Chapter 6: Retirement Issues

Corrections were made to this workbook through January of 2007. No subsequent modifications were made.

Note. President Bush signed the Pension Protection Act of 2006 on August 18, 2006. Many of the retirement provisions that were due to sunset in future years were extended by this act. In addition to extending certain retirement provisions, the bill is designed to provide greater security for funded plans by penalizing employers who underfund their pension plans. It also contains provisions to encourage taxpayers to save more for retirement. This bill is covered in detail in Chapter 14, "New Legislation."

This chapter provides information on the new designated Roth plans and updated contribution limitations for 2006. It also reviews some basic information on the types of retirement plans available and the advantages and disadvantages of the various plans from both an employer's and an employee's perspective.

The chapter also focuses on tax preparation issues, such as the pension rights of reservists and guards, and minimum distribution requirements.

DESIGNATED ROTH 401(k) AND 403(b) PLANS

Spurred by predictions of the impending failure of the social security system, Congress drafted another incentive for Americans to save for retirement by expanding the Roth IRA concept to 401(k) and 403(b) plans. These new plans are referred to as "designated Roth" accounts and are available for tax years beginning after December 31, 2005.

Under a designated Roth plan, participants can elect to defer up to $15,000 of after-tax compensation, or $20,000 if age 50 or over by the end of 2006. Employers must offer a designated Roth option before employees can participate. Eligible employees can opt to participate in either a traditional deferred compensation plan, a designated Roth plan, or both. However, these accounts must be kept separate. The combined contributions to both plans cannot exceed the $15,000 or $20,000 limit. Further information on these new elective deferral plans is provided later in this chapter under the heading "Designated Roth Accounts."

2006 PLAN CONTRIBUTION LIMITS

The IRS is statutorily required to adjust certain dollar limitations annually on qualified retirement plans to keep pace with cost-of-living increases.[1] In addition to these cost-of-living adjustments (COLAs), the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) mandated specific annual increases to certain limitations from 2002 through 2006.

1. IRC §415

Employer-sponsored plans may also impose contribution limitations on participants. Sometimes these limitations are more restrictive than the statutory limitations. For example, a 401(k) plan that allows participants to annually defer up to 10% of their compensation would restrict an employee earning $35,000 a year to a maximum deferral of only $3,500, despite an IRS-allowed maximum of $15,000. A plan document may also impose limitations on catch-up contributions for participants age 50 or over.

EGTRRA Increases

The scheduled EGTRRA increases for 2006 are:

1. IRC §402(g)(1)(B) elective deferrals increased from $14,000 to $15,000, affecting employer contributions to the following types of plans:
   - IRC §401(k) private-sector salary reduction plans
   - IRC §403(b) nonprofit and public school salary reduction plans
   - IRC §408(k) qualified salary reduction arrangements (SARSEPs)
2. IRC §457(e)(15) elective deferrals increased from $14,000 to $15,000, affecting the deferred compensation plans of the following employers:
   - State and local government
   - Tax-exempt organizations
3. IRC §414(v)(2)(B)(i) age 50 and over catch-up contributions for applicable employer plans other than SIMPLE plans increased from $4,000 to $5,000
4. IRC §401(k)(11) and IRC §408(p) SIMPLE retirement plans age 50 and over catch-up contribution limits increased from $2,000 to $2,500

These are the final designated changes under EGTRRA. Beginning January 1, 2007, the 2006 EGTRRA limitations will be indexed annually for inflation in $500 increments.

2006 COLA Increases

The following table indicates the 2006 limitations in effect for retirement plans, as adjusted by EGTRRA and COLA:

Retirement Plan Limitations	2006	Age 50+ Catch-up
Traditional IRA and Roth IRA contributions	$ 4,000	$1,000
Elective deferrals to SIMPLE IRA and SIMPLE 401(k) plans under IRC §408(p)(2)(E)	10,000	2,500
Elective salary reduction contributions under IRC §402(g) to §401(k), §403(b), §408(k) SARSEPs, and the Thrift Savings Plan	15,000	5,000
Elective deferrals to IRC §457 state or local government plans or IRC §501(c) tax-exempt organization plans	15,000	5,000
The sum of employee elective deferrals and employer contributions to defined contribution plans (IRC §415(c)(1)(A)) and SEP plans (IRC §408(j))	Lesser of: $44,000 or 100% of compensation	
Annual benefit limitation under defined benefit plan allowed by IRC §415(b)(1)(A)	175,000*	
Annual compensation caps under IRC §§401(a)(17),** 404(l), 408(k)(3)(C), and 408(k)6)(D)(ii)	220,000	
SEP minimum compensation threshold	450	
Dollar limitation under IRC §414(q)(1)(B) used to define a highly compensated employee	100,000	
Dollar limitation under IRC §416(i)(1)(A)(i) used to define a key employee in a top-heavy plan	140,000	
Maximum account balance in an ESOP subject to 5-year distribution under IRC §409(o)(1)(C)(ii)	885,000	
Dollar limitation used to determine the lengthening of the 5-year distribution period for ESOPs under IRC §409(o)(1)(C)(ii)	175,000	

* For participants who separated from service before January 1, 2006, the limitation for defined benefit plans under IRC §415(b)(1)(B) is computed by multiplying the participant's 2005 adjusted compensation limitation by 1.0383.

