Chapter 11: Retirement

Self-Employed 401(k) 397
Sources of Retirement Income 399
Choosing the Right Retirement Program 400
Comparison of Net After-Tax Retirement Benefit 404
Employer Goals 405
Employee Considerations 415
Other Considerations 417
Starting, Maintaining, Changing, and Terminating Plans 421
Uniform Lifetime Table/Single Life Expectancy Table 424
Endnotes 425

Corrections were made to this workbook through January of 2004. No subsequent modifications were made.

There have been many changes and clarifications to retirement plans in the past three years. These changes have been covered extensively in chapters on retirement in prior *University of Illinois Farm Income Tax Workbooks*. The first section of this chapter discusses one of the most talked-about plans coming out of the 2001 legislation. The remainder of the chapter describes various alternatives for an employer who wants to consider a retirement plan for his company.

SELF-EMPLOYED 401(K)

One of the hottest topics in the retirement market today is the self-employed 401(k). This plan is referred to as the "solo 401(k)," the "individual 401(k)," or the "Uni-K." The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) increased the deductible contributions to Profit Sharing Plans from 15% to 25% of compensation.[1] EGTRRA also made a new option available to self-employed profit sharing plans. This addition was a 401(k) feature. This feature allows self-employed individuals to take advantage of increased retirement and savings opportunities.

The solo 401(k) is available to sole proprietors, partnerships, corporations, and S corporations, provided they **only** employ a spouse or lawfully excludable employees. Lawfully excludable employees include employees under age 21, part-time employees working less than 1,000 hours per year, and employees subject to collective bargaining agreements. The solo 401(k) substantially reduces current taxable income because the entire amount of the plan contribution is deductible from taxable income. For an incorporated business, the contribution is deducted as a business expense. For the sole proprietor, the contribution is deducted from personal income. As shown in the following example, the contribution can significantly reduce income taxes.

The solo 401(k) allows an individual to contribute $12,000 per year plus 25% of the net business income (less half of the self-employment tax). The maximum is $40,000 in 2003. In addition, if the owner/employee is 50 years of age or older, an additional $2,000 catch-up contribution is allowed.

Example 1. Chris is 55 years old and has a Schedule C business with no employees. In 2003, the business has a net profit of $85,000. His maximum deduction is computed as follows:

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Net business profits	$85,000.00	$85,000.00
IRC §1402(a)(12) deduction = .9235	× 92.35%	
Medicare and FICA wage base	$78,497.50	
FICA and Medicare tax = 15.3%	× 15.3%	
	$12,010.12	
IRC §164(f) deduction (½ Medicare and FICA tax)	× 50%	
	$ 6,005.06	($ 6,005.06)
Self-employment income		$78,994.94
Self-employment income	$78,994.94	
(25% ÷ 1.25 = 20%)	× 20%	
Maximum profit sharing deduction	$15,798.99	$15,798.99
Maximum 401(k) catch-up contribution		$ 2,000.00
Maximum 401(k) contribution		$12,000.00
Maximum owner-only 401(k) deduction		$29,798.99

Example 2. Larry, who is 57 years old, has a part-time consulting business and works full time for another employer. His Schedule C shows a net profit of $15,000. His maximum contribution is calculated as follows:

Net business profits	$15,000.00	$15,000.00
IRC §1402(a)(12) deduction = .9235	× 92.35%	
Medicare and FICA wage base	$13,852.50	
FICA and Medicare tax = 15.3%	× 15.3%	
	$ 2,119.43	
IRC §164(f) deduction (½ Medicare and FICA tax)	× 50%	
	$1,059.72	($1,059.72)
Self-employment income		$13,940.28
Self-employment income	$13,940.28	
(25% ÷ 1.25 = 20%)	× 20%	
Maximum profit sharing contribution	$ 2,788.06	$ 2,788.06
Maximum 401(k) catch-up contribution		$ 2,000.00
Maximum 401(k) contribution		$12,000.00
Calculated maximum owner-only 401(k) contribution		$16,788.06
Actual maximum owner-only 401(k) contribution		$13,940.28

Note. Larry's maximum contribution is limited to his net self-employment income.

Observation. If the Schedule C income were Larry's only income, he may not be able to afford to make the maximum contribution. Consequently, he might be better off choosing to contribute to an IRA or a less expensive type of plan.

In addition to the higher contribution limits, another reason for the increased popularity of solo 401(k)s is the minimal paperwork required. The plan is exempt from discrimination testing, provided the business owner is the only employee. If plan assets exceed $100,000, the plan must file Form 5500 with the IRS. Smaller plans file Form 5500EZ.

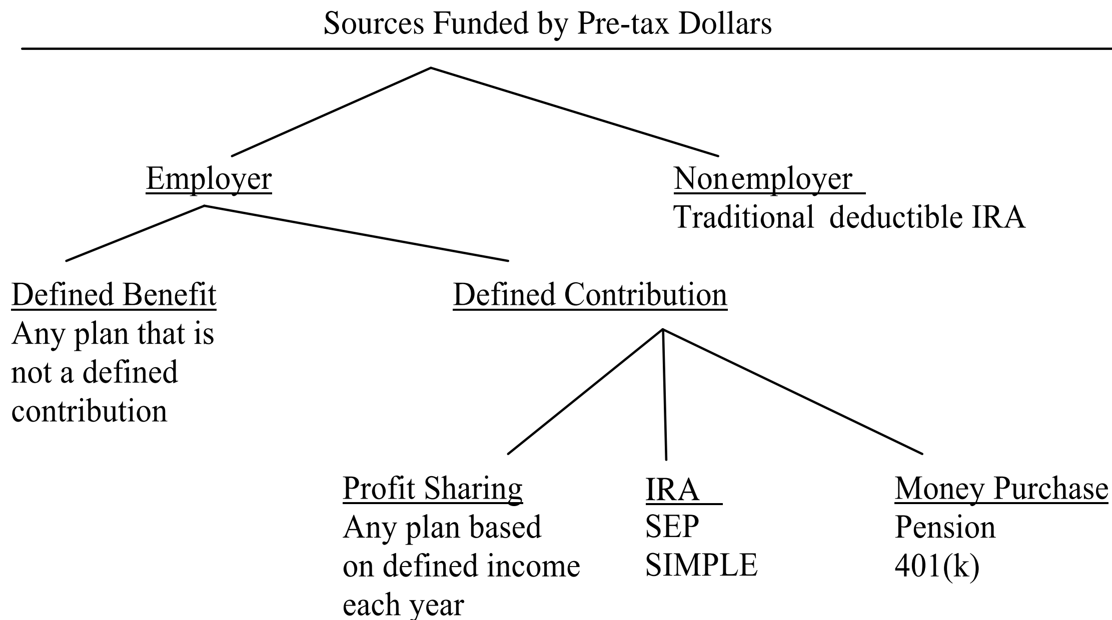
While SEP and SIMPLE IRA plans prohibit loans, profit sharing plans allow them. This means self-employed taxpayers with a solo 401(k) plan can roll their IRA plans into the 401(k) and take a plan loan.

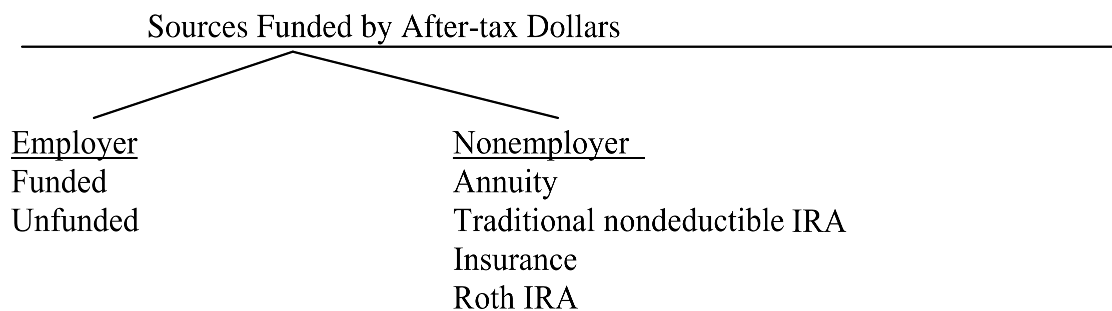
Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

There are some disadvantages to the solo 401(k). For example, establishing the plan requires more responsibility than a SEP or SIMPLE plan. The plan needs a trustee to hold the plan assets. If the taxpayer acts as his own trustee, he must be certain to follow all the details of the plan. The trustee must prepare and retain records regarding the plan and its activities. The plan requires a document describing how the plan operates. Typically, these are standard documents and many plan providers include these documents in their start-up cost.

