $160,000.

Compensation. Compensation for **employees** subject to FICA taxes is calculated without any adjustment for employer plan contributions. It generally includes all taxable pay plus amounts contributed to benefit plans under salary reduction agreements. However, plans can specifically exclude salary reductions. Compensation does not include nontaxable reimbursements under accountable plans.

Compensation for **self-employed persons** generally is the Schedule SE net earnings from self-employment minus the self-employment tax deduction, reduced by the Keogh plan contribution. The reduction for the plan contribution is accomplished by adjusting the contribution rate for the self-employed person.

Example 1. Marla is a sole proprietor and has employees. The terms of her plan provide that she contribute 10½% (.105) of her net earnings and 10½% of her common-law employees' pay. Her **1999** net earnings amount from line 31, Schedule C (Form 1040) is $200,000. In figuring this amount, she deducted her common-law employees' pay of $60,000 and contributions for them of $6,300 (10½% × $60,000). This net earnings amount is now reduced to $192,821 by subtracting her self-employment **tax deduction** of $7,179. She figures her self-employed rate and deduction for employer contributions on behalf of herself as follows:

Self-Employed Person's Rate Worksheet

1. Plan contribution rate as a decimal (for example, 10% would be 0.10).	0.105
2. Rate in line 1 plus 1, as a decimal (for example, 0.10 plus 1 would be 1.10).	1.105
3. Divide line 1 by line 2. This is your self-employed rate as a decimal.	0.095023
Step 1. Enter your rate from the Self-Employed Person's Rate Table or Self-Employed Person's Rate Worksheet.	$ 0.095023
Step 2. Enter the amount of your net earnings from line 31, Schedule C (Form 1040) or line 36, Schedule F (Form 1040).	$ 200,000
Step 3. Enter your deduction for self-employment tax from line 27, Form 1040.	$ 7,179
Step 4. Subtract Step 3 from Step 2 and enter the amount.	$ 192,821
Step 5. Multiply Step 4 by Step 1 and enter the anount.	$ 18,322
Step 6. Multiply $160,000 by your plan contribution rate. Enter the result but not more than $24,000. [0.105 × $160,000].	$ 16,800
Step 7. Enter the smaller of Step 5 or Step 6. This is your deductible contribution. Enter this amount on line 29, Form 1040.	$ 16,800

Practitioner Note. If a self-employed person has more than one business, only the compensation from the business(es) adopting a Keogh plan is considered for the plan.

Deductible Contributions. Keogh plan contributions are deductible by the employer, within limits. Different limitations apply to money-purchase pension plans than to profit-sharing plans. For a **money-purchase pension plan,** the contribution is limited to the lesser of:

1. $30,000, or
2. 25% of the employee's or self-employed individual's annual compensation [I.R.C. §415(c)].

Example 2. Phil has annual compensation of $100,000 and is a participant in a money purchase pension Keogh plan with a 25% contribution rate. The employer **must** contribute $25,000 on his behalf to the Keogh plan.

Example 3. Assume the same facts as Example 2 except that Phil's annual compensation is $150,000. The contribution to his plan is limited to $30,000.

For **profit-sharing plans,** the percentage limitation is lower–15%. The $30,000 limitation technically is the same as for money purchase plans, but the $160,000 compensation limit in reality lowers the maximum contribution to $24,000 [I.R.C. §404(a)(3)].

Example 4. Jane, an employee, is a participant in a profit-sharing Keogh plan and has annual compensation of $180,000. The maximum contribution to her profit-sharing Keogh plan is $24,000 ($160,000 compensation limitation × 15% limitation).

Employers have some flexibility in making contributions to a profit-sharing Keogh plan. However, contributions to a money purchase pension Keogh plan are **mandatory.**

ESTABLISHING A KEOGH

Establishing a Keogh plan is essentially the same as establishing a qualified plan for a corporation. A written plan must be adopted and communicated to the employees. Most businesses do not attempt to design their own plans. Master and prototype plans are provided by banks, trade organizations, insurance companies, brokerage firms, and mutual funds. **The plan must be established prior to the end of the business's tax year. Contributions then can be made on or before the due date (including extensions) of the business's federal income tax return for the year. Form 5500 is required annually.**

WHO IS A LIKELY CANDIDATE FOR A KEOGH?

Employers who want to exclude certain part-time employees and who want vesting schedules are excellent candidates for Keogh plans. A money-purchase pension plan involves additional administrative tasks, and therefore expense, compared to a profit-sharing plan. In addition, employers who do not want to have mandatory contributions may choose a **profit-sharing** Keogh plan. An employer who can afford to contribute more than 15% to a plan (typically a company with stable profits) may desire a money purchase pension Keogh plan. A combination of plans can be used, but administrative cost is increased.

SIMPLIFIED EMPLOYEE PENSION (SEP)

A simplified employee pension (SEP) is a plan under which the employer makes contributions directly to an IRA that satisfies the statutory requirements of I.R.C. §408(k). The investment provisions of the individual's SEP will determine how the funds are invested.

WHO MUST BE INCLUDED

An employee must be permitted to participate in a SEP if the employee has:

1. Attained age 21,
2. Performed service for the employer during at least three of the immediately preceding five years, and
3. Received at least $400 (for 1999) in compensation from the employer for the year.

An employer may establish more liberal participation standards. Every employee who meets the established requirements is eligible to participate in the SEP. A SEP may not discriminate in favor of highly compensated employees.

CONTRIBUTION LIMITATIONS

Compensation and contribution limits for SEPs are the same as those for profit-sharing Keogh plans [I.R.C. §404(h)]. Employer contributions to a SEP can vary from year to year. A participant may make additional contributions to an IRA, but he or she is treated as a participant in a qualified plan for purposes of computing the deductibility of the SEP contribution.

ESTABLISHING A SEP

An employer may use Form 5305-SEP to satisfy the written arrangement requirement for creating a calendar-year SEP. In addition, SEPs must be opened for each employee. The SEP can be established **after** the close of the year for which contributions are made. However, the plan must exist at the time the contributions are made. The deadline for establishing and contributing to a SEP plan is the due **date** of the business's income tax return, **including extensions.**

An employer who signs a SEP agreement is not required to make any contribution to the SEPs that are established. However, if the employer does make contributions, the contributions must be based on a written allocation formula that does not discriminate in favor of highly compensated employees.

WHO IS A LIKELY CANDIDATE FOR A SEP?

There is no limit on the number of employees for an employer to establish a SEP. Generally, small business owners (fewer than 30 employees) should consider the use of SEPs due to the relative low cost of establishing a SEP. Further, the employer has flexibility with regard to contributions to the plan each year. Because contributions to a SEP consist solely of employer contributions, the employer must be willing to contribute to the SEP on behalf of the employee. An advantage of a SEP over a Keogh plan is the ability to establish it after December 31 of the current tax year.

Observation. Salary reduction SEPS (SARSEPs) cannot be established after 1996.

SAVINGS INCENTIVE MATCH PLAN FOR EMPLOYEES (SIMPLE-IRA) [I.R.C. §408(P)]

SIMPLE-IRAs may be established by employers with no more than 100 employees who earned $5,000 or more in the prior year. A SIMPLE-IRA plan allows employees to elect to defer compensation up to specific limitations. All contributions are deposited into SIMPLE-IRAs maintained with an institution licensed to maintain IRAs. A separate SIMPLE-IRA is maintained for each participant. Employer contributions may be matching (going only to employees who elect a salary deferral) or nonelective, on behalf of all eligible employees.

WHO MUST BE INCLUDED

An employee is eligible to participate in a SIMPLE-IRA if the employee:

1. Received at least $5,000 in compensation from the employer during any **two** preceding years.
2. Is reasonably expected to receive at least $5,000 in compensation during the **current** year.

An employer may establish less restrictive eligibility requirements.

CONTRIBUTION LIMITATIONS

The 1999 maximum annual salary deferral for a SIMPLE-IRA is $6,000. The minimum employer contribution required is either (1) a 3% match or (2) a 2% nonelective contribution. The 3% match can be reduced to 1% in two out of five years, with prior notification to the employees. The percentage is applied to the employee's compensation before adjustment for the salary deferral.

Example 5. Bob established a SIMPLE for his unincorporated consulting business with a 3% employer match. He elects to defer $6,000 of his 1999 $20,000 net earnings into a SIMPLE. The employer contribution is $600 (3% of $20,000). Bob's $6,600 contribution is deducted on Form 1040 as shown below.

Adjusted Gross Income	23	IRA deduction (see page 25)	23			
	24	Student loan interest deduction (see page 27)	24			
	25	Medical savings account deduction. Attach Form 8853	25			
	26	Moving expenses. Attach Form 3903	26			
	27	One-half of self-employment tax. Attach Schedule SE	27			
	28	Self-employed health insurance deduction (see page 28)	28			
	29	Keogh and self-employed SEP and SIMPLE plans	29	*6,600*		
	30	Penalty on early withdrawal of savings	30			
	31a	Alimony paid **b** Recipient's SSN ►	31a			
	32	Add lines 23 through 31a			32	
	33	Subtract line 32 from line 22. This is your **adjusted gross income** ►			33	

Example 6. Tom is an employee of Bob's consulting firm and has elected to defer $400 of his 1999 compensation of $20,000. Even though Bob has established a 3% employer matching contribution, he is only required to contribute $400 to Tom's SIMPLE-IRA. An employer is required to match the employee deferred amount **up to** the 3% maximum or the 1% reduced matching contribution.

ESTABLISHING A SIMPLE-IRA

There are two steps in establishing a SIMPLE-IRA: (1) the plan document is executed to establish the program and authorize the employer to make the contributions and (2) a SIMPLE-IRA document is signed by the employee to establish the IRA vehicle that accepts SIMPLE contributions.