**The 2006 compensation limit is $325,000 for certain governmental plans in effect on July 1, 1993, that allowed for cost-of-living increases.

MULTIPLE PLAN LIMITS

Often participants invest in more than one retirement plan. Limits can apply to the aggregate annual contributions made to multiple plans based on the type of plan. Contributions to the following categories of retirement plans must be totaled to determine whether or not an excess contribution has been made:

- **Individual Retirement Arrangements —** Combined qualified Roth and traditional IRA contributions may not exceed $4,000 ($5,000 if age 50 or older)
- **Salary Reduction Plans** — The sum of elective deferrals to the following plans may not exceed $15,000 ($20,000 if age 50 or older):
  - §401(k) plans
  - §403(b) plans
  - Thrift Savings Plans
  - SARSEPs
  - SIMPLE plans[2]
  - §501(c)(18)(D) plans[3]
- **Government Deferred Compensation Plans** — Contributions to §457 plans are not required to be aggregated with any other plan contributions. An employee can contribute to a §457 plan and also contribute the maximum amount to any other plan(s) for which he is eligible. However, the total combined contributions of an employee and his employer cannot exceed $15,000 ($20,000 if age 50 or older) or 100% of the employee's includable compensation in 2006.

Example 1. Dan, age 35, works for a state university and also has an Internet-based business selling items on eBay. He earned $50,000 from the university and his business netted $25,000 in 2006. Since Dan is approaching middle age, he wants to save as much as possible for retirement. Dan has both a §457(b) plan and a §403(b) plan available from his employer, and has established a SIMPLE plan for his business. He also would like to diversify his retirement funds by establishing a Roth IRA.

Dan's university §403(b) plan allows him to make contributions through payroll deduction based on a percentage of his salary. He may contribute up to 100% of his compensation,[4] but is limited to the 2006 IRS maximum of $15,000. He has elected to contribute 15% of his compensation. His §457(b) plan allows him to specify a flat monthly dollar amount to be deferred through payroll deduction. This deduction is limited to $15,000 in 2006.

Although Dan's employer does not offer any matching contributions to these plans, it does offer a defined benefit pension through the State University Retirement System (SURS). Dan is required to contribute 8% of his compensation to SURS, in lieu of social security withholding. The state is required to contribute enough funds to insure the guaranteed pension benefit.

2. SIMPLE IRA and SIMPLE 401(k) plan contributions are limited to $10,000 in 2006 ($12,500 if age 50 or older).

3. IRC §501(c)(18)(D) contributions are not deducted from Form W-2, box 1 wages; they should be identified by the employer in box 12 with a code "H." The employee should deduct the amount deferred on Form 1040, line 36, entering "501(c)(18)(D)" on the dotted line next to the amount. The amount deducted cannot exceed the applicable limit for all aggregated contributions.

4. For purposes of determining the maximum annual contribution to a §403(b) plan, compensation excludes non-elective contributions which are excluded from income. Since university employees are required to contribute 8% of compensation to the State University Retirement System, this effectively means university employees may contribute only 92% of their compensation, up to the annual limitation.

Question 1. What are the maximum amounts Dan can contribute to his various retirement plans in 2006?

Answer 1. Before applying the aggregate limitation rules, Dan **potentially** may contribute the following maximum elective amounts to each plan for 2006:

Plan	2006 Plan Limit
§457	$15,000
§403(b)	15,000
SIMPLE	10,000
Roth IRA	4,000
	$44,000

The multiple plan limitation rules require Dan to aggregate his contributions to certain accounts in order to determine his annual maximum contribution amount. The Roth IRA and §457 plans stand alone. However, Dan must add his §403(b) plan contribution and his SIMPLE plan contribution to make sure the total does not exceed his 2006 maximum allowed contribution of $15,000.

Since Dan has elected to defer 15% of his university salary into his §403(b) plan, his 2006 contribution will be $7,500 ($50,000 × 15%). Dan may contribute only the "balance" of $7,500 ($15,000 – $7,500) to his SIMPLE plan, regardless of the $10,000 SIMPLE limitation.

Dan may contribute the maximum amount of $4,000 to his Roth IRA account since his AGI is below the lowest threshold amount of $95,000 in the Roth IRA income phaseout range. He also may contribute a maximum of $15,000 to his §457 plan, since 100% of his university compensation is adequate enough to cover the maximum allowable contribution.

Plan	Dan's Maximum Contributions
§457	$15,000
§403(b)	7,500
SIMPLE	7,500
Roth IRA	4,000
	$34,000

SOCIAL SECURITY CHANGES FOR 2006

Social security recipients received a 4.1% cost-of-living increase in 2006. The 2006 maximum monthly social security benefit allowed for a worker retiring at full retirement age is $2,053, but the average recipient's benefit is estimated to be only $1,002 per month. The monthly Medicare Part B premium increased to $88.50. By law, this premium increase cannot exceed the COLA increase and cause a recipient's net benefit to be reduced.