The solo 401(k) plan must be set up prior to the end of the business tax year, although contributions may be made until the due date of the tax return, including extensions.

SOURCES OF RETIREMENT INCOME





Other Sources of Retirement Income

Stocks
Bonds
Mutual Fund savings
Real estate
Savings
Social Security

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

This is an overview of the choices employers and employees have in retirement planning. For many, at least two of the three will be used in accumulating the needed retirement funds.

CHOOSING THE RIGHT RETIREMENT PROGRAM

INTRODUCTION

Before 1974, when individual retirement accounts were initiated, employees who worked for employers who did not have retirement plans were unable to save tax sheltered money for their retirement. Since that time, a multitude of changes and additions have been made to the code so both employers and employees have numerous choices. Unfortunately, with all of the choices available, it becomes more difficult to know which is the right plan to choose.

Government data from 1999 indicate that 58% of all private-sector workers were employed by firms sponsoring a retirement plan. The data also indicate that only 20% of the small employers (100 or fewer employees) have retirement plans. It is no secret that the government is searching for a method to encourage more taxpayers to take a larger role in funding their retirement. The average monthly social security check is less than $900 in 2003. The amount of this benefit continues to decrease as a percentage of the amount needed for retirement income. Available retirement plans have expanded, reporting requirements have decreased, and credits are available to the employer and employee.

To determine the best plan for an employer or employee, a detailed analysis must be performed. The following is meant to be a guide to help decision makers.

CATEGORIES OF PLANS

Retirement plans fall into two major categories. They are either **qualified plans** or **nonqualified plans.** Outside investments are also used in retirement planning but are not considered retirement plans per se.

QUALIFIED PLANS

A qualified plan is one that meets the requirements of IRC §401. Contributions are usually deductible by the employer in the current year,[2] earnings of the retirement plan trust accumulate tax-deferred,[3] and employees are not taxed until the benefits are received.[4]

Qualified plans must:

- Be in writing;
- Be created by the employer as a permanent arrangement;
- Provide for definitely determinable benefits, in the case of a pension plan, or contributions must be allocated according to a definite predetermined formula, in the case of a profit-sharing plan;
- Be in writing and be domestic if it is a trust; and
- Be communicated to employees.

Additionally the plan must:

- Provide for contributions to the trust by the employer and/or the employees,
- Make it impossible for any part of the trust's corpus or income to be used for any purpose other than the exclusive benefit of the employees or the beneficiaries,
- Satisfy minimum participation and minimum coverage requirements,
- Satisfy nondiscrimination requirements, and
- Comply with minimum vesting standards and rules on benefit accruals.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

If a plan benefits owner-employees, the plan must satisfy other requirements. They must:

- Comply with rules relating to top-heavy status;
- Provide for payment of joint and survivor and preretirement survivor annuities;
- Include provisions protecting beneficiaries in the case of mergers, terminations, and transfers;
- Ensure benefits cannot be assigned or alienated;
- Ensure distributions will begin in accordance with the rules on required distributions;
- Ensure the amount of benefits payable to retired employees will not be reduced because of an increase in the amount of benefits received under social security if the plan is integrated with social security;
- Provide for benefits or contributions exceeding the limitations on contributions and benefits;
- Provide for direct transfers of eligible rollover distributions;
- Limit the compensation taken into account under the plan for any year to $200,000 ($150,000 before inflation adjustment);
- Allow any part of the benefits under the plan that are attributable to employer contributions to be forfeited because of the withdrawal of employee contributions, except as permitted under the vesting rules; and
- Not be amended while the employer is a debtor in a bankruptcy case to increase its liabilities.[5]

Types of Qualified Plans

Defined Benefit Plans. A defined benefit plan is usually based on compensation and length of service; it may or may not be integrated with social security benefits. There are no separate employee accounts and the contributions cannot be tied to profits. A defined benefit plan is a pension plan using a predetermined funding formula to fund the plan. In addition to the general requirements of all qualified plans listed previously, the following also must be met for a defined benefit plan:

- Plan forfeitures cannot be used to increase benefits paid to any employee.
- Actuarial assumptions must be stated to preclude employer discretion.
- Plan must meet minimum participation requirements.
- Any plan amendments that increase current liabilities, while underfunded, must meet the requirements of IRC §401(a).

Defined benefit plans work very well in certain circumstances. The plans are based on a needed benefit, not a set contribution amount. The following example is not based on actuarial numbers.

Example 3. Toby is 53 and earns $125,000 annually as a self-employed decorator. He has nothing saved for retirement. He would like a retirement income of $62,500 per year plus social security. He plans to retire at age 62 and hopes to live until age 87.

The first year contribution will be $77,177 assuming a 6% rate of return. The remaining years' contribution will be computed based upon the previous year's balance.

It takes approximately $14,250 to generate $1,000 per year for 25 years using 5% growth. Toby will need $890,625 in his account when he retires in nine years in order to create the $62,500 per year he desires.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

The only choice available to meet Toby's goal of $62,500 per year would be a defined benefit plan. If Toby had employees it would be necessary to look at the overall cost of covering everyone with a defined benefit plan. If most employees are young and paid considerably less, a defined benefit plan could still make sense. If that is not the situation, a defined contribution plan coupled with a nonqualified plan might provide the solution. Investing outside of any plan is also a consideration.

A defined benefit plan is more expensive to set up and maintain than other types of plans. However, for the right situation, the cost will be recovered by the tax savings. In addition, the plan has the ability to shelter the earnings and growth each year. Points to consider regarding defined benefit plans include the following:

- The plan is employer funded.
- An actuary must determine annual contributions.
- Employees over 21 who worked at least 1,000 hours in a prior year generally must be covered.
- The plan must file Form 5500 annually.
- Benefits are based on a combination of age, salary, and benefit.
- The plan can be integrated with social security.
- A vesting schedule is allowed.
- Loans can be allowed by the plan.

A defined benefit plan is not as popular today as in the past. Plans being set up today in small businesses tend to include an aging employer who wants to contribute the maximum amount in a short period of time.

Defined Contribution Plans. Defined contribution plans are based on the contribution, not the expected benefit. The retirement benefit will be determined by contributions, earnings, expenses, and forfeitures. Each employee will have a separate account during employment and at retirement. There are some additional requirements for the defined contribution plan in addition to the general requirements of all qualified plans:

- If more than 10% of the plan's securities are employer securities, and it is not a profit-sharing plan, it must meet voting requirements for employer securities.
- If the plan is a stock bonus plan, it must meet the option and distribution requirements applicable to employee stock option plans (ESOPs).
- If the plan is a money purchase or target benefit plan, contributions must be made annually. A defined contribution plan that is a profit-sharing plan does not have a yearly contribution requirement.

Defined contribution plans are far more popular today with small employers than defined benefit plans. The most popular of the defined contribution plans are IRA-based plans. SEP IRA plans are employer funded and SIMPLE IRA plans are funded by both the employee and employer. Reasons for the popularity of defined contribution plans include the following:

- The cost to fund the plan is controllable.
- The plan is inexpensive to start and maintain.
- There are fewer filing requirements.
- Deferred vesting is allowed in non-IRA based plans.
- There is less permanence in IRA-based plans.
- The investment risk is carried by the employee rather than the employer.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

NONQUALIFIED PLANS

Nonqualified plans are all plans that do not meet the requirements of a qualified plan. They include deferred compensation arrangements and employer-funded or employee-funded annuities.

Funded Nonqualified Plans

If plan assets are earmarked for the **exclusive** benefit of the employees and beneficiaries, it is considered **funded.**

An employee must generally include the contributions to a funded nonqualified deferred compensation plan in gross income in the first year that the rights to the contributions are transferable or are not subject to a substantial risk of forfeiture.[6] Similarly, if an employer pays premiums for an annuity contract that is not part of a qualified plan, the employee must include the amount of the premiums as income in the first year that the amount is transferable or is not subject to a substantial risk of forfeiture.[7] Transferable simply means the employee can actually transfer or take the funds, and not be subject to a substantial risk of forfeiture.

The following rules determine income recognition and employer deduction:

- If the employee becomes vested immediately, the contribution amount will be the amount included in income.
- If the employee becomes vested at a later date, the amount included in income will be the contributions plus earnings and growth.