A SIMPLE-IRA plan year must be a calendar year. A plan must be established before October 1 for contributions in the current calendar year (Notice 98-4, Q&A K-1). Employer contributions may be made by the due date of the employer's income tax return, including extensions. However, an employee's elective deferral contributions must be deposited within 30 days after the end of the month in which they were withheld. The employee's salary reduction contributions must be taken out of the current compensation during the tax year.

WHO IS A LIKELY CANDIDATE FOR A SIMPLE-IRA?

Since the $6,000 limit is not subject to a percentage of income, a SIMPLE allows employees with compensation of less than $50,000 to defer more income than other plans do. Conversely, the $6,000 imposes a lower limit on more highly compensated employees. A SIMPLE-IRA is immediately vested; therefore, employers who are not concerned with vesting of employer contributions should consider a SIMPLE-IRA. A SIMPLE-IRA is also desirable where minimal employer contributions are desired. Perhaps the largest advantage is the low cost of establishing a SIMPLE-IRA.

Example 7. Sharon's compensation is $45,000. The maximum employer contribution to a profit-sharing Keogh or SEP is $6,750 (15% of $45,000). If the employer chooses a SIMPLE plan with a 3% match, Sharon can defer and contribute $6,000 and the employer must contribute $1,350 (3% of $45,000), for a total of $7,350.

Form 5500 is not required to be filed for SIMPLE-IRA plans.

DISTRIBUTION RULES DURING LIFETIME [I.R.C. §§408(A)(6) AND 401(A)(9)]

Tax law provides guidelines that govern distributions from both qualified plans and IRAs during a taxpayer's lifetime and thereafter. The next sections discuss the early distribution rules, elections the taxpayer must make at his or her required beginning date, and the required minimum distribution rules.

> **Observation.** SEPs and SIMPLEs are types of IRAs. Qualified plans include profit-sharing, pension, and stock bonus plans. The Tax Reform Act of 1986 established uniform minimum distribution requirements for most qualified employer plans, tax-sheltered annuities, and regular IRAs. While the following discussion focuses on regular IRAs, the same rules generally apply to other plans.

PRE-59½ DISTRIBUTION RULES [I.R.C. §72(T)]

A 10% federal penalty tax [I.R.C. §72(t)] is imposed on taxable distributions prior to the IRA owner's attaining 59½ years of age, subject to exceptions. Many states also impose a penalty on early distributions. The most common federal exceptions applicable to **both** employer plans and IRAs are:

1. Distributions made to a beneficiary after the **owner's death,**
2. Distributions made because the **owner is disabled,** and
3. Distributions made as a series of **substantially equal periodic payments.**
4. Distributions from **employer** plans—**not** including any type of IRA—are excepted from the penalty if the employee **separated from the employer's service** during or after the year the employee attained age 55. For this purpose, a self-employed person is not an employee.

Example 8. John, who just turned 55, retires from ABC Company. He takes a distribution from his ABC Company profit-sharing plan of $50,000. He will **not** be subject to the early distribution penalty because he has separated from service after age 55.

Example 9. Assume the same facts as Example 8, except that John first rolled his ABC Company profit-sharing plan to an IRA. Now he will **not** qualify under this exception to the early distribution penalty, as one cannot "separate from service" for purposes of distributions from an IRA.

Several other exceptions apply only to IRA distributions, such as:

1. Distribution to the extent you have medical expenses deductible under I.R.C. §213
2. Distributions made to an alternate payee under a qualified domestic relations order
3. Distributions made to unemployed individuals for health insurance premiums
4. Distributions made for higher education expenses
5. Distributions made for first home purchases

SUBSTANTIALLY EQUAL PERIODIC PAYMENT EXCEPTION

The early distribution penalty does not apply to distributions that are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life expectancy of the owner.

Q&A 12 of Notice 89-25 provides guidance on establishing substantially equal periodic payments. There are three methods:

- The minimum distribution method.
- The annuity method.
- The amortization method.

Typically these calculations are made using computer software. (An edited version of Q&A 12 of Notice 89-25 follows.)

NOTICE 89-25, 1989-1 CB 662, (MAR. 20, 1989)

Q-12: In the case of an IRA or individual account plan, what constitutes a series of substantially equal periodic payments for purposes of §72(t)(2)(A)(iv)?

A-12: Section 72(t)(l) imposes a penalty tax of 10 percent on the portion of early distributions from qualified retirement plans (including IRAs) includible in gross income. However, §72(t)(2)(A)(iv) provides that this tax shall not apply to distributions which are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and beneficiary. Section 72(t)(4) provides that, if the series of periodic payments is **subsequently modified within five years of the date of the first payment, or, if later, age 59½, the exception** to the 10 percent penalty tax does not apply.

Payments will be considered to be substantially equal periodic payments within the meaning of §72(t)(2)(A)(iv) if they are made according to **one of the methods** set forth below.

Payments shall be treated as satisfying §72(t)(2)(A)(iv) if the annual payment is determined using a method that would be acceptable for purposes of calculating the **minimum distribution** required under §401(a)(9). For this purpose, the payment may be determined based on the life expectancy of the employee or the joint life and last survivor expectancy of the employee and beneficiary.

Payments will also be treated as substantially equal periodic payments within the meaning of §72(t)(2)(A)(iv) if the amount to be distributed annually is determined by amortizing the taxpayer's account balance over a number of years equal to the life expectancy of the account owner or the joint life and last survivor expectancy of the account owner and beneficiary (the **annuity method**) at an interest rate that does not exceed a reasonable interest rate on the date payments commence. For example, a 50-year-old individual with a life expectancy of 33.1, having an account balance of $100,000, and assuming an interest rate of 8 percent, could satisfy §72(t)(2)(A)(iv) by distributing $8,679 annually, derived by amortizing $100,000 over 33.1 years at 8 percent interest.

Finally, payments will be treated as substantially equal periodic payments if the amount to be distributed annually is determined by dividing the taxpayer's account balance by an annuity factor (the **amortization method**) with such annuity factor derived using a reasonable mortality table and using an interest rate that does not exceed a reasonable interest rate on the date payments commence. For example, if the annuity factor for a $1 per year annuity for an individual who is 50 years old is 11.109 (assuming an interest rate of 8 percent and using the UP-1984 Mortality Table), an individual with a $100,000 account balance would receive an annual distribution of $9,002 ($100,000/11.109 = $9,002).

Practitioner Note. Both the amortization and the annuity methods result in **much larger payouts** than the minimum distribution method. Over a single life expectancy, a 55-year-old with a $250,000 account balance could withdraw $8,741 the first year under the minimum distribution method. Using the same life expectancy and a 6% interest rate, the annuity distribution would be $21,574.

Proposed regulations require that the distribution rules be applied separately to each plan. In combination with IRA rollover and transfer provisions, this gives IRA owners flexibility in calculating substantially equal payments. Once the taxpayer determines the amount needed annually, IRAs can be **divided** into separate accounts as required to yield that annual payment under any of the three methods.

Table 1 shows computations for substantially equal periodic payments for a person age 55, factoring in three different interest rates and four different IRA balances. If the taxpayer has a $1,000,000 IRA for which 6% is a reasonable interest rate, but does not want to take distributions of $86,298 a year for the next five years, he or she can reduce the required payments by **splitting** the IRA into separate accounts **before** establishing the stream of payments.

TABLE 1: ANNUAL SUBSTANTIALLY EQUAL PERIODIC PAYMENTS (SEPPS): SINGLE LIFE, AGE 55

	Reasonable Interest Rate		
IRA Balance	**6%**	**7%**	**8%**
$250,000	$21,574.41	$23,681.64	$25,840.06
$500,000	$43,148.83	$47,363.28	$51,680.12
$750,000	$64,723.24	$71,044.93	$77,520.18
$1,000,000	$86,297.66	$94,726.57	$103,360.24

Annuity factors can be used to compute the amount to be segregated in an IRA to yield the desired payment. Table 2 gives sample factors at four ages and three interest rates. The annuity factor multiplied by the desired payout equals the necessary balance.

TABLE 2: ANNUAL FACTORS USING ANNUITY METHOD

	Reasonable Interest Rate		
Age	**6%**	**7%**	**8%**
40	13.9928	12.4697	11.2168
45	13.3093	11.9408	10.8011
50	12.5056	11.3027	10.2879
55	11.5878	10.5567	9.6749

Example 10. Suppose an IRA owner wants to receive $5,000 per month ($60,000 annually) from an IRA at age 50. Assuming a 7% "reasonable interest rate," the IRA (or group of IRAs) would have to equal $678,162 (11.3027 annuity factor × $60,000 annual distribution).

Effect of Changes. The series of substantially equal periodic payments can be changed after five years or when the taxpayer reaches age 59½, whichever is later. The IRA owner then will be able to take distributions of any amount.

If the taxpayer **changes** the amount distributed **before** the later of five years or age 59½, there is a "catch-up" penalty. For example, if after three years the taxpayer took out more or less than the calculated substantially equal periodic payment amount, he or she would be subject to the penalty tax on that distribution and on all prior distributions. Additionally, interest would be computed on the "catch-up" payment. (See *Robert C. Arnold v. Commissioner* [CCH Dec. 52,888] in the "What's New: Rulings and Cases" chapter.)

REQUIRED BEGINNING DATE ELECTIONS

The first required distribution for an **IRA owner** is for the year the owner reaches age 70½—six months after the 70th birthday. The distribution for that year must be taken by the required beginning date—April 1 of the **next** year.

The required beginning date for employee plan distributions is April 1 after the later of the year the employee is 70½ or the year the employee retires from that employer (assuming the employee does not own more than 5% of the company).

Before the required beginning date, a taxpayer must make three crucial elections that will determine the required minimum distributions during life as well as after death. The three elections are:

1. Whether to use a joint or a single life expectancy.
2. Whether to recalculate life expectancy or use a term certain.

3. Who should be the designated beneficiary.

These decisions determine which life expectancy factor is used in the required minimum distribution calculation.