The 2006 combined **Medicare** and **Old Age Survivors and Disability Insurance (OASDI)** withholding rates remained at 7.65% for both the employer's and employee's share, and 15.30% for self-employed individuals. The OASDI tax is required to be withheld on wages up to $94,200 at a rate of 6.20% in 2006; the Medicare portion is required to be withheld on all earnings at a rate of 1.45%.

To receive social security at full retirement age (FRA), a recipient must be age 65 and 6 months if born in 1940 or 65 and 8 months if born in 1941. Consequently, only taxpayers born before July 1, 1940 may be eligible to receive full benefits in 2006. Recipients who choose to receive social security benefits before their FRA will have $1 in benefits withheld for every $2 they earn above $12,480 annually ($1,040 per month) in 2006.

Recipients who attain FRA during the tax year are allowed annual earnings of $33,240 ($2,770 per month) before their benefits are reduced. Their benefit reduction is then $1 for every $3 earned above the limit, but this reduction applies only to compensation earned in months prior to attaining FRA.

There is no limit on earnings beginning the month an individual attains FRA. Since many recipients erroneously believe the removal of this restriction also applies to the taxation of social security benefits, it often falls on tax return preparers to educate their clients on the differences in social security benefit rules and social security taxation rules.

RETIREMENT SAVINGS CONTRIBUTIONS CREDIT

The retirement savings contribution credit, due to sunset in 2006, was made permanent by the Pension Protection Act of 2006 (PPA).

DESIGNATED ROTH ACCOUNTS

Although Congress initiated the concept of designated Roth 401(k) and 403(b) plans under EGTRRA in 2001, the option to contribute to these plans was made available for the first time starting January 1, 2006. Although designated Roth accounts were originally scheduled to sunset in 2010, these accounts were made permanent by the PPA.

Despite the 5-year advance warning, employers have been slow to warm up to this new hybrid retirement savings vehicle that combines features of traditional 401(k) plans with attributes of Roth IRAs. Since employers must add a Roth option to their 401(k) or 403(b) plan documents before designated Roth contributions can be made, many taxpayers will not be able to take advantage of this new savings option in 2006.

COMPARING DESIGNATED ROTH ACCOUNTS TO OTHER PLANS

These new plans are referred to as “designated Roth accounts” since an employee may designate the amount of any contribution he would like his employer to withhold from his wages in lieu of all or a portion of any other elective deferral options the employer’s plan provides. The employer then deducts the designated amount from the employee’s earnings and deposits the contribution into an individual account for the employee, separate from any pretax contributions.

Compared to Roth IRA

Like the Roth IRA, which was introduced in 1998, contributions to designated Roth retirement accounts are made with **after-tax dollars.** Employers deduct designated Roth contributions from employees’ gross wages, but **do not reduce** W-2 wages for these contributions.

Also like the Roth IRA, designated Roth account **earnings are exempt from income tax** if held in an account until qualified to be distributed. To be qualified, designated **Roth contributions must be held until an employee has participated in the plan for five years, and the participant:**

- Attains the age of 59½,
- Becomes permanently and totally disabled, or
- Dies.

The tax treatment of nonqualified distributions is dissimilar to Roth IRAs. Nonqualified distributions actually are treated more like traditional IRAs that contain nondeductible, after-tax contributions. The difference lies in the ordering rules for distributions. While Roth IRA distributions are considered to come first from contributions (basis), then from earnings, traditional IRA and designated Roth account distributions **are allocated between basis and earnings.**[5] (See **Examples 2 and 3** later in this section.)

5. IRC §72(e)(8)

Designated Roth accounts also differ from Roth IRAs because they are **available to high income wage earners**. Roth IRAs are restricted to taxpayers who have adjusted gross income less than $160,000 if married filing joint, $110,000 if single or head of household, or $10,000 if married filing separate.[6]

The tax treatment of recharacterizations, conversions, and rollovers from designated Roth accounts are also dissimilar from those of Roth IRAs. Unlike a Roth IRA contribution, there is no provision for a participant to recharacterize a pretax 401(k) or 403(b) contribution into an after-tax contribution before the due date of the participant's return.

Likewise, the balance in a pretax-deferred compensation account cannot be converted or rolled into a designated Roth account. Designated Roth funds may be rolled over only into another designated Roth 401(k) account or a Roth IRA. Designated Roth accounts cannot be rolled over into 403(b) accounts.

Compared to Traditional 401(k) or 403(b) Plans

Designated Roth accounts also share many attributes with traditional 401(k) and 403(b) deferred compensation plans. Like its pretax predecessors, a designated Roth 401(k) or 403(b) account is **available to employees without regard to adjusted gross income limitations**. Designated Roth accounts also are **subject to required minimum distributions** rules (see discussion under the "Required Minimum Distribution" section of this chapter).

Like pretax 401(k) or 403(b) plans, designated Roth plans can feature auto-enrollment options and offer participants the opportunity to **take out loans** against their balances. Designated Roth participants are also allowed to change investment options as frequently as their plan documents allow, but plans must provide an election to change the designation of contributions at least once per year.