Contributions made by an employer to a nonqualified deferred compensation plan are treated as wages subject to employment taxes when the services are performed, or when there is no substantial risk of forfeiture of the rights to the contributions, whichever is later.[8]

An employer deducts its contributions to a funded nonqualified deferred compensation plan. The deduction is taken in the year in which an amount attributable to the contribution is includable in the gross income of the employees participating in the plan.[9]

An example of a nonqualified funded plan is the supplemental executive retirement plan (SERP).

> **Example 4.** Able Corporation has a nonqualified plan for the upper-level managers. Able Corporation contributes 7% of compensation to an investment fund set up for the exclusive benefit of this group. These employees are not allowed access to their account. If Able Corporation entered into bankruptcy, the investment account would be considered an asset of the bankrupt business. The employer, during the current year, has no deduction for the contribution and the employee has no reportable income.

Most nonqualified funded plans are in addition to a qualified employer plan. They are used to attract and retain employees needed for specific positions, without requiring the strict criteria of a qualified plan to be met.

Unfunded Nonqualified Plans

In most cases, an unfunded nonqualified plan will not receive contributions. The employer will report deductions, and the employee will report taxable income when the employer pays the deferred compensation to the employee. This usually happens at retirement. In some cases, an employer will fund the plan, but because it is not transferable and forfeitable, it is considered unfunded.

OUTSIDE PLANS

A third source of retirement income is investments that do not grow tax deferred and allow no deduction for monies invested. These types of plans are included for two reasons:

1. Changing tax brackets can cause one funding method to be preferable to another. With the latest tax bill, this area will receive more scrutiny.
2. Outside plans have the obvious advantage of being able to be used for other important life events without penalties.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

COMPARISON OF NET AFTER-TAX RETIREMENT BENEFIT

The chart in the following example compares using a qualified retirement account, using a nonqualified retirement account, and using an outside account (i.e., contributions are not deductible and earnings are not deferred).

Example 5. Jeremy has $10,000 to invest each year and has no other monies available. He pays $3,000 in taxes on this $10,000 each year, consequently only $7,000 is available for investment. All accounts are invested in identical index funds with 8% growth per year.

Situation A. Jeremy is in a 30% tax bracket during contribution years and at retirement.

	Qualified	Nonqualified (Annuity)	Outside Plan
Investment per year	$ 10,000	$ 7,000*	$ 7,000*
8% growth per year for 30 years	1,132,800	792,960	733,040**
Basis at retirement	0	210,000	285,000***
Taxable portion	1,132,800	582,960	448,040
Tax (30% rate on ordinary income, 20% rate on capital gain)****	339,840	174,888	89,608
Net to owner	792,960	618,072	643,432

*$10,000 − tax.
**A nonsheltered account using an index fund such as the S&P 500 reults in approximately 0.5% tax burden on the growth.
***Because it is nonsheltered, part of the growth will be taxed each year.
****Assume the capital gain rate is 20% during his retirement years.

Situation B. Jeremy is in a 30% tax bracket during contribution years and 38% at retirement.

	Qualified	Nonqualified (Annuity)	Outside Plan
Investment per year	$ 10,000	$ 7,000	$ 7,000
8% growth per year for 30 years	1,132,800	792,960	733,040
Basis at retirement	0	210,000	285,000
Taxable portion	1,132,800	582,960	448,040
Tax (38% rate on ordinary income, 20% rate on capital gain)	430,464	221,255	89,608
Net to owner	702,336	571,435	643,432

Situation C. Jeremy is in a 15% tax bracket during contribution years and 30% at retirement.

	Qualified	Nonqualified (Annuity)	Outside Plan
Investment per year	$ 10,000	$ 8,500	$ 8,500
8% growth per year for 30 years	1,132,800	962,880	890,120
Taxable portion	1,132,800	707,880	554,050
Tax (30% rate on ordinary income, 20% rate on capital gain)	339,840	212,364	110,810
Net to owner	792,960	750,516	779,310

In all three scenarios, the qualified account yielded more money.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Note. The outside account produced a larger after-tax benefit than the nonqualified account. This raises the following question: In comparison, what will a 15% rate on dividends and capital gains do?

EMPLOYER GOALS

Before discussing the goals of a retirement plan with a client, it is helpful to graphically show the different retirement options available. The following pages outline the basic plan requirements of various options for 2003. It should be noted that advantages and disadvantages are very subjective. In many cases an advantage is also a disadvantage for the same plan (e.g., defined benefit plans have the advantage of higher contribution levels but the plan is 100% employer funded). The advantages and disadvantages are described from an employer's perspective.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Plan Type	Qualified Employer	Who MUST be covered	Plan establishment deadline	Employee maximum annual deferral
401(k)	• All taxable businesses • Tax-exempt organization	Any employee with 1,000 hours of service for 1 year; age 21 or older; can exclude certain employees	Last day of fiscal year; not later than beginning of employee contributions	Up to $12,000; 50+ catch-up contributions of $2,000 allowed
401(k) with Safe Harbor	• All taxable businesses • Tax-exempt organization	Same as 401(k)	First day of plan year	Up to $12,000; 50+ catch-up contributions of $2,000 allowed
403(b)	I.R.C. 503(c)(3) organization	If one employee participates, all other employees are allowed to participate if they contribute at least $200, regardless of years of service	Last day of fiscal year; not later than beginning of employee contributions	Up to $12,000; 50+ catch-up contributions of $2,000 allowed
Defined Benefit Pension	• All taxable businesses • Tax-exempt organization • Government entities	Same as 401(k), except if immediate 100% vesting, 2 years of service may be required	Last day of fiscal year	No pretax contributions allowed
Money Purchase	• All taxable businesses • Tax-exempt organization • Government entities	Same as 401(k), except if immediate 100% vesting, 2 years of service may be required	Last day of fiscal year	No pretax contributions allowed
Profit-Sharing	• All taxable businesses • Tax-exempt organization • Government entities	Same as 401(k), except if immediate 100% vesting, 2 years of service may be required	Last day of fiscal year	No pretax contributions allowed
SEP	• All taxable businesses • Tax-exempt organization • Government entities	Any employee who worked 3 of past 5 yrs; age 21 or older; may exclude employees with less than $450 in wages	Tax filing deadline, plus extensions	No pretax contributions, except grandfathered SAR-SEP; 50+ catch-up contributions of $2,000 allowed
SIMPLE IRA	• 100 employees or less • All taxable businesses • Tax-exempt organization • Government entities	Any employee earning $5,000 during past 2 years and who is expecting to earn $5,000 in current year; can exclude certain employees	Between January 1 and October 1	$8,000; 50+ catch-up contributions of $1,000 allowed

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Plan Type	Employer deductible annual combined contribution maximum	Employer contribution requirement	Maximum total allocation to employee's account	Allocation formulas for contributions
401(k)	25% of total eligible payroll (maximum pay per employee is $200,000); plus amount of elective deferrals contributed	None, unless plan is top-heavy	100% employee pay or $40,000 whichever is less	• Nonintegrated allocation • Integrated with Soc. Sec. • Cross tested
401(k) with Safe Harbor	Same as 401(k)	One of the following: • Basic match formula • Enhanced match formula • Nonelective contribution	Same as 401(k)	Same as 401(k)
403(b)	Tax deduction is not issue for tax exempt organizations	None	Same as 401(k)	Does not apply
Defined Benefit Pension	Limited to amount needed to fund future benefits (maximum pay per employee is $200,000)	Contributions based on predicted payouts	No individual accounts	Does not apply
Money Purchase	25% of total eligible payroll (maximum pay per employee is $200,000)	Described in plan document	Same as 401(k)	Same as 401(k)
Profit-Sharing	Same as Money Purchase	Flexible contributions allowed each year; employer must make substantial and recurring contributions	Same as 401(k)	No pretax contributions allowed
SEP	25% of employee's pay or $40,000, whichever is less	None; unless plan is top-heavy	25% of employee's pay or $40,000, whichever is less	• Nonintegrated allocation • Integrated with Soc. Sec.
SIMPLE IRA	$16,000 ($8,000 deferral plus $8,000 maximum match)	Dollar for dollar match up to 3% pay, or 2% gross pay for all eligible employees who earn $5,000 during the year	$16,000	Does not apply