Practitioner Note. Appropriate planning requires that these elections be coordinated with other estate planning documents and recommendations. This analysis is limited to the three elections that must be made by the required beginning date.

CALCULATION OF REQUIRED MINIMUM DISTRIBUTION

A taxpayer's required minimum distribution is calculated by dividing the prior December 31 account balance by the life expectancy factor from Reg. §1.72-9, Table V and Table VI. The tables are reprinted in IRS Publications 575, 590, and 939. This equation is illustrated as follows:

$$\text{Required minimum distribution for current year} = \frac{\text{Prior December 31 balance}}{\text{Life expectancy factor}}$$

Example 11. Bob and Bonnie, a married couple, attain ages 75 and 70 in 1999. The value of Bob's IRA was $100,000 on December 31, 1998. Bob and Bonnie's joint life expectancy factor is 18.8. Bob's 1999 required minimum distribution is calculated as follows:

$$\$100{,}000 \div 18.8 = \$5{,}319.15$$

Observation. When an IRA owner defers the first year's distribution until the April 1 required beginning date, a special rule applies in calculating the required minimum distribution in the succeeding year. Because the prior December 31 balance will not reflect the first year's distribution, it must be reduced by the required minimum distribution received between January 1 and April 1.

Example 12. Duane turned 70½ in May of 1999 and took his 1999 required minimum distribution on April 1, 2000. To calculate his year 2000 required minimum distribution, he reduces his December 31, 1999 IRA balance by the distribution taken April 1, 2000.

JOINT VERSUS SINGLE LIFE EXPECTANCY

The simplistic question of planning for retirement distributions is whether distributions should take place over the life expectancy of the IRA owner or over the life expectancies of the IRA owner and another beneficiary. **At the very heart of planning for retirement distributions, we seek to minimize taxes while maximizing return.** Generally, **both** of these objectives can be achieved through **deferral.** Because longer deferral is obtained by use of two life expectancies, **joint life expectancy should be utilized** to calculate required minimum distributions. This allows the longest payout period and defers tax for a longer period of time.

Caution must be exercised to ensure the application of joint life expectancy. If the appropriate elections are not made at the required beginning date, the IRA custodial document or plan document may require use of the single life expectancy method by default.

DESIGNATED BENEFICIARY

A named beneficiary is not necessarily a designated beneficiary for purposes of computing required minimum distributions. A designated beneficiary must be an individual or a certain kind of trust. (Qualifying trusts will be discussed later.) Charitable organizations do not qualify; if a charity is named as a beneficiary, the owner will be treated as having no beneficiary, and distributions must be taken over the owner's single life expectancy.

If multiple beneficiaries are named, the one with the shortest life expectancy is treated as the designated beneficiary for computing minimum required distributions. If a living beneficiary is replaced by a new beneficiary with a shorter life expectancy, a new distribution period based on the shorter life expectancy must be computed for subsequent years. If the designated beneficiary predeceases the owner, changes to the distribution period depend on the recalculation elections made by the required beginning date. Both the recalculation election and the joint-versus-single election are typically made when the beneficiary form is completed before the IRA owner's required beginning date.

RECALCULATING LIFE EXPECTANCIES

Recalculating life expectancy will extend the time period over which distributions are taken. Generally, a married IRA owner has three options.

1. *Recalculation method:* The joint life expectancy of both the IRA owner and his or her spousal beneficiary is recalculated.
2. *Nonrecalculation method:* Neither the life expectancy of the IRA owner nor that of his or her spousal beneficiary is recalculated.
3. *Hybrid method:* The IRA owner's life expectancy is recalculated but the spousal beneficiary's is not.

If the designated beneficiary is not the IRA owner's spouse, the options are limited to the nonrecalculation method and the hybrid method.

Observation. The availability of the calculation elections is governed by the custodial agreement or plan document.

Table 3 illustrates all of the possible recalculation elections with respect to an IRA owner and the beneficiary.

TABLE 3: RECALCULATION OPTIONS

	Owner		*Beneficiary*	
	Recalculate	**Nonrecalculate**	**Recalculate**	**Nonrecalculate**
Owner and Spousal Beneficiary	x		x	
	x			x
		x		x
Owner and Nonspouse Beneficiary	x			x
		x		x

In the nonrecalculation method (also called the term certain method), the beginning life expectancy factor is determined. Then one is subtracted for each successive year. In the recalculation method, the life expectancy factor is not reduced by a full year each year, because mortality tables indicate that a person one year older does not have an actuarial life expectancy of exactly one year less. Table 4 illustrates the concepts of recalculation and nonrecalculation based on a single life.

TABLE 4: SINGLE PERSON LIFE EXPECTANCY TABLE

Nonrecalculation		*Recalculation*	
Age	Single Life Expectancy	Age	Single Life Expectancy
70	16.0	70	16.0
71	15.0	71	15.3
72	14.0	72	14.6
73	13.0	73	13.9
74	12.0	74	13.2
75	11.0	75	12.5
76	10.0	76	11.9
77	9.0	77	11.2
78	8.0	78	10.6
79	7.0	79	10.0
80	6.0	80	9.5

Since required minimum distributions for a given year are calculated by dividing the prior December 31 account balance by the life expectancy factor, they will be **smaller** for an IRA owner who **recalculates** because the life expectancy factor is larger.

Table 5 illustrates a recalculated versus a nonrecalculated joint life expectancy for an owner and spouse who are the same age.

TABLE 5: MARRIED COUPLE LIFE EXPECTANCY TABLE

Nonrecalculation		*Recalculation*	
Age	Joint Life Expectancy	Age	Joint Life Expectancy
70	20.6	70	20.6
71	19.6	71	19.8
72	18.6	72	18.9
73	17.6	73	18.1
74	16.6	74	17.3
75	15.6	75	16.5
76	14.6	76	15.7
77	13.6	77	15.0
78	12.6	78	14.2
79	11.6	79	13.5
80	10.6	80	12.8

RECALCULATION METHOD

When the IRA owner uses the **double recalculation method,** distributions are made in the **smallest** amount relative to other options while both the IRA owner and spouse are alive.

However, upon the first death, the recalculated life expectancy of the decedent is zero. If the spousal beneficiary predeceases the IRA owner, required minimum distributions in subsequent years must be based on the recalculated single life expectancy of the owner. While seemingly the best choice during the joint lives, **the double recalculation method will result in the most rapid required minimum distribution after the first death.**

Example 13. Scott's wife, Lori, is the beneficiary of his IRA. At Scott's required beginning date he elected the double recalculation method. Several years later, Lori predeceases Scott. Scott is now forced to take distributions based on his single recalculated life expectancy.

After both spouses have died, assuming the spousal beneficiary dies first, the **entire** amount of the IRA must be paid out by December 31 of the year following the year of the IRA owner's death.

Example 14. Assume the same facts as in Example 13. Upon Scott's death, his **beneficiaries** must withdraw the **entire** IRA balance no later than December 31 of the following year.

The hazards are less if the IRA owner dies first. A surviving spouse who is the designated beneficiary may roll the IRA into his or her own name and designate new beneficiaries. This can allow **additional deferral** after the second spouse's death.

Example 15. Assume the same facts as Example 13 except that Scott predeceases Lori. Upon Scott's death, Lori may roll the IRA into her own name and make new required beginning date elections.

NONRECALCULATION METHOD

A **fixed term** is created when the IRA owner's and spouse's life expectancies are **not** recalculated. Regardless of which spouse dies first, or when they die, the required minimum distributions continue over this fixed term. The obvious **disadvantage** of this strategy is the relatively **higher distributions** during life. It could result in liquidation of the IRA before both the IRA owner and beneficiary die.

Example 16. Joe elected the **double nonrecalculation method** using joint life expectancy with his wife, Jill. He receives distributions based on their joint nonrecalculated life expectancy. Several years later, Jill predeceases Joe. Joe can continue to receive distributions based on his and Jill's joint nonrecalculated life expectancy. His new beneficiary also may use the remainder of the fixed term.

With the **double nonrecalculation method,** the premature death of an owner or beneficiary will **not** result in a more rapid required lifetime distribution.

HYBRID METHOD

The third method of distribution recalculates the IRA owner's life expectancy but not the beneficiary's. There are two distinct advantages to this method. **First, required distributions are lower** if no recalculation is made. **Second,** since the IRA owner's spouse does not recalculate life expectancy, **there is a fixed-term element.** This method hedges against the IRA owner's spouse predeceasing the IRA owner. If the spouse dies first, the survivor may continue to receive required minimum distributions over the same joint life expectancy. Of course, where the IRA owner dies first, the surviving spouse always has the option to roll over the IRA into his or her own name.

Example 17. Ben names his wife, Julie, as primary beneficiary of his IRA. At his required beginning date he elected the **hybrid method.** Ben and Julie receive distributions based on the hybrid method (recalculating Ben's life expectancy, but not Julie's). Several years later, Julie predeceases Ben. Ben can continue to receive distributions based on his recalculated life expectancy and Julie's "ghost" nonrecalculated life expectancy.

If the IRA owner's **spouse** dies first, the hybrid method will result in the **lowest** required minimum distribution after the spousal beneficiary's death and therefore in the longest deferral.

If an IRA owner fails to make an election, the default depends on the plan document. If this document is silent, the default is recalculation for the owner and beneficiary (if the beneficiary is eligible to recalculate) [Prop. Reg. §1.401(a)(9)-1, Q&A E-7].

Table 3 illustrates all of the possible recalculation elections with respect to an IRA owner and the beneficiary.

Tables 6, 7, and 8 summarize the options and consequences when a spouse is the designated beneficiary.