Designated Roth plans share IRC §402(g) contribution limitations with pretax 401(k)or 403(b) plans, including the additional **catch-up contribution option** available to participants aged 50 and over. For 2006, these **contribution limitations are $15,000 and $5,000** respectively. Designated Roth contributions are also **included when figuring the overall IRC §415 limitation** of $44,000 for aggregated annual employer and employee contributions.

The chart on the following pages offers a comparison of features of the new designated Roth plans with features of Roth IRA and traditional 401(k) and 403(b) plans.

6. Spouses who file married filing separate but live apart all year long are eligible for Roth IRA accounts if their income is below $110,000.

Plan Comparisons

	Designated Roth 401(k) or 403(b) Plans	Roth IRA	Traditional 401(k) or 403(b) Plans
Income eligibility limitations	No limits	MFJ: $160,000 Single/HoH: $110,000 MFS: $10,000*	No limits
Age/minimum service limitations	Qualified plan must offer participation to employees age 21+ or who have more than one year of service.	No age restrictions	Qualified plan must offer participation to employees age 21+ or who have more than one year of service.
Contributions	After-tax	After-tax	Pre-tax
Maximum dollar contribution limit**	$15,000 (under age 50) $20,000 (age 50+)	$4,000 (under age 50) $5,000 (age 50+)	$15,000 (under age 50) $20,000 (age 50+)
Deadline for employee contributions	December 31	Due date of return, without extensions	December 31
Earnings	Tax-exempt***	Tax-exempt***	Tax-deferred
Qualified distributions	Tax-free	Tax-free	Taxable
Loans allowed	Yes, if plan allows	No	Yes, if plan allows
Hardship withdrawals allowed	Yes, if plan allows	N/A	Yes, if plan allows
Required minimum distributions	Employees: **later** of age 70½ or retirement Self-employed and 5% owners: age 70½	No requirement to take distributions during owner's lifetime	Employees: **later** of age 70½ or retirement Self-employed and 5% owners: age 70½
Qualified distributions	Owner participation in the account for at least **five years** and funds withdrawn after: • Age 59½ • Disability • Death	Owner participation in the account for at least **five years** and funds withdrawn after: • Age 59½ • Disability • Death • First time home purchase (lifetime limit of $10,000)	Funds withdrawn after: • Age 59½ • Disability • Death

*If married filing separate but spouses did not live together at any time during the year, the maximum AGI is $110,000.

**Other limitations may apply, such as earnings limits, plan limits, and combined employer/employee elective deferral limits.

***Earnings withdrawn with nonqualified distributions may be subject to tax and penalty .

Plan Comparisons (continued)

	Designated Roth 401(k) or 403(b) Plans	Roth IRA	Traditional 401(k) or 403(b) Plans
Early withdrawal penalties	10% penalty on nonqualified early withdrawals that are required to be included in income	Contributions (basis): none Earnings: 10% penalty on nonqualified early withdrawals	10% penalty on nonqualified early withdrawals of both contributions and earnings
Common exceptions to early withdrawal penalties	Unknown	• Equal lifetime payments • Used to pay medical expenses over 7.5% of AGI • Used to pay health insurance premiums for unemployed • College expenses	• Equal lifetime payments • Used to pay medical expenses over 7.5% of AGI • Age 55+ and separated from service
Recharacterization of contributions	Not allowed; Roth contribution designation is irrevocable	Allowed by due date of return	No statutory provision
Rollovers/conversions	May be rolled over to Roth IRA or another designated Roth 401(k) account	• Roth IRA to Roth IRA • Nondeductible IRA to Roth IRA • Traditional IRA to Roth IRA if AGI is under $100,000 (proposal to lift income restriction in 2010 see New Legislation chapter)	Pre-tax contributions can be rolled over to: • Traditional IRA • SEP • §403(b) plan • §457 plan • Qualified plan After-tax contributions can be transferred to a traditional IRA by direct transfer only Pre-tax contributions cannot be converted to designated Roth account

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DESIGNATED ROTH ACCOUNT SPONSOR ISSUES

Many employers have been slow to jump on the designated Roth bandwagon. An October 2005 survey taken by the Chicago-based Profit Sharing/401(k) Council of America revealed that less than 20% of the 425 employers it surveyed intended to sponsor a designated Roth plan and less than half of those would offer them in 2006.[7]

Initially, small companies have been more receptive to sponsoring designated Roth accounts. T. Rowe Price indicated that only two of the nearly 1,000 plans it administers intend to sponsor designated Roth plans in 2006.

7. www.psca.org

Employers who intend to sponsor a designated Roth option face their first hurdle when creating or amending a plan document to allow for Roth contributions. Existing 401(k) or 403(b) plan documents may be altered to contain language permitting Roth contributions, but the designated Roth option applies to only to these types of plans, not to SARSEP or SIMPLE IRA plans.