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Plan Type	Vesting	Distributions controlled by	Employee Loans	Plan Advantages
401(k)	According to schedule	Employer, through plan terms	Yes	• Employer can use profit sharing to enhance plan • Employee deferral of taxes • More design flexibility than IRA-based plans • More flexibility with amounts due to increased deferral limits
401(k) with Safe Harbor	Immediate 100% on non-safe harbor contributions	Employer, through plan terms	Yes	• No discrimination testing • Employee deferral of taxes • Maximum employer exposure is 4% • More flexibility with amounts due to increased deferral limits
403(b)	According to schedule	Employer, through plan terms	Yes, except indiv. established accts	• Employee deferral of taxes • More flexibility with amounts due to increased deferral limits
Defined Benefit Pension	According to schedule	Employer, through plan terms	Yes	• Favors long-term employees • Annual retirement benefit can be as high as 100% of the highest 3-yr average pay, up to $160,000 • Guaranteed annuity payments for life
Money Purchase	According to schedule	Employer, through plan terms	Yes	• More design flexibility • Vesting flexibility • Can be paired with other retirement plans
Profit-Sharing	According to schedule	Employer, through plan terms	Yes	Flexible contributions
SEP	100% immediate vesting	Employee	Not applicable	• Minimal paperwork and expense • Minimal tax filing • Ongoing contributions not required • More flexibility with amounts due to increased deferral limits
SIMPLE IRA	100% immediate vesting	Employee	Not applicable	• Owner-employee can contribute even if no other employee chooses to participate • Minimal paperwork and expense • Minimal tax filing • Employee deferral of taxes • More flexibility with amounts due to increased deferral limits

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

PLANS DESIGNED FOR EMPLOYEE RETENTION

Adding a retirement plan to employee benefits has a double benefit. If the plan has forfeitable contributions, employees are encouraged to stay because they will lose something by leaving. Another advantage or benefit is that the existence of a retirement plan makes a statement that the employer cares about an employee's future and is doing something to protect it.

Recent studies show employees consider the employer's retirement plan package to be the secondmost important employee benefit. Since the retirement plan is considered this important, it is worth putting adequate thought and time into its proper design.

A retirement plan for the employee helps in the business in many ways:

- **Indicates Concern for the Employee.** Every employee wants to feel important to the employer and the employer wants the employees to know they are important to the employer.
- **Competitive Advantage.** Having a well-thought-out retirement plan that is viewed by the employee as fair and significant will help recruit and retain employees.
- **Reduces Training Cost.** It is estimated that the cost of hiring and training a new employee can exceed 50% of the first year's salary. Although the cost varies depending on the industry in which the employee works, it is still very high. The cost of a retirement plan might be viewed as justified since it may reduce overall cost by eliminating or reducing training expenses.
- **More Productive Employees.** Whenever an employer does something to reduce the stress or uncertainty in employees' lives, the result will likely be more productive employees.

Example 6. New Home Builders (NHB) has been building new homes in the Madison area for the last 15 years. The corporation has three equal shareholders, consisting of a 62-year-old mother, a 40-year-old daughter, and a 37-year-old son. All three shareholders are also employees.

NHB is an S corporation and has 6 full-time employees, in addition to the shareholder employees. The full-time employees have an average age of 43. All employees have worked for NHB for more than 5 years and the 2002 gross payroll was $199,800. In addition, each employee-shareholder received $65,000.

The business income of NHB reflects the economy and has an average net income of $90,000. Its best year was 2002, producing a net income of $178,000. Its worst year was 1998, producing a net loss of $83,000.

In past years, NHB borrowed money to build "spec" homes. Now it is able to fund "spec" homes with retained earnings. NHB rarely uses part-time employees. The three stockholder/employees would like to start a retirement plan with the stated goal of helping the employees achieve a more secure retirement.

Further analysis indicates the mother is not rich, but lives comfortably, and has no need to shield large retirement monies for herself. All employee-shareholders would appreciate tax savings. NHB indicates it is willing to commit $25,000 per year to the new retirement plan in the beginning years. NHB's analysis is as follows:

Defined Benefit Plan. A defined benefit plan for NHB is too costly. It benefits the wrong person and puts the company at risk because of the fluctuating economy. If the building industry experienced a severe downturn, the company would have to use equity for its retirement contributions instead of funding its spec homes.

Defined Contribution Plan. Since NHB has nine employees, including the shareholder employees, and an annual $25,000 retirement plan budget, a stand-alone defined contribution plan may not be the best choice. If NHB contributes an average of $3,000 per year for 20 years for each employee, and experiences 6% net growth, the individual accounts would have approximately $110,000 at retirement. This would provide monthly retirement income of approximately $550, which is a very low retirement income.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

SIMPLE IRA. A salary deferral plan, with a company match, will allow employees to substantially increase their total retirement plan contributions. A SIMPLE IRA plan allows a maximum employer contribution of 3% of participating employee compensation. For NHB, with a gross payroll of $394,800 ($199,800 + ($65,000 × 3)), this will allow a maximum employer contribution of approximately $12,000. This plan does not align with the employer's desire to budget $25,000 per year to the plan. Also, a SIMPLE IRA precludes any other retirement plan.

401(k). A 401(k) with an employer match would meet NHB's requirements. The match can be set at 100% of the employee's deferred contribution up to 6% of compensation. This allows an overall plan contribution of approximately $47,000 per year between employee and employer. The employer portion is close to the $25,000 budgeted amount.

Because a 401(k) plan allows other pension plans to be active with the employer, a profit-sharing plan can also be implemented. Profit sharing will only be applicable in profitable years. The plan can be designed to limit employer risk. For both the matching 401(k) and the profit-sharing plan, the overall plan cost and maintenance will need to be discussed. The cost of this type of plan will be greater than for IRA-based plans; however, it appears to be justified by the result.

Plans Not Selected for NHB

- **SEP IRA.** Limited employer contribution to less than $3,000 per employee (within budget of $25,000).
- **SIMPLE IRA.** Limited employer contribution to less than one-half the budgeted amounts and prohibits other plans from being used.
- **Defined Benefit.** Too costly and benefited wrong individuals.
- **Other Defined Contribution Plans.** Without an employee contribution, the budgeted $25,000 will not produce the meaningful retirement dollars considered needed.

PLANS DESIGNED TO MAXIMIZE EMPLOYER TAX SAVINGS

Tax savings will be accomplished to some degree for any plan chosen. The employee saves with deferral plans. The employer saves on matching deferral plans, and all other qualified plans into which contributions are made. As part of advising the client, social security taxes should be discussed. If a retirement plan is viewed as merely another form of compensation, social security taxes come into play in addition to workers' compensation insurance.

Example 7. Gail has an annual payroll of $420,000 and is faced with a choice between a 5% wage increase and starting a retirement plan that contributes at least 5% for the employees. For both options, Gail will save income taxes on the $21,000 (420,000 × 5%) of added expense.

If Gail chooses a retirement account (e.g., SEP IRA), she will save social security taxes and workers' compensation premiums. Her employees are carpenters with a workers' compensation rate of 12.69%. If she chooses a retirement account, she will have a 20.34% cost reduction which includes a 7.65% social security rate. By contributing $21,000 into a retirement account rather than providing a 5% wage increase, she will reduce other expenses by $4,271.

Not all cases can be viewed as a trade-off between a retirement plan and a raise, but in most cases, negotiations take place and the overall cost to the employer must be considered. The employer could offer a **6%** retirement plan, and the cost would still be less than a 5% wage increase.

PLANS DESIGNED TO MAXIMIZE AN EMPLOYER'S RETIREMENT

In order to help a client decide which plan will be most appropriate, the professional needs to understand the client's goal for the retirement plan. The professional must:

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

- Understand what constitutes a secure retirement for everyone at a minimal cost and
- Understand what is expected of the plan and determine the amount of money the employer is willing to commit, thereby eliminating plans that cost too much

How Much Is Needed

When advising clients, it is important to help them gain a realistic understanding of the amount of money needed to produce an adequate retirement income. Many clients have no idea how much the retirement years are going to cost. As a beginning step, the professional can determine what the client believes is a sufficient yearly income in retirement. Typically, individuals need at least 75% of their current income. This percentage may vary depending on current income and other factors.

A "6,6,3" Table is shown to help illustrate how much money is needed at retirement. Any of the variables can be changed; however, this chart is based on $100,000 and what it will provide at retirement earning 6% per year, withdrawing 6% per year with the withdrawal rate increasing 3% per year to cover inflation. Each $100,000 at retirement will yield $6,000 per year. This amount is increased yearly for inflation.