TABLE 6: RECALCULATION METHOD

IRA owner dies with a surviving spouse.	Spousal rollover, or The IRA owner's life expectancy becomes zero and subsequent distributions are calculated based on the spouse's recalculated single life expectancy.
Spouse dies with IRA owner surviving.	The spouse's life expectancy becomes zero and subsequent distributions are calculated based on the IRA owner's recalculated single life expectancy.
IRA owner dies subsequent to spouse's death.	Entire account must be paid out by December 31 following the year of death. Remaining life expectancy becomes zero.
Spouse dies subsequent to IRA owner's death without spousal rollover.	Entire account must be paid out by December 31 following the year of death. Remaining life expectancy becomes zero.

TABLE 7: FIXED-TERM METHOD

IRA owner dies with a surviving spouse.	Spousal rollover, or Distributions continue to be made over the joint **fixed** life expectancy of the IRA owner and spouse.
Spouse dies with IRA owner surviving.	Distributions continue to be made over the joint **fixed** life expectancy of the IRA owner and spouse.
IRA owner dies subsequent to spouse's death.	Distributions continue to be made over the joint **fixed** life expectancy of the IRA owner and spouse.
Spouse dies subsequent to IRA owner's death without spousal rollover.	Distributions continue to be made over the joint **fixed** life expectancy of the IRA owner and spouse.

TABLE 8: HYBRID METHOD

IRA owner dies with a surviving spouse.	Spousal rollover, or The IRA owner's life expectancy becomes zero and subsequent distributions are calculated based on the spouse's nonrecalculated single life expectancy.
Spouse dies with IRA owner surviving.	Distributions continue to be made over the joint life expectancy of the IRA owner (recalculating) and the spouse (non recalculating). The spouse has a "ghost" life expectancy.
IRA owner dies subsequent to spouse's death.	Distributions continue to the beneficiary over the remaining fixed "ghost" single life expectancy of the spouse, if any.
Spouse dies subsequent to IRA owner's death without spousal rollover.	Distributions continue to the beneficiary over the remaining fixed "ghost" single life expectancy of the spouse, if any.

MINIMUM DISTRIBUTION INCIDENTAL BENEFIT (MDIB) RULES [PROP. REG. §1.401(A)(9)-2]

Naming a very young beneficiary (e.g., a grandchild) could yield a much **lower** required minimum distribution during the IRA owner's lifetime. To accelerate distributions over the owner's lifetime, Congress created the MDIB rules in 1986. **The MDIB rules apply only to nonspousal beneficiaries and only during the IRA owner's lifetime.**

If an IRA owner names a nonspousal beneficiary who is more than 10 years younger than the owner, the beneficiary will be treated as being 10 years younger for purposes of calculating the IRA owner's required minimum distributions. The MDIB factors for ages 70 through 80 are excerpted in Table 9.

TABLE 9: MDIB FACTORS

Owner and MDIB Beneficiary

Age of Owner (nonspousal beneficiary more than 10 years younger)	Joint Life Expectancy
70	26.2
71	25.3
72	24.4
73	23.5
74	22.7
75	21.8
76	20.9
77	20.1
78	19.2
79	18.4
80	17.6

After the death of the IRA owner, the MDIB rules disappear. Distributions after death are based on the joint life expectancies of the IRA owner and the nonspousal beneficiary, or on the single life expectancy of the nonspousal beneficiary, depending on the recalculation method elected at the IRA owner's required beginning date. This permits for very powerful planning techniques and tremendous deferral.

Example 18. Dennis named his grandson Bob as primary beneficiary of his IRA and elected the **hybrid method.** Dennis will receive distributions based upon the MDIB rules. After Dennis's death, Bob can receive distributions based on his single nonrecalculated life expectancy, unencumbered by the MDIB rules.

Tables 10 and 11 summarize the options and consequences of naming a nonspousal beneficiary.

TABLE 10: HYBRID METHOD

IRA owner dies with a surviving beneficiary.	The IRA owner's life expectancy becomes zero. Subsequent distributions are calculated based upon the beneficiary's nonrecalculated single life expectancy, not subject to the MDIB rules.
Beneficiary dies with the IRA owner surviving.	Distributions continue to be made over the joint life expectancy of the IRA owner (recalculating) and the nonspousal beneficiary (nonrecalculating), subject to the MDIB rules.
IRA owner dies subsequent to the beneficiary's death.	Distributions continue to the second beneficiary of the IRA over the remaining fixed single life expectancy (not subject to the MDIB rules) of the nonspousal beneficiary, if any.
Beneficiary dies subsequent to the IRA owner's death.	Distributions continue to the heirs of the beneficiary of the IRA over the remaining fixed single life expectancy (not subject to the MDIB rules) of the nonspousal beneficiary, if any.

TABLE 11: FIXED-TERM METHOD

IRA owner dies with a surviving beneficiary.	Distributions continue to be made over the joint fixed life expectancy of the IRA owner (nonrecalculating) and the nonspousal beneficiary (nonrecalculating), not subject to the MDIB rules.
Beneficiary dies with the IRA owner surviving.	Distributions continue to be made over the joint fixed life expectancy of the IRA owner (nonrecalculating) and the nonspousal beneficiary (nonrecalculating), still subject to the MDIB rules.
IRA owner dies subsequent to the beneficiary's death.	Distributions continue to the alternate beneficiary over the remaining fixed joint life expectancy (not subject to the MDIB rules) of the IRA owner and the nonspousal beneficiary, if any.
Beneficiary dies subsequent to the IRA owner's death.	Distributions continue to the heirs of the beneficiary of the IRA over the remaining fixed joint life expectancy (not subject to the MDIB rules) of the IRA owner and the nonspousal beneficiary, if any.

DISTRIBUTION RULES AFTER DEATH

Elections of a designated beneficiary, joint or single life expectancy, and recalculation must be in place as of an IRA owner's required beginning date. Failure to make at least tentative choices earlier, however, can result in loss of deferral and potentially disastrous tax consequences from a premature death.

DEATH PRIOR TO REQUIRED BEGINNING DATE [I.R.C. §401(A)(9)(B)]

If an IRA does not have a designated beneficiary and the owner dies **before** his or her required beginning date, the IRA must be distributed by December 31 of the year containing the fifth anniversary of the owner's death. The distribution can be made in any fashion the default beneficiary or executor chooses. It may be spread over this period of time, or in a lump sum on December 31 of the year containing the fifth anniversary of the IRA owner's death. This relatively rapid withdrawal may cause the default beneficiaries or heirs of the IRA to lose many years of deferral.

A designated beneficiary can choose to receive minimum distributions over his or her single life expectancy if the distributions begin by December 31 of the year following the IRA owner's death. This is far more advantageous than the five-year rule. **Therefore, having a designated beneficiary is critical to preserving the deferral that can be achieved with proper planning.** Of course, a beneficiary may always withdraw more than the minimum required distribution.

DEATH AFTER REQUIRED BEGINNING DATE

If the IRA owner dies **after** the required beginning date, the remaining portion of the IRA must be distributed at least as rapidly it was required to be distributed before death. Therefore, distributions continue based on the elections in effect at the IRA owner's required beginning date. **For this reason, retirement distribution planning is critical, as the effect may last for decades.**

If the owner of an IRA dies **after** his or her required beginning date and did **not** have a designated beneficiary, the consequences are disastrous if the owner had chosen recalculation. The IRA must be distributed by December 31 of the year after the year of death, eliminating many years of deferral. For many families, this would have a significant impact on the wealth transfer to future generations.

TABLE 12: DISTRIBUTION RULES UPON DEATH OF IRA OWNER

	Death Prior to Owner's Required Beginning Date	Death After Owner's Required Beginning Date
With a Designated Beneficiary	Minimum distributions over the oldest beneficiary's single life expectancy; special rules apply for spouse	Minimum distributions continue to be made based on the elections made at owner's required beginning date
Without a Designated Beneficiary	IRA must be liquidated by December 31 of the year containing the fifth anniversary of the owner's death	IRA must be liquidated by December 31 of the year after the year of the owner's death if owner was recalculating; over remainder of fixed term if owner was not recalculating

SPOUSAL ROLLOVER PLANNING

When a taxpayer dies after naming his or her spouse as beneficiary of an IRA, the surviving spouse has two options:

1. Rollover the IRA into his or her own name, or
2. Treat the IRA as an inherited IRA.

Usually, rolling the IRA into the surviving spouse's name is **more advantageous** because of the additional deferral.

ROLLOVER TO A NEW IRA IN THE SURVIVING SPOUSE'S NAME

Under typical circumstances, a surviving spouse will roll over an IRA into his or her own name. This is **generally advisable** because of the **additional deferral** that can usually be obtained. If the IRA is rolled over to a new IRA, the surviving spouse can name new beneficiaries and make new required beginning date elections. In some cases this can resolve a faulty required beginning date election, since a surviving spouse can roll over an IRA even after the required beginning date [Ltr. Ruls. 9311037 and 9433031].

The law does not provide a procedure for making a rollover election or dictate the timing of when a rollover must take place. From a procedural standpoint, it may be advisable to notify the IRA custodian if a spousal rollover is desired.

An election is considered to have been made by the surviving spouse if either of the following occurs:

1. Any required amount has not been distributed within the appropriate time period applicable to the decedent, or
2. Any additional amounts are contributed to the account.

The spouse can elect rollover treatment or inherited IRA treatment for **each** specific IRA. For this reason it is critical that inherited IRAs and rollover IRAs are not commingled. If an inherited IRA and a spousal rollover IRA are commingled, all IRAs are deemed to have been rolled over. This becomes very important when dealing with the early distribution penalties from IRAs for spouses who are younger than 59½.

SPOUSE MAY TREAT AS AN INHERITED IRA

The surviving spouse may elect to treat the decedent's IRA as an inherited IRA. If this is done, the surviving spouse cannot name a new beneficiary for purposes of I.R.C. §401(a)(9). **The most common use of this strategy is when a surviving spouse is younger than 59½.** If the surviving spouse rolls the IRA into his or her own name, he or she would be subject to the early distribution penalty. However, an inherited IRA will not be subject to this penalty.