Plans cannot be exclusively Roth. If a plan allows designated Roth contributions, it also must allow pretax contributions. New or amended plans must be adopted by the end of the plan year in which the amendment is to become effective. No retroactive designated Roth contributions are allowed. IRS Notice 2006-44 contains a sample plan amendment that sponsors can use to conform their plans to IRS requirements.

Although employers are not required to offer designated Roth accounts, those who choose to sponsor Roth plans must apply the decision universally to all plan participants. Plans that feature automatic employee enrollment must specify whether default contributions are to be considered pretax or designated Roth contributions. This is an important distinction because **designated Roth contributions — even those made by default — are irrevocable.**

Communicating the option to employees is one drawback to sponsoring a Roth account. Because an after-tax employer-sponsored investment vehicle is a new concept in retirement planning, employers need to educate employees about the benefits and shortcomings of this opportunity. This education process can be both difficult and time consuming. Since service providers are expected to make "turnkey" communications packages available to plan participants in 2007, many employers are waiting until then.

Perhaps the largest drawback to sponsoring a designated Roth account is the **recordkeeping requirement**. Regulations[8] require that Roth contributions be kept segregated from pretax salary deferrals, in individual employee accounts. **No amounts other than designated Roth contributions and qualified rollovers may be deposited into Roth accounts.** Employer-matching contributions, plan forfeitures, and any other employer contributions must be allocated to pretax accounts.

Designated Roth plan contributions, gains, and losses also must be accounted for separately. This requires plan fiduciaries to maintain two sets of records for participants who contribute to both pretax and designated Roth accounts. Sponsors must report contributions on each participating employee's Form W-2 and issue Form 1099s to report any distributions from employee accounts.

In addition, sponsors must track an employee's basis in his designated Roth account, including recording the employee's beginning participation date to provide a base date for the 5-year participation rule. Because participants are allowed to take loans out against their designated Roth accounts, maintaining basis records may be difficult. The effective date for reporting and recordkeeping requirements is the beginning of the 2007 taxable year.

Employer-withheld Roth contributions are subject to all applicable wage withholding requirements (i.e., federal, state, and local income taxes; FICA; and Medicare taxes). Contributions are also subject to the actual deferral percentage (ADP) test in the same manner as pretax 401(k) contributions. Pretax and Roth account balances can be considered separately for purposes of disregarding the requirement to offer a direct rollover option.[9] Sponsors are not required to offer participants a direct rollover option when an account balance is under $200.

Many employers are hesitant to sponsor designated Roth accounts because they still have unanswered questions, such as how to track an employee's 5-year participation period in the event of company acquisitions or mergers. They are also unclear about the interplay between ESOP and Roth 401(k) rules. Additional regulations may help clear some of this confusion and increase the future popularity of this new investment vehicle.

8. Final Treas. Reg. amendments to §§1.401(k) and (m), published January 3, 2006

9. Treas. Reg. §1.401(a)(31)-1

DESIGNATED ROTH CONTRIBUTOR ISSUES

Employees who are given the option of contributing to a designated Roth account may choose to defer part of their earnings into a traditional 401(k) or 403(b) retirement plan, a designated Roth account, or both. However, the combined contributions may not exceed $15,000 in 2006 ($20,000 for participants who are age 50 or over). The election to contribute after-tax earnings is irrevocable — once a contribution is designated as a Roth contribution, it remains a Roth contribution and cannot later be converted to or recharacterized as a pretax contribution.

Designated Roth contributions cannot be comingled with an employee's pretax contributions, but must be deposited into a separate account. Since employer-matching contributions must also be deposited into the employee's pretax account, participants have a nonforfeitable right to funds in their designated Roth accounts.

However, employees generally cannot withdraw funds from their designated Roth accounts while they are still employed, unless their plan permits in-service hardship withdrawals or a qualifying event (i.e., the participant reaches age 59½, disability, or death) occurs after the employee's 5-year participation mark. Corrective distributions and participant loan default distributions are not treated as qualified distributions.

Participants may take out loans against their designated Roth accounts, but it is not a prudent option. Reducing the principle balance of a Roth account defeats the purpose of accumulating tax-free growth. Since participants may designate which account they would like to borrow against, it may be more advantageous to take a loan against traditional 401(k) funds. Defaulted loan balances are not treated as qualified distributions.

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The 5-year participation period for qualified distributions begins on the first day of the taxable year for which an employee makes designated contributions and ends five consecutive taxable years later. If the balance of an existing designated Roth account is rolled over directly to another qualified account, the beginning participation date carries over to the new plan. However, if an employee receives the distribution and later indirectly rolls the funds over to another Roth account, the participation date begins anew.

ADVANTAGES OF DESIGNATED ROTH ACCOUNTS

Designated Roth accounts generally benefit the following types of taxpayers:

- **Highly Compensated Workers.** The expanded eligibility requirements for designated Roth accounts opens up the Roth opportunity to high income taxpayers for the first time. Because highly compensated workers are more likely to be better prepared for retirement, they are also more likely to benefit from the Roth concept since they will presumably be in a high tax bracket in retirement. They also may be attracted to the concept of leaving a portion of their retirement income tax-free to heirs.