6,6,3 Table (Based on $100,000 Savings)

Year	Earnings (6% Annually)	Withdrawals (6% Annually, Increasing 3%/Yr.)	Year-End Balance
1	$6,000.00	$ 6,000.00	$100,000.00
2	6,000.00	6,180.00	99,820.00
3	5,989.20	6,365.40	99,443.80
4	5,966.63	6,556.36	98,854.07
5	5,931.24	6,753.05	98,032.26
6	5,881.94	6,955.64	96,958.55
7	5,817.51	7,164.31	95,611.75
8	5,736.70	7,379.24	93,969.21
9	5,638.15	7,600.62	92,006.74
10	5,520.40	7,828.64	89,698.51
11	5,381.91	8,063.50	87,016.92
12	5,221.02	8,305.40	83,932.53
13	5,035.95	8,554.57	80,413.92
14	4,824.84	8,811.20	76,427.55
15	4,585.65	9,075.54	71,937.66
16	4,316.26	9,347.80	66,906.12
17	4,014.37	9,628.24	61,292.25
18	3,677.53	9,917.09	55,052.70
19	3,303.16	10,214.60	48,141.26
20	2,888.48	10,521.04	40,508.70
21	2,430.52	10,836.67	32,102.55
22	1,926.15	11,161.77	22,866.94
23	1,372.02	11,496.62	12,742.34
24	764.54	11,841.52	1,665.36
25	99.92	1,765.28	0.00

The Future Value Table that follows shows the results of investing $1.00 per year at various growth rates over various numbers of years. Investing $1,000 per year at 10% for 26 years will yield $109,180 (1,000 × 109.18).

A Future Value Table can be constructed using any number of years and any growth rate. Because inflation has such a devastating effect on retirements, it is advisable to use a net growth rate (growth rate minus inflation rate).

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Future Value Table of $1.00 per Period with Annual Compounding

Years	4%	6%	8%	10%
2	$ 2.04	$ 2.06	$ 2.08	$ 2.10
4	4.25	4.37	4.50	4.64
6	6.63	6.97	7.33	7.71
8	9.21	9.89	10.63	11.43
10	12.01	13.18	14.48	15.93
12	15.03	16.86	18.97	21.38
14	18.29	21.01	24.21	27.97
16	21.82	25.67	30.32	35.94
18	25.65	30.90	37.45	45.59
20	29.78	36.78	45.76	57.27
22	34.25	43.39	55.45	71.40
24	39.08	50.81	66.76	88.49
26	44.31	59.15	79.95	109.18
28	49.97	68.52	95.33	134.20
30	56.08	79.05	113.28	164.49

Example 8. John is currently earning $75,000 per year and expects to work another 30 years.

Question A. What is his estimated retirement income requirement?

Answer A. $75,000 × 75% = $56,250 is his total estimated needed retirement income.

John has no other money set aside for retirement, and his accountant estimates John will receive $12,000 from social security per year. If John had other retirement income, an additional adjustment would be made for that source.

$56,250 – $12,000 social security = $44,250 needed from retirement account

Question B. What will John need to contribute annually to obtain $44,250 per year in retirement income?

John believes the 6,6,3 Table is reasonable and believes for the next 30 working years his investment will earn 9%. The net growth rate in this calculation is 6% (9% growth minus 3% inflation).

Answer B. If John expects $44,250 per year from his retirement account, he will need $737,500 in the account when he is age 65.

$44,250 ÷ 6,000 × 100,000 = $737,500
(6,6,3 Table shows he needs $100,000 to produce income of $6,000 per year)

Using the Future Value Table, John must contribute $9,330 per year to end up with $737,500 at the end of 30 years with a net growth rate of 6%.

737,500 ÷ 79.05 = $9,330

Although the retirement account amount factored in a growth percentage and an inflation rate, there is still one more inflation factor to consider. John's salary is likely to increase over time, and his annual contribution should be a fixed percentage, rather than a fixed dollar amount. In John's case, he should contribute 12.5% of his salary annually rather than $9,330 per year. This adjustment will make the plan more meaningful.

As the 6,6,3 Table indicates, the money will last approximately 25 years. Most clients believe $100,000 will yield more than $6,000 per year in retirement. They also do not realize how fast money is depleted when employment and paychecks cease.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

The 6,6,3 Table shows the amount of money needed at retirement to provide income through an individual's remaining years. If a client is currently earning $80,000, it is reasonable to assume he will need $60,000 per year in retirement. If $100,000 produces $6,000 per year, $1 million will yield the desired $60,000.

Plan Choices

When there are no employees, the plan choice becomes one of income now or later for the employer. Other than tax savings, it is a simple trade-off between current income versus retirement income.

With a defined contribution plan, most clients will be able to contribute and deduct around $40,000 per year. The plan can be designed to be funded using smaller contributions to reduce the funding risk. This can be done with a SEP IRA or a profit-sharing plan. If more retirement funds are needed, a defined benefit plan can be set up to allow greater contributions and deductions. The cost of a defined contribution plan can be close to zero, and the cost of a defined benefit will be greater. In **Example 8**, it appears a defined contribution plan will meet John's goal. A SEP plan is an inexpensive plan that John can use.

Although a particular retirement plan may appear to be a great solution at one point in time, will the same be true in the future? Over the years, businesses can significantly change.

Example 9. Janice is a self-employed land surveyor. She is 30 years old, and her annual income is $50,000. She is considering four retirement plans consisting of SEP IRA, SIMPLE IRA, 401(k) with a deferred contribution maximum, and a 401(k) plan with a 6% match. She analyzes each plan assuming zero employees, 2 employees, and 25 employees.

Zero Employees

Plan Type	Maximum Owner Contribution	Maximum Owner Added Employee Cost	Benefits as % of Cost to Employer
SEP IRA 25%/20%	$ 9,294	0	100
SIMPLE IRA	9,394	0	100
401(k) with deferred contribution maximum	21,294	0	100
401(k) 6% match	14,630	0	100

2 Employees at $22,000 Each

Plan Type	Maximum Owner Contribution	Maximum Owner Added Employee Cost	Benefits as % of Cost to Employer
SEP IRA 25%/20%	$ 9,294	$11,000*	46
SIMPLE IRA	9,934	1,320	88
401(k) with deferred contribution maximum	21,294	11,000*	66
401(k) 6% match	14,630	2,640	85

* 2 employees @ $22,000 = $44,000 × 25% = $11,000.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

25 Employees at $28,000 Each

Plan Type	Maximum Owner Contribution	Maximum Owner Added Employee Cost	Benefits as % of Cost to Employer
SEP IRA 25%/20%	$ 9,294	$175,000*	5
SIMPLE IRA	9,394	21,000	31
401(k) with deferred contribution maximum	21,294	175,000*	11
401(k) 6% match	14,630	42,000	26

* 25 employees @ $28,000 = $700,000 × 25% = $175,000.

Example 10. Assume the same facts as **Example 9,** except Janice has an annual salary of $100,000.

Zero Employees

Plan Type	Maximum Owner Contribution	Maximum Owner Added Employee Cost	Benefits as % of Cost to Employer
SEP IRA 25%/20%	$18,653	0	100
SIMPLE IRA	10,798	0	100
401(k) with deferred contribution maximum	30,652	0	100
401(k) 6% match	17,278	0	100

2 Employees at $22,000 Each

Plan Type	Maximum Owner Contribution	Maximum Owner Added Employee Cost	Benefits as % of Cost to Employer
SEP IRA 25%/20%	$18,653	$11,000	63
SIMPLE IRA	10,798	1,320	89
401(k) with deferred contribution maximum	30,653	11,000	74
401(k) 6% match	17,278	2,640	87

25 Employees at $28,000 Each

Plan Type	Maximum Owner Contribution	Maximum Owner Added Employee Cost	Benefits as % of Cost to Employer
SEP IRA 25%/20%	$18,653	$175,000	10
SIMPLE IRA	10,798	21,000	34
401(k) with deferred contribution maximum	30,653	175,000	15
401(k) 6% match	17,278	42,000	29

Many scenarios can be created by changing the employer's compensation, the number of employees, and average compensation of employees. These tables do not identify which plan works best for each scenario. They only describe what an employer can expect if one plan is chosen over another.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

EMPLOYEE CONSIDERATIONS

PROVIDING INFORMATION

When an employer introduces a new retirement plan, an important role for the professional is to provide information. This helps reduce employee uncertainty and stress that can be associated with a change in benefits. As previously mentioned, the retirement plan is the secondmost important benefit to an employee. Employers need to help employees understand what a retirement plan **will do** and what it **will not do.** All employees need to understand there are no guarantees.

Most plans being implemented today are defined contribution plans. This type of plan is based on set contributions, not a set benefit. Therefore, the risk lies with the employee.

Many plans are funded by a combination of employee and employer funds, rather than exclusively employer funds. Because these plans are based on an employer match, the maximum employer contribution can only be achieved when employees make contributions. The consequences of an employer match in relation to the one-year rate of return on employee contributions must be properly explained.