Observation. If a spouse who is younger than 59½ uses the inherited IRA penalty exemption, the spouse waives the right to a rollover of that account. If there is more than one account, the waiver applies only to the accounts from which distributions have been taken [Ltr. Rul. 9418034].

Another situation where a spouse should consider inherited IRA treatment is when the surviving spouse is past his or her required beginning date and the IRA owner died before reaching his or her required beginning date. Because the surviving spouse can defer distributions until the decedent would have reached the required beginning date, it may be advisable to treat the IRA as an inherited IRA. The additional deferral that may be achieved by a spousal rollover also must be analyzed before an informed decision can be made.

Special care may be required to prevent IRAs from being automatically given "rollover" status by uninformed custodians. Many financial institutions are not familiar with the concept of an inherited IRA. As a result, a surviving spouse may be advised that this status is not available, when in fact it is.

The IRA agreement or plan document must be carefully reviewed to ensure that distributions occur as desired. The major provisions that must be investigated are:

1. The default provisions for an IRA owner who does not make timely required beginning date elections.
2. Whether an IRA owner and/or spouse may recalculate life expectancy (particularly in the hybrid method).
3. The beneficiary's options after the death of the IRA owner (the beneficiary wants the ability to stretch out distributions over life expectancy).

FAILURE TO TAKE A REQUIRED MINIMUM DISTRIBUTION [I.R.C. §4974(A)]

An IRA owner must begin distributions when he or she reaches his or her required beginning date. A **50% penalty** is imposed on the difference between the required minimum distribution and any distributions actually taken during the year. This rule also applies to beneficiaries who are entitled to receive distributions after the death of an IRA owner.

Example 19. Since John turned 70½ in May 1998, his required beginning date was April 1, 1999. John failed to take his required minimum distribution of $12,136 by April 1, 1999. The penalty is $6,068 ($12,136 × 50%), which is reported in Part VII of Form 5329.

Form **5329** | **Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs**
(Under Sections 72, 530, 4973, and 4974 of the Internal Revenue Code)
► Attach to Form 1040. See separate instructions.
OMB No. 1545-0203
1999
Attachment Sequence No. 29
Department of the Treasury
Internal Revenue Service

Name of individual subject to additional tax. (If married filing jointly, see page 2 of the instructions.) John
Your social security number 408 72 5329

Part VII **Tax on Excess Accumulation in Qualified Retirement Plans**
Complete this part if you did not receive the minimum required distribution from your qualified retirement plan (including an IRA other than an Ed IRA or Roth IRA).

42	Minimum required distribution. See page X	42	12,136
43	Amount actually distributed to you	43	0
44	Subtract line 43 from line 42. If zero or less, enter -0-	44	12,136
45	**Tax due.** Enter 50% (.50) of line 44. Also include this amount on Form 1040, line 53	45	6,068

Signature. Complete **ONLY** if you are filing this form by itself and not with your tax return.

An exception to the penalty applies under certain circumstances. If a taxpayer establishes to the satisfaction of the IRS that the shortfall was due to "reasonable error" and that reasonable steps are being taken to remedy the shortfall, the IRS may waive the penalty.

ESTATE PLANNING WITH RETIREMENT ASSETS

The income tax aspects of retirement assets make estate planning with these assets especially challenging. The planner must properly weigh the income tax effect versus the estate tax effect, in addition to providing for the client's non-tax goals and objectives. The focal point of this discussion is whom to designate as beneficiary of retirement assets.

The beneficiary designation election has virtually unlimited possibilities. However, within these possibilities lie many pitfalls. A thorough understanding of the impact of electing a certain beneficiary or beneficiaries is imperative.

TYPICAL BENEFICIARY OPTIONS

Common choices for an IRA beneficiary include:

- Spouse
- Children
- Grandchildren
- Family trust created under a revocable trust
- Stand-alone IRA trust
- Revocable trust
- QTIP trust
- Charity
- Charitable trust
- Estate

SPOUSE AS BENEFICIARY

In many cases the IRA owner will name his or her **spouse** as the primary beneficiary. Even though this is the most common beneficiary designation, **it may very well be the wrong choice when the family will be subject to estate tax.**

The major **advantage** of naming a spouse as beneficiary is the surviving spouse's ability to execute a rollover, transferring the IRA into his or her own name and specifying new designated beneficiaries. Subsequently, at the spouse's death, minimum distributions will be calculated based upon the oldest beneficiary's life expectancy, allowing for tremendous additional deferral.

From an estate planning standpoint, the advantage of a spousal beneficiary is the ability to pass the IRA under the estate tax marital deduction [I.R.C. §2056]. This may be appropriate in smaller estates or where the IRA owner has sufficient other property to utilize his or her unified credit.

A significant **disadvantage** of naming the spouse as primary beneficiary is that after the required beginning date, the owner may not subsequently name a beneficiary with a longer life expectancy for minimum distribution purposes. It is imperative to understand that with a traditional IRA, the elections made at the required beginning date will substantially constrain the minimum distributions from the IRA. Naming a younger beneficiary (e.g., a child) after the required beginning date will not affect the required minimum distributions.

A potential **remedy** when the IRA owner wishes to maximize deferral is a Roth IRA conversion. In effect, a Roth IRA conversion allows the owner to make new required beginning date elections as there are no required minimum distributions during the Roth IRA owner's lifetime. Table 13 shows the enormous impact of a Roth conversion and subsequent deferral.

TABLE 13: IMPACT OF A ROTH CONVERSION

Ending Outside Balance and IRA

Year	Traditional IRA-Spouse as Designated Beneficiary	Roth IRA-Child as Designated Beneficiary	Difference
1	$545,083	$549,659	$4,576
5	$763,109	$797,998	$34,889
10	$1,137,978	$1,255,579	$117,601
15	$1,652,919	$1,948,722	$295,803
20	$2,372,979	$2,983,299	$610,320
25	$3,406,718	$4,501,769	$1,095,051
30	$4,890,785	$6,686,270	$1,795,485
35	$7,021,354	$9,750,920	$2,729,566
40	$10,080,062	$14,007,654	$3,927,592

This table assumes a beginning IRA balance of $500,000. As of the owner's required beginning date, the spouse is age 70 and the child is age 45. It is further assumed that the IRA owner dies in the year of his or her required beginning date. Note that the four-year spread is no longer available after 1998.

A Roth conversion is made by filling out Part II of Form 8606. A $500,000 conversion is shown on the following Form 8606.

Form **8606**

Department of the Treasury
Internal Revenue Service (99)

Nondeductible IRAs

▶ See separate instructions.

▶ Attach to Form 1040, Form 1040A, or Form 1040NR.

OMB No. 1545-1007

1998 9

Attachment Sequence No. **48**

Name. If married, file a separate Form 8606 for each spouse who is required to file Form 8606. See page 4 of the instructions.

Your social security number

Part II **Conversions from Traditional IRAs to Roth IRAs**

Before you begin, see page 5 if: **(1)** your filing status is married filing separately, **(2)** your modified AGI is more than $100,000, **(3)** you converted only part of your traditional IRAs to Roth IRAs, or **(4)** you received any distributions (withdrawals) from traditional IRAs during 1998.

14a	Enter the total amount of distributions from traditional IRAs during 1998 that were converted to Roth IRAs	**14a**	*500,000*
b	Recharacterizations. See page 3	**14b**	*0*
c	Subtract line 14b from line 14a	**14c**	*500,000*
15	Enter your basis in the amount you entered on line 14c. See pages 5 and 6	**15**	*0*
16	**Taxable amount of conversions.** Subtract line 15 from line 14c	**16**	*500,000*

CHILDREN AS BENEFICIARY

A second option is to name children as the designated beneficiaries. This can result in greater deferral, since the required minimum distribution will be smaller if the child or children are younger than the spouse.

- During the IRA owner's life, required minimum distributions are based on the joint life expectancies of the owner and the oldest beneficiary.
- When the IRA owner dies, the distributions will be calculated based on the oldest child's actual single life expectancy (or on the joint life expectancy if the IRA owner elected the nonrecalculation method). The postmortem life expectancy calculation is unencumbered by the MDIB rules.

Practitioner Note. See discussion of separate shares near the end of this chapter.

The greatest perceived disadvantage of this strategy is that after the owner dies, distributions will be made to the children with no provision for the surviving spouse. This disadvantage may be alleviated by providing the children with the **option to disclaim** all or a portion of the IRA to the surviving spouse, named as the contingent beneficiary (I.R.C. §2518). Use of a disclaimer will not provide the surviving spouse with the control or flexibility he or she would have if he or she were the primary beneficiary, since the benefits received will depend upon the action of the children. This plan requires a willingness on the part of the children to make the disclaimer.

For estate tax purposes, the IRA owner must coordinate use of the unified credit. When non-IRA assets are insufficient to fully use the unified credit, it may be appropriate to make use of the unified credit by naming children as beneficiaries. A disclaimer can work to "fine-tune" the IRA. Operationally, the spouse would be primary beneficiary and children contingent beneficiaries. Upon the owner's death, the surviving spouse can disclaim to the extent necessary to fully utilize the deceased spouse's unified credit [GCM 39858]. In this instance, there is a trade-off between including the spouse as beneficiary (higher required minimum distributions) and fully utilizing the IRA owner's unified credit. A partial solution is to **divide** the IRA into two separate IRAs and name the children as primary in IRA 1 (less than the current unified credit). IRA 2 would name the spouse as primary beneficiary and the children as contingent. This will result in the children receiving IRA 1 distributions over the oldest child's life expectancy and full use of the unified credit by the spouse disclaiming the necessary amount from IRA 2.