- **Younger Workers.** Because younger workers are more likely to be starting out in a lower tax bracket, they may benefit more from the long-range tax benefits offered by Roth savings vehicles. They also benefit from the longer length of time they have to accumulate tax-free growth in their Roth accounts. An added benefit may be increasing their present loan eligibility, since lenders sometimes reference an applicant's adjusted gross income.

- **Participants with Adequate Traditional Retirement Accounts.** The Roth option allows retirement savers to diversify their nest-eggs and hedge their risks against tax rate uncertainty.

- **Participants Who Plan to Continue Working Past Their Traditional Retirement Age.** Participants who plan to continue working after their normal retirement age will likely benefit from the flexibility of having a designated Roth account because they are more likely to be in a higher income tax bracket and face taxable social security issues.

ROLLOVERS

A Roth account may not accept any rollovers from a nonRoth account, nor can funds from a Roth account be rolled over to any nonRoth account. However, funds from a Roth IRA and a designated Roth account can be comingled.

DISTRIBUTIONS

Although designated Roth contributions are made with after-tax dollars, participants cannot freely withdraw funds held in designated Roth accounts without tax consequences. Distributions are subject to the same rules as traditional 401(k) or 403(b) plans. **Hardship withdrawals** may be taken if a plan document allows, but any earnings on nonqualified distributions may be subject to tax.

Qualified Distributions

For a distribution to be qualified as tax-exempt, a taxpayer must have participated in the designated Roth account for five years. After the 5-year rule is met, distributions are tax-free if one of the following events transpires:

- The participant attains age 59½
- The participant becomes disabled
- The participant dies

Nonqualified Distributions

Unlike Roth IRAs, in which distributions are treated as coming first from contributions (basis) and then from earnings, designated Roth distributions must be **allocated** between basis and earnings. The amount of any nonqualified distribution allocated to earnings must be included in the taxpayer's gross income.

The allocation is based on the following formula:

$$\textbf{Distribution} \times \frac{\textbf{Basis in account}}{\textbf{Account balance}} = \textbf{Nontaxable distribution}$$

Example 2. Kay, age 49, decided to take advantage of the designated Roth option her employer offered by electing to contribute her full $8,000 bonus to a designated Roth account in January of 2006. Her investment did quite well, and her account balance grew to $12,000 by year's end. However, on December 31, 2006, Kay took a $10,000 hardship withdrawal from her account to pay for emergency medical expenses.

Since Kay did not participate in her designated Roth account for at least five years, her withdrawal is not qualified for tax exemption. Kay must allocate a portion of her distribution to earnings, which she then must include in her gross income. She determines the nontaxable portion of her distribution by multiplying the $10,000 total distribution by a fraction; the numerator of which is her $8,000 basis in the account, and the denominator of which is the $12,000 account balance, as follows:

$$\$10{,}000 \times \frac{\$8{,}000}{\$12{,}000} = \$6{,}667$$

Kay may exclude $6,667 of her $10,000 distribution, which represents the initial investment portion of her distribution. However, she must include the $3,333 ($10,000 – $6,667) investment earnings portion of her distribution in her 2006 gross income.

Kay may be subject to an early distribution penalty of $333 ($3,333 × 10%) on the taxable portion of her distribution.

Note. As of August 2006, it is unknown whether any exceptions to the early withdrawal penalty will apply to nonqualified designated Roth distributions.

Example 3. Assume Kay had the same account balance and basis-to-investment ratio as in **Example 2,** except she took the $10,000 distribution from her Roth IRA account. Because a Roth IRA considers distributions to come first from contributions, and then from growth, Kay would include only $2,000 of earnings in her 2006 gross income ($10,000 distribution – $8,000 basis).

Kay may qualify for an exception to the early withdrawal penalty on her Roth IRA distribution if her medical expenses exceed 7.5% of her AGI. Since this would reduce her initial investment in the account to $0, all future nonqualified distributions from her Roth IRA would be fully taxable (assuming she made no further contributions).

ROTH PLANNING STRATEGIES

Employees can often become overwhelmed when confronted with a variety of retirement investment plans. This besieged feeling may result in a paralyzing inability to choose any investment option. To combat this inertia, employees need to be presented with information that will allow them to make informed choices.

For employees who have the option of contributing to a designated Roth account, the first choice is whether immediate or long-term tax benefits are desired. This decision is complicated by the fact that no one knows what the tax rates will be when they retire. Although there are fewer and wider tax brackets today, there is no guarantee that the brackets of the future will resemble the present rate structure.

The decision boils down to an educated guess: Does the employee think he is in a higher tax bracket now than he will be in retirement? To maximize tax benefits, a taxpayer wants to shelter income when rates are highest and withdraw income when rates are lowest. To achieve this balance, many investment strategists advise retirement savers to strive for "tax diversification" by contributing funds to both pretax and after-tax savings vehicles.

One advantage of contributing to a designated Roth account is that investors are protected against future, unknown tax rate hikes. Many like the security of knowing and paying their taxes in advance. Having a Roth account can offer a flexible retirement income stream to handle unexpected expenses without increasing a retiree's tax liability. Roth account distributions can also be used to supplement traditional retirement income without increasing the taxability of the retiree's social security benefits.