The responsibility for investment choices in many plans now rests 100% with the employee. The employer cannot give investment advice, and most tax professionals are not licensed to give specific investment advice. However, professionals can help by:

- Having an easy-to-understand Future Value Table based on monthly investments,
- Having charts that show the rate of return for the last 1, 3, 5, 10, and 15 years that can be used with the Future Value Table,
- Explaining what index mutual funds are and how they work,
- Encouraging the employer to use a low-cost company that uses funds based on approximate retirement dates, and
- Explaining retirement choices and options.

Future Value Chart — $1,200 Invested per Year

Monthly Investment	Rate of Return (%)	Number of Years	Year-End Balance
$100.00	2	10	$ 13,140
100.00	2	15	20,751
100.00	2	20	29,156
100.00	2	25	38,436
100.00	4	10	14,407
100.00	4	15	24,029
100.00	4	20	35,734
100.00	4	25	49,975
100.00	7	10	16,579
100.00	7	15	30,155
100.00	7	20	49,194
100.00	7	25	75,899
100.00	10	10	19,124
100.00	10	15	38,126
100.00	10	20	68,730
100.00	10	25	118,016

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

When explaining examples to clients, the professional will want to use inflation-adjusted rates of return so the Year - End Balance column has meaning in current dollars. A retirement account is not only about dollars, it is about what dollars will buy. It is easier to plan using the value of today's money than to use inflation growth and bring it back to a present value. This is preferable to speculating on the cost of a 1,500 square foot condo in a retirement village 30 years from now.

Example 11. Toni's Beauty Palace is starting a SIMPLE IRA plan with a 3% match. Sheila is employed by Toni's Beauty Palace and earns $38,500 annually. She believes she needs this retirement account to provide her $1,900 per month in retirement. She is 40 years old and she wants to retire at age 65. Sheila should be asked the following questions:

Professional's Question A. Looking at the Fund Return Table (that follows) what growth rate do you consider reasonable?

Sheila's Answer A. For the 25 years remaining, I hope to earn an average of 9%.

Observation. This seems like a very reasonable rate of return when looking at the 15-year rates for all categories.

Professional's Question B. On average, do you believe inflation will be greater than 2% per year for the 25 years?

Sheila's Answer B. No, I prefer to use 9% growth rate less 2% for inflation, which makes the net growth rate 7%.

Analysis

- In order to have $1,900 per month available in 25 years, Sheila will need a balance in her retirement account of $380,000:

  22,800/year ÷ 6,000/year × 100,000 = $380,000

- Sheila needs $501 per month contributed to her retirement account:

  $380,000 ÷ $75,899 × 100 = $501 ($100 per month at 7% for 25 years equals $75,899)

- Toni will contribute $96 per month to Sheila's retirement account:

  $38,500 × 3% = $1,155 ÷ 12 = $96

- Sheila must contribute the remaining $405 month. This is 12.5% of her salary. Sheila's future year contributions should remain at 12.5%.

Now Sheila has a good understanding of her retirement plan and its funding method based on specific dollars.

The following Fund Return Table identifies the average yearly growth or loss per year for various types of funds. The funds shown in the table cover a wide range of investment choices. It gives the client a good view of the concept of diversification by comparing the one- and three-year averages to the fifteen-year averages. It also emphasizes that long-term does not mean five years.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Fund Return Table — Annualized and Rounded (%)

	One Year	Three Years	Five Years	Ten Years	Fifteen Years
Large Cap Blend	(23)	(13)	(2)	7	10
Large Cap Value	(19)	(6)	(1)	9	10
Large Cap Growth	(28)	(21)	(3)	6	9
Small Cap Blend	(25)	(3)	(1)	7	10
Small Cap Value	(22)	4	0	9	11
Small Cap Growth	(30)	(20)	(4)	6	9
Mid Cap Blend	(19)	(5)	0	9	11
Mid Cap Value	(17)	(4)	1	9	10
Mid Cap Growth	(24)	(24)	(3)	6	9
U.S. Govt. Bond — Short	5	8	6	6	7
U.S. Govt. Bond — Intermediate	9	9	6	6	8
U.S. Govt. Bond — Long	13	11	7	8	9

PAYMENT OPTIONS

Employees will likely want information regarding how their account is handled at retirement. There are usually **four alternatives:**

1. Lump sum distribution
    - Taxation issue
    - Loss of deferred status
2. Rollover/transfer to IRA
    - Wide investment choices
    - Many distribution choices
3. Annuities
    - Guaranteed amount for life or time certain
    - Not inflation protected
4. Leave in plan
    - Limited by plan payout options
    - Limited by plan distribution options

Many of these options are determined by the plan. Employees and their tax professionals need to know these options.

OTHER CONSIDERATIONS

TAX CREDIT FOR RETIREMENT PLANS

Beginning in 2002, a small employer pension plan start-up costs credit is allowed as a part of the general business credit.[10]

Note. See Chapter 2, Small Business Issues, Issue 6: New Business Credits, in this workbook for a detailed discussion of the small employer pension plan start-up cost credit.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

RETIREMENT SAVINGS CONTRIBUTION CREDIT

Both the employer and employee need to be aware of the new credit available for both qualified and nonqualified retirement accounts. Starting in 2002, certain individuals are allowed up to a 50% credit for retirement contributions. The credit depends on the taxpayer's filing status and modified adjusted gross income. Employees must meet the following requirements:

- Be at least 18 at year end
- Not be a dependent on another return
- Not be a full-time student

Retirement contributions to all IRAs, qualified pension plans, and deferral plans including after-tax contributions qualify. The $2,000 maximum contribution limit is reduced by pension distributions during the current year and two prior tax years. The credit will not apply after 2006.

RETIREMENT ACCOUNT LOSSES

Losses on qualified retirement plans and deductible IRAs are not deductible because the taxpayer has no basis. However, for Roth IRAs, annuities, nondeductible IRAs, and after-tax contributions to qualified accounts, a loss can turn into a tax deduction. In all cases, the loss is reported on Form 1040 Schedule A, *Miscellaneous Itemized Deductions,* and is subject to 2% of AGI. The following rules apply:

- **Roth IRA.** All contributions add to basis and all Roth IRAs must be liquidated to determine if basis exceeds amount realized.
- **Traditional IRA.** All traditional IRAs, whether deductible or nondeductible, must be liquidated before any loss can be used (total basis versus total realized).
- **After-Tax Contributions to Qualified Account.** The entire retirement account must be distributed. If the entire distribution is not in cash or worthless securities, the loss cannot be recognized until the noncash property is sold.

In the case of a refund annuity (an annuity with some type of guarantee), any basis not received is a loss. This treatment is different than the unrecovered basis in an annuity or retirement plan of a participant who dies. In that case, the unrecovered basis is a loss on Schedule A, but is not subject to 2% of AGI.

Example 12. Ramsey has a Roth IRA that has an FMV of $38,500 with a basis of $12,000 from contributions, plus $62,500 of basis from a conversion. If he takes a partial distribution, no loss is recognized because there is no method of determining what the ultimate payout will be. A total liquidation and distribution to Ramsey of the $38,500 will allow a Schedule A deduction of $36,000.[11]

$38,500 – ($12,000 + $62,500) = $36,000 loss

If Ramsey also has any traditional IRA funds, they do not need to be distributed to recognize the $36,000 loss on the Roth accounts.

Any potential tax saving on a retirement account or Roth IRA must be weighed carefully against the loss of current tax sheltered status. In **Example 12,** the immediate tax saving is approximately $9,000, but the possibility of the tax-free income which the $38,500 might produce is lost.

Example 13. Using the facts in **Example 12,** Ramsey decides not to liquidate his Roth IRA accounts. Ten years later, the Roth IRA has grown to **$82,775,** which resulted from an 8% annual growth rate. Ramsey now has $82,755 tax free available.

However, if Ramsey took the loss and invested his $47,500 ($38,500 distribution + $9,000 saved in taxes) at the same 8% growth for ten years, his outside account would be **$102,125.**

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Question A. Which situation is better for Ramsey?

$82,775 in tax-free funds or

$102,125, and owing tax on $54,625 ($102,125 distribution – $47,500 basis)?

Answer A. It depends.

ESTATE PLANNING

Estate planning has different meanings to different people. In the context of retirement accounts, it usually relates to saving estate taxes or planning who should receive what, or a combination of the two. The basic rule in gifting a tax deferral asset is to give it to the person in the lowest tax bracket. In the case of a retirement account or traditional IRA, the asset cannot be gifted during the owner's life, but the beneficiary can be a charity. This will often result in a larger after-tax estate when considering income tax paid by the beneficiary.