GRANDCHILDREN AS BENEFICIARIES

Naming a grandchild or grandchildren as beneficiary will result in a **greater deferral** after the owner's death compared with naming a spouse or child:

- The payout is based on the joint life expectancies of the IRA owner and the **oldest** grandchild, which results in a **smaller distribution** and therefore longer tax deferral (subject, however, to the MDIB rules during lifetime).
- Upon the owner's death, the distributions will be calculated based on the oldest grandchild's actual single life expectancy (or on the joint life expectancy if the IRA owner elected the nonrecalculation method). The distribution is based on each grandchild's life expectancy if they have separate accounts after the date of death.

When the children of an IRA owner have substantial assets of their own, consideration should be given to naming grandchildren as beneficiaries. Given the substantial time horizon for distributions, a small IRA could expand exponentially over a grandchild's life expectancy. However, the surviving spouse does not have any control over the benefits or rate of distribution to the grandchildren.

When grandchildren are named as beneficiaries, the taxpayer must also address the generation-skipping transfer tax (GSTT). A taxpayer usually would allocate a GSTT exemption to the value of the IRA at the time of death. This may be a much smaller value than the actual amount paid to the beneficiaries because of the ability to defer distributions over a grandchild's life expectancy. This is of particular value with a Roth IRA, as distributions from the Roth IRA are not subject to income tax. Therefore, allocating a GSTT exemption to a Roth IRA allows greater leverage of the exemption.

Table 14 compares a family's after-tax wealth for distributions over the spouse's, child's, and grandchild's life expectancy.

TABLE 14: NET TO FAMILY: SPOUSE VERSUS CHILD VERSUS GRANDCHILD

Year	Spouse's Life Expectancy	Child's Life Expectancy	Grandchild's Life Expectancy
1	$329,525	$329,824	$329,895
5	$473,039	$479,393	$480,924
10	$720,575	$756,728	$765,441
15	$1,058,198	$1,180,689	$1,210,209
20	$1,519,180	$1,821,132	$1,901,409
25	$2,180,979	$2,776,031	$2,969,224
30	$3,131,077	$4,178,674	$4,608,792
35	$4,495,066	$6,202,670	$7,110,054
40	$6,453,249	$9,059,251	$10,899,431
45	$9,264,473	$13,027,183	$16,596,480
50	$13,300,349	$18,702,205	$25,087,988

This chart assumes a $500,000 beginning IRA balance in 1999. The IRA owner dies and distributions begin in 2000. In the year 2000, the grandchild is 10 years old, the child is 40, and the spouse is 70. Distributions are invested outside at 7.5% after-tax. The IRA growth rate is 10% and the tax rate on distributions is 40%.

TRUST AS BENEFICIARY

A taxpayer making the required beginning date election may choose to designate a family trust (unified credit shelter trust) as beneficiary. **This may be appropriate when the IRA owner does not have sufficient other assets to fully utilize the unified credit.** The benefits of using a trust include additional control and protection of assets. Proposed regulations impose very specific requirements for a trust to qualify as a designated beneficiary.

A Trust as Designated Beneficiary. In December 1997, the Treasury **revised** the proposed regulations to allow a **revocable** trust to be named as a designated beneficiary. When a trust qualifies as a designated beneficiary, required distributions are made to the trust. However, the distribution period is calculated based on the trust beneficiaries' life expectancy.

Under the **original** proposed regulations, the trust had to be **irrevocable** as of the **earlier** of the required beginning date or death. Many individuals were unaware that the trust had to be irrevocable as of the owner's required beginning date. Further, family trusts created under a will or revocable trust ordinarily do not exist until after death. Therefore, many found that their planning did not comply with the regulations and that it was too late to create a trust that would qualify. Also, the requirement that a trust be irrevocable added inflexibility and made it difficult for planners and their clients to deal with unforeseen changes in circumstances.

The revisions allow a trust to qualify as a designated beneficiary **if it becomes irrevocable upon the individual's death.**

As amended, Prop. Reg. §1.401(a)(9)-1, Q&A D-5 states that for a trust to be a designated beneficiary for purposes of computing lifetime distributions, the following requirements must be met:

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

For required distributions before death, the required documentation must be provided to the plan administrator by the required beginning date. The IRA owner has two options under Prop. Reg. §1401(a)(9)-1 Q&A D-7:

1. Provide the plan administrator with a copy of the trust instrument and agree that if the trust instrument is amended at any time in the future, the IRA owner will, within a reasonable time, provide a copy of the amendment to the plan administrator.
2. Provide the plan administrator with a list of all the beneficiaries (income and remainder) of the trust, certify to the best of the IRA owner's knowledge that this list is correct and complete and that the specific requirements of the trust are met, agree to provide corrected certifications to the extent that there are any amendments or changes to the information previously submitted, and agree to provide a copy of the trust instrument to the plan administrator upon demand.

For required distributions after death, documentation is required of the trustee. By the end of the ninth month beginning after the death of the IRA owner, the trustee must either:

1. Provide the plan administrator with a final list of all beneficiaries (income and remainder) of the trust as of the date of death, certify that to the best of the trustee's knowledge this list is correct and complete, and agree to provide a copy of the trust instrument to the plan administrator upon demand, or
2. Provide the plan administrator with a copy of the actual trust document for the trust that was named as a beneficiary as of the IRA owner's date of death.

Family Trust as Beneficiary. Naming a spouse as primary beneficiary and a credit shelter trust as contingent beneficiary provides flexibility to make full use of the IRA owner's unified credit. The surviving spouse may at that point decide whether to remain as beneficiary and elect a rollover or to disclaim the assets to the family trust.

This raises the question of whether it is better to use IRA assets or non-IRA assets for funding a unified credit trust. Some clients have no choice but to use their IRA assets for unified credit purposes. Even if there are sufficient non-IRA assets to fund the credit shelter amount, analysis should occur when the client wishes to name nonspousal beneficiaries. The benefits of obtaining a potentially longer distribution (and income tax deferral) period must be weighed against the disadvantage of using unified credit on assets whose value will be diminished by income tax.

Stand-Alone IRA Trust as Beneficiary. A stand-alone IRA trust is directly funded at death with IRA assets and is designed to receive required minimum distributions from the IRA. This allows continued compounding and growth of the IRA. Typically, a stand-alone trust would be used where the IRA owner intends to pass a substantial IRA to children, grandchildren or more remote descendants.

In contrast, if the named beneficiary of an IRA is a typical revocable trust with a pecuniary funding mechanism, recognition of income in respect of a decedent may occur upon funding the family trust. Second, a potential pitfall exists if the tax apportionment language in the revocable trust is designed so that IRA assets need to be liquidated to pay debts, taxes or expenses of administration, reducing the deferral and incurring income tax on distribution. Worse yet, Ltr. Rul. 9820021 hints that when IRAs may be invaded under the tax apportionment clause, the estate effectively becomes the beneficiary– forcing maximum payout to occur by December 31 of the year following death if the owner was receiving minimum required distributions and recalculating life expectancy.

Where the IRA owner has insufficient non-IRA assets to fully fund the credit shelter trust, consideration should be given to using a stand-alone trust specifically designed to hold IRA assets. The terms of the stand-alone trust will be very similar to the terms used in the credit shelter trust; however, the stand-alone trust avoids many of the potential pitfalls associated with passing the IRA through a revocable trust.

In addition to affording the opportunity to maximize the deferral of an IRA, a trust can provide benefits such as creditor/asset protection, divorce protection, investment management, spendthrift protection, direct descendent protection, and generation-skipping transfer planning.

Revocable Trust as Beneficiary. Where the IRA owner has reached the required beginning date with an estate substantially composed of IRA assets, it will likely be necessary to use some or all of the IRA to ensure full use of the unified credit. Where it is envisioned that a revocable trust be named primary beneficiary, the attorney drafting this trust must include certain provisions to avoid adverse tax consequences.

"Boilerplate" provisions in trusts requiring payment of debts, taxes, and expenses of administration should be limited so that no IRA or qualified plan will be required to pay any of these items not directly attributable to the IRA or qualified plan. If an alternative cannot be found, the IRA should be divided into several accounts so that only certain accounts are available for payment of taxes and expenses while others are protected.

Four critical issues must be addressed:

- *Estate tax apportionment*. Proper estate tax apportionment is a critical issue that in most circumstances is one of state law. Most states allow the statutory or case law presumption of apportionment to be overridden by specific language contained in a will or trust document. To achieve maximum deferral, these documents must be carefully coordinated to apportion debts, taxes, and expenses of administration away from IRA assets and the trust or trusts containing IRA assets. Should other assets be insufficient for these payments, the apportionment provisions should allow reimbursement by the trust beneficiaries before invasion of the trust. Since payment of tax is considered an obligation of the estate, the IRS may argue that using IRA or qualified plan assets to pay taxes in effect makes the estate a de facto beneficiary of the IRA or plan. Since an estate is not a natural person, and therefore not a designated beneficiary, deferral of distributions may be lost.