Although designated Roth accounts are subject to required minimum distribution rules, the balance of these accounts may be rolled over into Roth IRA accounts to avoid this distribution requirement. Roth accounts also can be used to pass retirement income tax-free to heirs. However, nonqualified distributions (i.e., contributions held in an account less than five years) may subject heirs to tax.

Designated Roth plans also have their disadvantages. Foremost is the loss of an immediate tax savings. Roth investors are often gambling that their tax rates will be higher in retirement, so they are willing to pay up-front. However, this may result in the loss of other immediate tax breaks.

Since many credits and deductions are based on a taxpayer's adjusted gross income, diverting previously tax-deferred retirement contributions to designated Roth contributions may cause several immediate adverse tax consequences, such as:

- Reduced Schedule A deductions for medical or miscellaneous employee business expenses
- Reduced or eliminated education credits
- Loss of eligibility for retirement savers or earned income tax credits
- Increased state tax liability

Example 4. Don and Debbie Donnelly have two dependent children. Their estimated 2006 income and expenses are as follows:

Wages ($68,000 + $80,000)	$148,000
Interest income	2,000
Medical expenses	11,500
Mortgage interest and taxes	10,000
Employee business expenses	3,000

Don and Debbie would like to contribute $10,000 each to their retirement accounts this year. They both have the option to contribute to either a traditional 401(k) or a designated Roth 401(k). The Donnellys would like to compare the tax consequences of both types of contributions before selecting an option.

The following chart illustrates these consequences on the Donnelly's 2006 tax return.

Income, Expense, or Credit		Traditional 401(k)		Designated Roth 401(k)
Taxable wages ($20,000 combined 401(k) contribution)		$128,000		$148,000
Interest income		2,000		2,000
AGI		130,000		150,000
Exemptions (4 × $3,300)		(13,200)		(13,200)
Schedule A:				
Allowable medical ($11,500 total)	$ 1,750		$ 250	
Interest and taxes	10,000		10,000	
Allowable employee business expenses ($3,000 total)	400		0	
Total itemized deductions	$12,150	(12,150)	$10,250	
Standard deduction ($10,300)				(10,300)
Taxable income		$104,650		$126,500
Tax (computed using the 2006 federal tax rate schedule)		$ 19,278		$ 24,824

The Donnellys would save $5,546 in federal income taxes if they invested their $20,000 retirement contribution in a traditional 401(k) plan in 2006. This savings would result from their wage deductions of $20,000 and the additional $1,850 they would be able to deduct as a result of allowable itemized deductions. Their top tax bracket would also be reduced from 28% to 25% as a result of their decrease in taxable income.

In addition, the Donnellys would save $600 ($20,000 × 3%) in Illinois tax if they selected the traditional 401(k) option. This $600 represents a true savings. Since Illinois computes taxable income based on federal adjusted gross income and presently does not tax retirement income when it is withdrawn, their $20,000 traditional 401(k) contribution could escape state tax altogether.

However, the Donnellys should be cautioned that their $20,000 contribution, plus earnings, will be taxable to them when withdrawn if they elect to contribute to their traditional 401(k) plans in 2006. They should consider their projected tax bracket at retirement before deciding on the best retirement savings option for them.

OVERVIEW OF RETIREMENT PLANS

Retirement plans can be government-sponsored, employer-sponsored, or can be set up and maintained by individuals to provide for their own personal retirement needs. Many occupations even have their own unique retirement plans, such as railroad workers, service members, teachers, and civil servants.

This section begins with an overview of the federal agencies that regulate retirement plans, followed by a discussion of the various types of plans, including social security, civilian government-sponsored plans, private sector employer-sponsored plans, and individual retirement accounts.

ERISA AND THE FEDERAL REGULATING AGENCIES

Congress established the Employee Retirement Income Security Act of 1974 (ERISA) to better regulate private industry retirement plans. ERISA sets forth minimum standards to which employer-sponsored plans must adhere in order to be considered qualified for tax-deferred advantages. These standards include:

- Disclosure requirements compelling employers to provide plan participants with regular information about plan features and funding
- Minimum participation standards covering eligibility, vesting, and benefit accrual rights
- Detailed funding rules requiring employers to adequately fund sponsored plans
- Accountability standards for fiduciaries
- Grievance and appeals processes for participants to get benefits from their plans
- Legal recourse rights granting participants the right to sue for benefits and breaches of fiduciary duty

Pension Benefit Guaranty Corporation (PBGC)

ERISA also created the Pension Benefit Guaranty Corporation (PBGC), a nonprofit, federally charted corporation that guarantees payments of certain benefits on behalf of insufficiently funded, terminated defined benefit plans. It currently protects the pensions of 44.1 million American workers and retirees in 30,330 private single-employer and multiemployer defined benefit pension plans.[10]

PBGC receives no funds from general tax revenues. Operations are financed by:

- Insurance premiums set by Congress and paid by sponsors of defined benefit plans
- Assets from pension plans for which PBGC is trustee
- Recoveries from the companies formerly responsible for the plans
- Investment income

Employee Benefits Security Administration (EBSA)

The Department of Labor's Employee Benefits Security Administration (EBSA) is charged with enforcing ERISA. EBSA assists benefit plan sponsors in understanding and complying with the requirements of ERISA as it applies to the administration of employee pension and welfare benefit plans.