Example 14. At his death on December 30, 2002, Dan's estate has no liabilities and deductible estate fees were $247,000. His estate has the following assets:

Home	$ 580,000
Rental property	1,100,000
Personal property	92,000
Savings	380,000
Brokerage account	695,000
IRA account	1,100,000
Total estate	$3,947,000

Dan was not married. However, he had two nieces and two nephews and wants each to receive 25% of his estate after taxes and expenses are paid, and a $1 million gift is made to his church. Due to the $1 million donation, the tax on the estate will be approximately $490,000 less. The net estate would be the same if an IRA or cash and securities were donated.

The difference between donating cash and donating the IRA will be in what the beneficiary ultimately pays in income tax. All assets in the estate step up to FMV, except the IRA accounts. If the $1 million donation does not come from the IRA, the IRA beneficiary may be required to pay a very large income tax upon distribution. Traditional deductible IRAs make an excellent source of funds for donations in an estate.

Another important issue in retirement accounts and estate planning is naming the proper beneficiary to allow the smallest account payout possible. If the only criterion is to keep the account in a sheltered status as long as possible, the spouse should be the first in line for inheritance, followed by the youngest beneficiary. If there are multiple nonspouse beneficiaries, the IRA accounts should be split to allow each beneficiary to take distributions based on their own life expectancy.

Note. See pages 379–386 in the *2002 University of Illinois Income Tax Workbook* for extensive coverage on choosing a beneficiary.

REV. RUL. 2002-62

Employers and employees frequently wonder if they can withdraw money from a retirement account before they retire. It is possible to withdraw money if needed. The withdrawal will be either a loan, a hardship withdrawal, or an early distribution. Early distributions lead to penalties unless the distribution meets an exception under IRC §72(t).

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Exceptions to Early Withdrawal Penalties before Age 59½

IRC Section	Exception
72(t)(2)(A)(ii)	Distribution made after death of the employee
72(t)(2)(A)(iii)	Distribution made due to disability
72(t)(2)(A)(iv)	Distribution part of a scheduled series of substantially equal periodic payments made over the life expectancy of the participant and the beneficiary
72(t)(2)(A)(v)	Distribution made to an employee who has attained age 55 and separated from service (not applicable to IRAs)
72(t)(2)(A)(vi)	Dividends paid with respect to stock described in IRC §404(k)
72(t)(2)(B)	Distribution used to pay medical expenses to the extent such expenses exceed 7.5% of AGI
72(t)(2)(C)	Distributions made to an alternate payee pursuant to a qualified domestic relations order (not applicable IRAs)
72(t)(2)(D)	Distributions from IRAs to pay for health insurance premiums for certain unemployed individuals
72(t)(2)(E)	Distributions from IRAs to pay for qualified higher education expenses of the taxpayer, spouse, child, or grandchild
72(t)(2)(F)	Distributions from IRAs for first-time home purchases (no home ownership in prior two years); distribution limited to $10,000 (lifetime maximum)
72(t)(2)(A)(vii)	Distribution from qualified plans and IRAs due to an IRS levy on the plan or IRA; exception will not apply if funds are withdrawn to avoid a levy or to satisfy a levy on other property

Rev. Rul. 2002-62 discusses the change to IRC §72(t)(2)(A)(iv). Before Rev. Rul. 2002-62, if any change (other than death or disability) was made to the series of substantially equal payments before the later of 5 years or age 59½, the 10% penalty would apply to all payments received to date. There are now two exceptions to IRC §72(t)(2)(A)(iv).

COMPLETE DEPLETION OF ASSETS

If, as a result of following an acceptable method of determining substantially equal periodic payments, an individual's assets in an individual account plan or an IRA are exhausted, the individual will not be subject to additional income tax under IRC §72(t)(1) as a result of not receiving substantially equal periodic payments and the resulting cessation of payments will not be treated as a modification of the series of payments.

ONE-TIME CHANGE TO REQUIRED MINIMUM DISTRIBUTION METHOD

An individual who begins distributions in a year using either the fixed amortization method or the fixed annuitization method may, in any subsequent year, switch to the required minimum distribution method to determine the payment for the year of the switch and all subsequent years. The change in method will not be treated as a modification within the meaning of IRC §72(t)(4). Once a change is made under this paragraph, the required minimum distribution method must be followed in all subsequent years. Any subsequent change will be a modification for purposes of IRC §72(t)(4). This ruling refers to the final two of the three following allowed methods.

There are **three methods** of determining substantially equal periodic payments to satisfy IRC §72(t)(2)(A)(iv).

Required Minimum Distribution Method

The account balance is divided each year by life expectancy using the Uniform Lifetime Table. The table appears at the end of this chapter.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Example 15. Sara turns 56 in 2003 with a retirement account balance of $842,000 on December 31, 2002. Sara would like to quit working and begin withdrawing funds from the account.

842,000 ÷ 40.7 = $20,688 for 2003

For 2004 she will divide the December 31, 2003, balance by 39.7. Although the amount of payment will change each year, the method remains constant.

Fixed Amortization Method

The account balance is amortized using the Life Expectancy Table and a chosen interest rate. This method keeps payments the same each year.

Example 16. Use the same facts as **Example 15,** except Sara chooses the fixed amortization method. Her payment would be approximately $42,225 per year using 4% interest. Investment results do not change the annual distribution (4% is approximately 120% of midterm rate).

Fixed Annuitization Method

In this method, the annual payment is determined by dividing the taxpayer's account balance by an annuity factor. This annuity factor is derived by using a reasonable mortality table and an interest rate that does not exceed a reasonable interest rate on the date payments begin. The results will be similar to the fixed amortization method.

STARTING, MAINTAINING, CHANGING, AND TERMINATING PLANS

STARTING

To ensure a plan is a qualified plan, the plan administrator can, but is not required to, submit a determination letter request to the IRS, under procedures set out in an annual revenue procedure. Under the determination letter process, the IRS will make a determination as to the plan's qualified status. If the IRS makes a favorable determination, it will issue a determination letter stating that the plan meets the qualification requirements, which may be relied on unless there is a change in material fact or until the effective date of a law change. If an adverse determination letter is received, a plan sponsor may, after exhausting its administrative remedies, ask for a declaratory judgment from the Tax Court that the plan at issue is a qualified plan.

Depending on the plan chosen, outside help may be needed. Following is a list of the forms that may be required.

Form 5300, *Application for Determination for Employee Benefit Plan.* Four pages with an 18-point checklist

Form 5307, *Application for Determination for Master or Prototype Plans.* Three pages with a 14-point checklist.

Form 5304-SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers* (not using designated financial institution). Three pages not filed with the IRS.

Form 5303-SIMPLE, Same as 5304-SIMPLE except the plan uses a designated financial institution. Three pages not filed with the IRS.

Form 5305-SEP, *Simplified Employee Pension.* One page not filed with the IRS.

The most design flexibility is available using Form 5300, and the least occurs with the 5305-SEP.

If the law or regulations change, a plan sponsor may be required to amend the plan. Employers have until the end of a **remedial amendment period** to amend the plan, but any amendment must be retroactive.[12] After an amendment, the plan sponsor should resubmit the amended plan to the IRS for a new determination letter, although this is not required.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

MAINTAINING

To remain qualified, a plan must comply with disclosure and reporting requirements. Under the disclosure requirements, a plan administrator must provide each participant and each beneficiary with a copy of the summary plan description, summary annual report, and any material modifications to the plan.[13] Plan administrators also must make copies of the latest annual report and the bargaining agreement, trust agreement, or other instruments under which the plan is established or operated available at all times in their principal offices and must make plan documents available upon request.[14]

Under the reporting requirements, qualified plans and employers maintaining qualified plans must file annual returns.[15] The annual return can be made by the employer or the plan administrator on Form 5500, *Annual Return/ Report of Employee Benefit Plan.* Form 5500-EZ, *Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan,* is used for plans whose only participants are a business owner and spouse. These are filed with the Pension and Welfare Administration, rather than the IRS.[16]

Under all employer plans, participants must be notified of any changes and their account balance. For the IRA-based employer plans, there are no requirements to file the 5500 or 5500-EZ. This is also true for the Uni-K plans under $100,000.