- *Fractional versus pecuniary funding clauses*. Typically, at the first death a revocable trust will split into a credit shelter trust and a marital trust. The revocable trust will fund these two trusts with either a fractional funding clause or a pecuniary funding clause. Essentially, the applicable exclusion amount will pass to the credit shelter trust, with the remaining assets passing to the marital trust. To avoid acceleration of income on funding these trusts through a revocable trust, a fractional funding clause must be used. A pecuniary funding clause will accelerate recognition of income in respect of a decedent (e.g., IRAs, annuities, U.S. savings bonds). For example, if an IRA is payable to a revocable trust at the owner's death and the revocable trust uses a pecuniary funding clause, the amount of the IRA passing through that clause is subject to income tax. Therefore, if a $300,000 IRA is used to fund the family trust, there would be immediate income tax on the $300,000. On the other hand, if a fractional funding clause is used, no income is recognized upon funding of the family trust. (**Note:** The IRA may also be transferred by a specific bequest of the entire IRA.)
- *Payment of probate expenses*. Sufficient provisions should be included in the revocable trust to allow for the payment of probate expenses from assets other than the IRAs. In this instance as well, the IRS appears to be poised to suggest that where IRA assets are available to pay expenses of the decedent, in effect the estate is the beneficiary of the IRA. Because an estate has no life expectancy, the result of this planning, or lack thereof, can be full distribution of the IRA by December 31 of the year following the account owner's death. To avoid this problem it is important to exclude IRAs from any liability relating to the payment of probate expenses.
- Plainly, a trust that is the designated beneficiary of an IRA should be examined to make certain that all named beneficiaries who may receive a required distribution at any time are qualified persons. If a nonqualifying entity has an interest in the IRA, the beneficiary's life expectancy is deemed to be zero.

Revocable QTIP Trust as Beneficiary. It is common in second marriages for a client to be concerned that assets left to his or her spouse may not ultimately pass to the children of his or her first marriage. In this instance, the beneficiary of the qualified plan or IRA could be a revocable QTIP trust. Naming a revocable QTIP trust as a beneficiary is extremely complicated and involves a number of inter-related tax and trust concepts. Rev. Rul. 89-89 and TAM 9220007 discuss how to structure a QTIP IRA.

CHARITY AS BENEFICIARY

An IRA is an excellent vehicle for tax-efficient gifting to a charity. The full pre-tax value of the IRA passes to the charity, yet the charity is not required to pay income tax on the IRA proceeds. This gift may be accomplished by naming the charity as the **primary beneficiary** of the IRA. However, since a charity is not a designated beneficiary, the lifetime required minimum distributions will be over the owner's single joint life expectancy. A **more appropriate strategy** (when both spouses agree) may be to **name the spouse as the primary beneficiary** (for purposes of calculating the required minimum distributions) and the **charity as contingent or secondary beneficiary.** Upon the IRA owner's death, the surviving spouse can disclaim his or her interest, allowing the IRA to pass to the charity. This achieves a more favorable result for **both** the client and the charity since the required minimum distributions will be **smaller** and therefore the corpus ultimately passing to charity will be **larger.**

CHARITABLE REMAINDER TRUST (CRT) AS BENEFICIARY

If an IRA owner has a charitable objective but would like to retain income for one or more beneficiaries, naming a charitable trust as the beneficiary of an IRA may have appeal. Instead of having the entire IRA paid out to beneficiaries upon death, a charitable remainder IRA trust would result in a stream of income to heirs and the ability to benefit a charity or charities after the income stream stops. The primary reasons for using charitable remainder IRA trusts are:

- If incorrect elections were made at the required beginning date, the charitable remainder trust may provide relief. There is no income tax at the time of distribution to the charitable remainder IRA trust.

- A CRT will create a stream of income and maximize deferral during the heirs' lifetimes without being subject to the required minimum distribution rules.
- A CRT will qualify for a charitable estate tax deduction to the extent of the actuarial value of the charity's interest.
- With a CRT, the designation of a charitable beneficiary may be changed or additional charities may be added at any time.

Disadvantages of naming a charitable remainder IRA trust are:

- There are a host of issues related to the complexity and uniqueness of the CRT.
- The persons holding the lifetime income interests are limited to receiving only the annual required payment.
- Depending on asset performance and the term of the trust, more or less money may pass to charity than planned.
- Heirs will not receive the remainder of the trust assets after the term of the trust is over. However, a wealth replacement trust may be used.

ESTATE AS BENEFICIARY

Another option, albeit the worst possible, is for an IRA owner to name his or her estate as beneficiary of an IRA. Because an estate is not a qualified designated beneficiary, the owner will have effectively chosen single life expectancy for the required minimum distribution calculations. The calculation method the taxpayer elects will necessarily result in greater distributions since only the IRA owner's life is being utilized. Upon the taxpayer's death, the remaining IRA balance must be distributed by December 31 of the year following death if the owner was recalculating life expectancy. The value of additional deferral over a beneficiary's life expectancy is lost. **In virtually no circumstance does naming one's estate as beneficiary make tax sense.** In addition, if an IRA passes to an owner's estate, the creditors of the estate could have a right to the IRA.

If an estate is named as the beneficiary of the IRA and the surviving spouse is the sole beneficiary of the estate, several letter rulings indicate that the surviving spouse may be able to roll the IRA into his or her own IRA.

CONTINGENT AND SECONDARY BENEFICIARIES

A critical aspect in retirement distribution planning is to **provide flexibility** to deal with unknown contingencies. These contingencies may include growth in an estate, family dynamics, and the sequence of deaths. To accommodate for these and other contingencies, **it is important to name a secondary beneficiary and possibly additional contingent beneficiaries.** If the primary beneficiary dies before the owner, failure to name contingent beneficiaries could result in an unanticipated disposition or in some instances a rapid distribution of the IRA, forgoing years of tax deferral and exponential growth. Many IRA custodial agreements will establish a default plan of disposition for the convenience of the custodian that does not contemplate tax planning issues.

Apart from the survivorship issue, the naming of a contingent and/or secondary beneficiary will facilitate wealth transfer planning and optimal use of the applicable exclusion amount. In addition, proper beneficiary designation planning may set the stage for disclaimer planning, as discussed next.

DISCLAIMER PLANNING

Wealth preservation planning requires the balancing of income tax issues, estate tax issues, control aspects, and many other variables. Thus, it often requires creating documents that enable one to appreciate a change in circumstances. An important tool in this process is the disclaimer. **With a contingent and/or secondary beneficiary, a primary beneficiary may be able to "fine-tune" a plan by disclaiming a portion or all of the IRA.**

This type of planning is often contemplated where non-IRA assets are insufficient to fully utilize the decedent's applicable exclusion amount. The primary beneficiary—typically a spouse to whom assets pass via the marital deduction—would disclaim his or her interest, allowing the IRA to pass to children, the family trust, or a stand-alone IRA trust, utilizing the decedent's then-applicable exclusion amount. Disclaimer planning also may be appropriate when a child named as beneficiary disclaims his or her interest, allowing the interest to pass to his or her issue, due to the child's own potential estate tax issues. **While the disclaimer is no substitute for proper planning, if used correctly, it remains a powerful tool to achieve objectives given unforeseen circumstances.**

A disclaimer might not reduce minimum required distributions. In a typical situation a spouse may be named as primary beneficiary and the children contingent beneficiaries. The intention is that if the spouse disclaims the IRA, the children will be able to use their life expectancies to calculate the required distribution after the owner's death. The IRS's view may be that if the spouse was the oldest designated beneficiary of the IRA, the spouse's life expectancy will be the measuring instrument, even though he or she disclaimed the benefits in favor of the contingent beneficiaries. The IRS appears to argue that a disclaimer is valid only for estate tax purposes and not for income tax purposes.

Example 20. Dave names his spouse, Judy, as the primary beneficiary of his IRA and his son Bill as the contingent beneficiary. If Dave dies and Judy disclaims the IRA, the IRS may take the position that distributions must be made over Judy's life expectancy rather than Bill's.

Clearly, care must be exercised to achieve the desired result. When a disclaimer is contemplated, it may be prudent to split the IRA and name the nonspouse beneficiary as primary beneficiary of one IRA and the spouse as primary beneficiary of the second IRA.

REQUIREMENTS FOR A PROPER DISCLAIMER [I.R.C. §2518]

From a technical standpoint, the disclaimer works as follows. If a person makes a qualified disclaimer with respect to any interest in property, such interest is treated as never having been transferred to the person. A qualified disclaimer must meet several requirements. The term "qualified disclaimer" is defined as an irrevocable and unqualified refusal by a person to accept an interest in property subject to the following conditions:

1. Such refusal is in writing.
2. Such writing is received by the transferor of the interest, his or her legal representative, or the holder of legal title to the property to which the interest relates within a specified time frame (no later than 9 months after the transfer).
3. Such person has not accepted the interest or any of its benefits.
4. As a result of such refusal the interest passes without any direction on the part of the person making the disclaimer either to the spouse of the decedent or to a person other than the person making the disclaimer.

SEPARATE SHARES

If more than one individual is the designated beneficiary of an IRA, the age of the beneficiary with the shortest life expectancy (i.e., the oldest) is used to calculate the required minimum distribution. However, if **separate shares or accounts** are set up for each beneficiary, each individual's respective life expectancy can be used. This applies not only during lifetime but also after death. The IRS recently issued Ltr. Rul. 199903050, stating that a taxpayer could create separate shares for multiple beneficiaries in a beneficiary designation prior to the owner's required beginning date. Therefore, if there are three beneficiaries, the beneficiary designation can create three separate shares, with distributions after death being calculated on each separate share. Alternatively, separate IRAs could be established by splitting a current IRA and naming each child a separate beneficiary of each respective IRA. Ltr. Ruls. 199931048 and 199931049 allow inherited accounts to be split into separate accounts for each beneficiary before the required beginning date for distributions.

CHANGING A BENEFICIARY AFTER AN OWNER'S REQUIRED BEGINNING DATE

An IRA owner can change the beneficiary **after** his or her required beginning date. If this is done the required minimum distribution calculation may be affected. If the IRA owner names a new designated beneficiary who is younger (i.e., has a longer life expectancy), the calculation of the required minimum distribution will not change. However, if the new beneficiary is older than the previous beneficiary, required minimum distributions will be calculated based on the new beneficiary's shorter life expectancy.

If a beneficiary is changed after the owner's required beginning date to a beneficiary that is not a designated beneficiary, distributions will be based on the owner's single life expectancy. In that case, after the death of the IRA owner, the entire IRA will have to be distributed by December 31 of the year after death if the owner was recalculating life expectancy. For estate planning reasons, it may still be advisable to change the owner's beneficiary after his or her required beginning date even if the new beneficiary has a shorter life expectancy.

CONCLUSION

Estate planning in the context of retirement distribution requires many considerations that must be fully appreciated and understood. The opportunities to leverage retirement assets into greater wealth are tremendous; however, one must be mindful of the ever-present pitfalls and traps.

For additional information regarding audiotapes and publications compiled by Robert S. Keebler, CPA, MST, please contact Helen M. Dombeck at (920) 490-5607.

Source: *1999 Retirement Plans Overview*, by A. G. Edwards & Sons, Inc.

Retirement Plan Comparison

Characteristics	**SEP-IRA** *(Simplified Employee Pension)*	**Profit Sharing** *(Defined Contribution)*	**Age-Weighted/Cross Tested Profit Sharing** *(Defined Contribution)*	**Money Purchase** *(Defined Contribution)*
Who may use	Corporation, partnership, self-employed, S corporation, nonprofit.	Corporation, partnership, self-employed, S corporation, nonprofit.	Corporation, partnership, self-employed, S corporation, nonprofit.	Corporation, partnership, self-employed, S corporation, nonprofit.
Client profile	Best suited for business owners who want simplicity. Ideally suited for companies with more volatile profits and low employee turnover.	Best suited for companies with more volatile profits where employee turnover may be a problem and the desired contribution rate does not exceed 15% of payroll.	The **Age-Weighted** profit sharing plan is best suited for companies that want to favor older employees. The **Cross-Tested** plan is best suited for companies that want to favor particular groups of employees.	Best suited for companies with stable yearly profits. May be useful in combination with a profit sharing plan, subject to combined limit of lesser of 25% or $30,000 of compensation.
Deadline for establishing	Tax filing due date, including extensions.	Last day of employer's tax year.	Last day of employer's tax year.	Last day of employer's tax year.
Deadline for employer contributions	Due date of employer's tax return, including extensions.	Due date of employer's tax return, including extensions.	Due date of employer's tax return, including extensions.	Due date of employer's tax return, including extensions.
Who must be included	Any employee older than age 21 who has worked for the employer for any part of three of last five plan years. May exclude employees earning less than $400 per year.	Any employee with 1,000 hours of service in two 12-month periods who is at least age 21. Can exclude certain employees.	Any employee with 1,000 hours of service in two 12-month periods who is at least age 21. Can exclude certain employees.	Any employee with 1,000 hours of service in two 12-month periods who is at least age 21. Can exclude certain employees.
Obligation to contribute[1]	Employer makes discretionary contributions and can change or discontinue them each year.	Unless fixed as a percentage of compensation or profits, contributions are at the discretion of the employer and are not dependent on profits.	Unless fixed as a percentage of compensation or profits, contributions are at the discretion of the employer and are not dependent on profits.	Employer must meet minimum funding requirement by making the percentage contribution chosen when the plan was adopted.
Maximum annual combined contribution (from the employer and employee) that the employer may deduct	15% of employee's pay (maximum eligible pay per employee is $160,000).	15% of total eligible payroll (maximum eligible pay per employee is $160,000).	15% of total eligible payroll (maximum eligible pay per employee is $160,000).	25% of employee's eligible pay, up to $30,000 (maximum eligible pay per employee is $160,000).
Maximum annual allocation[2] **to employee's account**	15% of employee's gross pay or $30,000, whichever is less.	25% of employee's gross pay or $30,000, whichever is less.	25% of employee's gross pay or $30,000, whichever is less.	25% of employee's gross pay or $30,000, whichever is less.
Maximum annual employee contribution	No employee contributions allowed, except in grandfathered SAR-SEPs.	No employee contributions allowed.	No employee contributions allowed.	No employee contributions allowed.
Vesting	Immediate 100% vesting.	Vesting schedules available.	Vesting schedules available.	Vesting schedule available.
Reporting and disclosure	When plan has been established, employer fills out SEP agreement and gives a copy to the employee when the employee becomes eligible. No additional annual reporting is required.	Full ERISA requirements. IRS Forms 5500, 5500-C, 5500-R or 5500-EZ and applicable schedules must be filed annually.	Full ERISA requirements. IRS Forms 5500, 5500-C, 5500-R or 5500-EZ and applicable schedules must be filed annually.	Full ERISA requirements. IRS Forms 5500, 5500-C, 5500-R or 5500-EZ and applicable schedules must be filed annually.

[1] Top-heavy minimums apply when more than 60% of account balances/accrued benefits are attributable to key employees (or for SEP-IRAs, 60% of aggregate contribution for key employees)
[2] Allocation refers to the total of employer-deductible contributions, forfeitures, and any employee salary deferral or voluntary after-tax contribution.

Defined Benefit Pension Plan *(Defined Benefit)*	**SIMPLE-IRA** *(Savings Incentive Match Plan for Employees)*	**401(k) Profit Sharing** *(Defined Contribution)*	**403(b)**	**457 Plan** *(Nonqualified Deferred Compensation)*
Corporation, partnership, self-employed, S corporation, nonprofit.	Corporation, partnership, self-employed, S corporation, nonprofit and government entities. Business must have 100 or fewer employees and cannot have any other qualified plan.	Corporation, partnership, self-employed, S corporation, nonprofit (excluding government entities).	Organizations qualified under IRC section 501(c)(3), such as schools, churches and hospitals.	State and local governments and nonprofit organizations, such as universities and hospitals. Does not include churches and qualified church-controlled organizations.
Best suited for established companies with consistent profits. Benefits companies with key employees age 50 or older.	Best suited for employers who want to encourage employee retirement savings and avoid costly administration. Employer obligation to contribute is relatively small compared with other plan choices.	Best suited for employers that want to minimize employer contributions and encourage employee savings.	Best suited for employers that want to minimize employer contributions and encourage employee savings, particularly plans that will be employee-funded only.	Best suited for employers that want to minimize employer contributions and encourage employee savings.
Last day of employer's tax year.	Oct. 1 for contributions in current calendar year. (Plan year must be calendar.)	Last day of employer's fiscal year, but no later than commencement of employee contributions.	Can be established anytime during calendar year.	Last day of employer's tax year.
Due date of employer's tax return, including extensions.	Due date of employer's tax return, including extensions. Deferrals must be deposited no later than 30 days following month of payroll.	Due date of employer's tax return, including extensions. Deferrals must be deposited no later than 15 days following month of payroll.	Due date of employer's tax return, including extensions.	Due date of employer's tax return, including extensions.
Any employee with 1,000 hours of service in two 12-month periods who is at least age 21. Can exclude certain employees.	Any employee who earned $5,000 or more during any two preceding years and is expected to earn $5,000 or more in the current year. For 401(k) SIMPLE, see 401(k) column.	Any employee with 1,000 hours of service within 12 months who is age 21 or older. Can exclude certain employees.	All employees of qualified organizations; some exclusions may be allowed.	Any employee with 1,000 hours of service within 12 months who is age 21 or older. Can exclude certain employees.
Employer must meet minimum funding requirements, dictated by the benefit formula and calculated annually by an actuary.	Employer contribution required. Choice of dollar-for-dollar matching contribution up to 3% of employee's compensation or nonelective, nonmatching contribution of 2% of compensation for all eligible employees.	Contributions come from employee salary reduction, and/or from employer.	Contributions typically come from employee salary reduction. Employer contributions are permitted but may subject the plan to additional reporting/ discrimination requirement.	Employer is not obligated to make contributions. All contributions are voluntary salary reductions.
Contribution is not limited (maximum pay per employee to determine benefits is $160,000). Note: Annual benefit from the plan may not exceed the lesser of 100% of participant's compensation or $130,000.	SIMPLE-IRA — $12,000 ($6,000 maximum match up to 3% of pay plus $6,000 deferral). SIMPLE 401(k) — see 401(k) column.	15% of total eligible payroll (maximum eligible pay per employee is $160,000).	25% of employee's eligible pay up to $30,000 (maximum eligible pay per employee is $160,000).	Employee contributions limited to 33 1/3% of includable compensation with a maximum of $8,000. Employee and employer contributions combined are unlimited.
No individual accounts.	Refer to maximum combined contribution, above.	25% of employee's gross pay or $30,000, whichever is less.	25% of employee's gross pay or $30,000, whichever is less.	$8,000. A limited catch-up provision can be used for any or all of the last three years before normal retirement age.
No employee contributions allowed.	$6,000 (adjusted for cost-of-living increases).	Elective contributions up to 25% of net annual compensation,[3] not to exceed $10,000.	Up to 20% of net annual compensation,[3] not to exceed $10,000.[4]	$8,000 (adjusted for cost-of-living increases).
Vesting schedules available.	Immediate 100% vesting.	**Employee elective deferrals:** immediate 100% vesting. **Employer contributions:** vesting schedules available.	**Employee elective deferrals:** immediate 100% vesting. **Employer contributions:** vesting schedules available.	**Employee elective deferrals:** immediate 100% vesting. **Employer contributions:** vesting schedules available.
Full ERISA requirements. IRS Forms 5500, 5500-C, 5500-R or 5500-EZ and applicable schedules must be filed annually.	Minimal for SIMPLE-IRA. Employer must give employees Summary Plan and Contribution Notice no later than Nov. 2 each year. For 401(k) type, see 401(k) column.	Full ERISA requirements. IRS Forms 5500, 5500-C or 5500-R and applicable schedules must be filed annually. Discrimination test applies to deferrals.	If employer makes contributions, IRS Forms 5500, 5500-C or 5500-R must be filed annually.	Under some circumstances, may require full ERISA reporting.

[3] Compensation is amounts shown on W-2 (wages, salaries, bonuses, etc.) and self-employed earned income.
[4] Maximum exclusions, allowances and/or catch-up options may affect individual deferral limits.

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