CHANGING/TERMINATING

A qualified plan is allowed to merge or consolidate with another plan, or transfer its assets or liabilities to another plan, provided requirements that protect the participants' benefits are met.[17]

Qualified plans also are permitted to terminate, despite the requirement that they be established as permanent arrangements. A terminating plan must notify the IRS, allocate all benefits to employees, provide that all benefits are nonforfeitable, be amended to comply with all qualification requirements in effect at the time it terminates, and distribute all benefits as soon as administratively feasible.[18] After plan obligations are satisfied, any residual assets of a terminated plan may be distributed to the employer.[19] However, these assets are included in the employer's income, unless transferred to another plan. In addition, an excise tax is imposed on the amount of any employer reversion from a qualified plan.[20]

As stated earlier, the IRA-based employer plans are not considered permanent arrangements. They are actually 1-year contracts with the employees. They can be modified or discontinued.

Note. The nonpermanence feature of IRA-based plans appears to be an incredible advantage to the employer. However, the employer must consider what a plan termination does to employee morale.

Most non-IRA-based qualified plans are regulated by the Department of Labor. To discontinue a plan or make substantial modifications, the employer must show a solid business reason. The ultimate penalty would be disqualifying the plan back to its inception.

Observation. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA of 2001) created what many consider a deathblow to defined contribution money purchase plans. Under EGTRRA of 2001, a defined contribution profit-sharing plan has the same limits as money purchase plans. With greater flexibility in profit-sharing plans, it appears that money purchase pension plans have no remaining advantage.

REV. RUL. 2002-42

Rev. Rul. 2002-42, *Merger or Conversion; Partial Termination Notice*, should be consulted if a client is contemplating a switch to a profit-sharing plan from a money purchase pension plan under IRC §411(d)(3). This ruling describes a situation where a merger or conversion of a money purchase pension plan into a profit-sharing plan is not a partial

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

termination of the money purchase pension plan, and describes the type of notice that must be given to affected plan participants.

ISSUES

1. Whether, in the absence of other facts indicating a partial termination, the merger or conversion of a money purchase pension plan into a profit-sharing plan results in a partial termination of the money purchase pension plan under IRC §411(d)(3).

2. Whether the notice required by IRC §4980F and §204(h) of the Employee Retirement Income Security Act (ERISA) of 1974, as amended, must be provided to affected individuals in a money purchase pension plan that is merged or converted into a profit-sharing plan.

FACTS

Situation 1. Employer Jay maintains a money purchase pension plan qualifying under IRC §401(a). The plan provides that upon a termination or partial termination of the plan, all affected participants will vest 100% in their account balances. Employer Jay converts the money purchase pension plan into a profit-sharing plan that covers the same employees as the money purchase pension plan and contains the same vesting schedule. It also provides that assets and liabilities in the profit-sharing plan that originated in the money purchase pension plan retain their money purchase pension plan attributes, in accordance with Rev. Rul. 94-76, 1994-2 C.B. 46.

Situation 2. Employer Louie maintains a money purchase pension plan qualifying under IRC §401(a). This plan provides that upon a termination or partial termination of the plan all affected participants will vest 100% in their account balances. Employer Louie also maintains a profit-sharing plan qualifying under IRC §401(a). Louie amends the money purchase pension plan to cease future employer contributions and to merge it into the profit-sharing plan in a transaction that satisfies the requirements of IRC §414(1). Following the merger, the profit-sharing plan covers the same employees and contains the same vesting schedule as the money purchase pension plan. Simultaneously, Louie amends the profit-sharing plan to provide that assets and liabilities transferred from the money purchase pension plan to the profit-sharing plan retain their money purchase pension plan attributes, in accordance with Rev. Rul. 94-76.

HOLDINGS

Issue 1. In the absence of other facts, the merger or conversion of a money purchase pension plan into a profit-sharing plan does not result in a partial termination of the money purchase pension plan under IRC §411(d)(3). Under the facts in either Situation 1 or 2 there is no partial termination.

Issue 2. The notice required by IRC §4980F and §204(h) of ERISA must be provided to affected individuals in a money purchase pension plan that is merged or converted into a profit-sharing plan. Under the facts in either Situation 1 or 2, the notice must be given to affected individuals.

REV. PROC. 2003-44

Rev. Proc. 2003-44 is designed to streamline and simplify problems in retirement plans. The Employee Plans Compliance Resolution System (EPCRS) consists of the following **three main** components:

1. **Self-Correction Program (SCP).** Plan administrators will be allowed to correct plan problems without notifying the IRS.

2. **Voluntary Correction Program (VCP).** Plan administrators will be allowed to correct plan problems after obtaining IRS approval.

3. **Audit Closing Agreement Program (AUDITCAP).** Corrections are allowed during audit with IRS approval.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

UNIFORM LIFETIME TABLE/SINGLE LIFE EXPECTANCY TABLE

This chart combines the *Uniform Lifetime Table* and the *Single Life Expectancy Table* found in IRS Pub. 590, *Individual Retirement Arrangements.*

Age	Single Life	Uniform Life	Age	Single Life	Uniform Life	Age	Single Life	Uniform Life	Age	Single Life	Uniform Life
10	72.8	86.2	34	49.4	62.3	58	27.0	38.7	82	9.1	17.1
11	71.8	85.2	35	48.5	61.4	59	26.1	37.8	83	8.6	16.3
12	70.8	84.2	36	47.5	60.4	60	25.2	36.8	84	8.1	15.5
13	69.9	83.2	37	46.5	59.4	61	24.4	35.8	85	7.6	14.8
14	68.9	82.2	38	45.6	58.4	62	23.5	34.9	86	7.1	14.1
15	67.9	81.2	39	44.6	57.4	63	22.7	33.9	87	6.7	13.4
16	66.9	80.2	40	43.6	56.4	64	21.8	33.0	88	6.3	12.7
17	66.0	79.2	41	42.7	55.4	65	21.0	32.0	89	5.9	12.0
18	65.0	78.2	42	41.7	54.4	66	20.2	31.1	90	5.5	11.4
19	64.0	77.3	43	40.7	53.4	67	19.4	30.2	91	5.2	10.8
20	63.0	76.3	44	39.8	52.4	68	18.6	29.2	92	4.9	10.2
21	62.1	75.3	45	38.8	51.5	69	17.8	28.3	93	4.6	9.6
22	61.1	74.3	46	37.9	50.5	70	17.0	27.4	94	4.3	9.1
23	60.1	73.3	47	37.0	49.5	71	16.3	26.5	95	4.1	8.6
24	59.1	72.3	48	36.0	48.5	72	15.5	25.6	96	3.8	8.1
25	58.2	71.3	49	35.1	47.5	73	14.8	24.7	97	3.6	7.6
26	57.2	70.3	50	34.2	46.5	74	14.1	23.8	98	3.4	7.1
27	56.2	69.3	51	33.3	45.5	75	13.4	22.9	99	3.1	6.7
28	55.3	68.3	52	32.3	44.6	76	12.7	22.0	100	2.9	6.3
29	54.3	67.3	53	31.4	43.6	77	12.1	21.2	101	2.7	5.9
30	53.3	66.3	54	30.5	42.6	78	11.4	20.3	102	2.5	5.5
31	52.4	65.3	55	29.6	41.6	79	10.8	19.5	103	2.3	5.2
32	51.4	64.3	56	28.7	40.7	80	10.2	18.7	104	2.1	4.9
33	50.4	63.3	57	27.9	39.7	81	9.7	17.9	105	1.9	4.5

Column 1: Age refers to either the owner while living or the beneficiary after owner's death.

Column 2: Single Life is used for a beneficiary.

Column 3: Uniform Life is used by owner before death.

Example:

If the plan had a $100,000 balance on December 31, 2002, and the **plan owner** was 80 years old, his minimum distribution would be $5,348.

$100,000 ÷ 18.7 = $5,348

If a **beneficiary** was 80 years old, the minimum distribution would be $9,804.

$100,000 ÷ 10.2 = $9,804

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

ENDNOTES

1 The 2003 maximum compensation limit for contributions is $200,000.
2 IRC §404(a)
3 IRC §401(a)
4 IRC §402(a)
5 IRC §401(a)
6 IRC §402(b)(1)
7 IRC §403(c)
8 IRC §§3121(v)(2), 3306(r)(2)
9 IRC §404(a)(5)
10 IRC §45E
11 IRC §§67(b)(10), 72(b)(3), and Rev. Rul. 61-201
12 IRC §401(b)
13 IRC §6047(d), ERISA §104
14 ERISA §104(b)(4)
15 IRC §6033
16 Treas. Reg. §301.6058-1
17 IRC §414(1)
18 IRC §§411(d)(3), 414(1)
19 ERISA §4044(d)(1)
20 IRC §4980(a)

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.