10. www.pbgc.gov

Internal Revenue Service (IRS)

The Internal Revenue Code sets forth qualification requirements under which plans must operate to maintain tax advantages. Plans which fail to meet these qualifications may lose their tax-deferred status. The IRS is responsible for ensuring that retirement plans comply with the code.

Social Security

Congress enacted the **Old-Age Survivors Insurance (OASI)** program in 1935 to provide retirement income to commercial and industrial workers over the age of 65. The program was expanded in 1937 to include survivors of covered workers. Beginning in 1950, a conditional option was granted to states to cover state employees. This option was made mandatory in 1990 for state and local employees not covered by any other state or local government retirement plans.[11]

Two more programs were folded into the social security system in the mid-twentieth century. The **Disability Insurance (DI)** program was added in the late 1950s to provide income to disabled workers and their dependents. **Medicare** health insurance coverage for the elderly was added in 1965 and expanded to cover beneficiaries of the DI program in 1972.

Social security provides retirement benefits to participants who reach "normal retirement age." In 1983, the legislature raised the normal retirement age from 65 to an age determined by the participant's year of birth, as the following chart demonstrates:[12]

Normal Retirement Age

Year of Birth	Age
1937 and prior	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-54	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

Recipients can start drawing social security as early as age 62, but must take a reduction in pay for each month prior to their normal retirement age. This reduction is computed as follows: 5/9ths of 1% per month for the first 36 months of retirement prior to the normal retirement age, plus 5/12ths of 1% for each additional month. For those born after 1960, the reduction at age 62 will be 30%.[13]

Participants may also delay receipt of benefits beyond their normal retirement age. Social security reform legislation in 1983 provided an incentive for participants to delay benefits by increasing the amount payable to them if they defer drawing benefits until after their full retirement age. Participants who continue to work past their normal retirement age may also receive increased benefits from their additional earnings.

11. Fact sheet from the Employee Benefit Research Institute, FS-190, May 2005; www.ebri.org

12. Social Security Online at www.ssa.gov/OACT/ProgData/nra.html. For benefit computation purposes, widows and widowers whose entitlement is based on having attained age 60 should add 2 years to the year of birth shown in the table.

13. William J. Wiatrowski, "Changing Retirement Age: Ups and Downs," *Monthly Labor Review,* April 2001

FEDERAL EMPLOYER PLANS

Federal Employer-Sponsored Plans

Civilian employees of the federal government are covered by one of the two following annuity plans:

- **Federal Employees Retirement System (FERS)**
- **Civil Service Retirement System (CSRS)**

These plans, administered by the Office of Personnel Management, provide a fixed, monthly retirement benefit based on salary and years of service. Many state governments have comparable plans for their employees.

The government provides the majority of funding for these plans, but participants must also make mandatory contributions, which are defined by law. FERS participants also are covered by social security, but government employees covered by CSRS do not participate in the social security system.

Thrift Savings Plan

The **Thrift Savings Plan (TSP)**, administered by the Federal Retirement Thrift Investment Board, was established in 1986 to provide federal employees the same type of retirement savings and tax benefits available to private sector employees under 401(k) plans. Participation was also extended to members of the uniformed services, including those in the National Guard and Reserve in 2000.

> **Note.** See the section on "Pension Rights of Reservists and Guard Members," later in this chapter.

The TSP has been called "possibly the finest 401(k)-style plan in the nation" that "beats the pants off Social Security's investment performance."[14] The plan is managed by a board of presidential appointees composed mainly of Wall Street and pension-industry veterans. It offers five index funds boasting results that outperform privately-managed funds because the TSP's expenses are three to ten times lower.

Participants covered under FERS and CSRS are eligible to participate in the TSP; however, participation rules are different for each group of employees. Contributions are voluntary and kept separate from contributions to the FERS Basic Annuity or the CSRS annuity.

FERS participants can elect to defer up to 100% of their basic pay, limited to a $15,000 annual maximum contribution, and receive an automatic 1% agency contribution, generally vesting in three years. Generous matching contributions are also available, providing a dollar-for-dollar match on the first 3% and 50¢ on the dollar for the 4th and 5th percentages contributed, with immediate vesting. CSRS participants can also elect to contribute any percentage of their pay up to 100% or a maximum of $15,000. However, they do not receive any matching agency contributions.

STATE AND LOCAL GOVERNMENT AND NONPROFIT EMPLOYER PLANS

IRC §403(b) Plans

Section 403(b) plans, also referred to as **tax-sheltered annuities (TSAs)**, are deferred compensation plans adopted by public schools, colleges, universities, churches, public hospitals, and §501(c)(3) charities. Plans must be employer-sponsored, and cannot be established by self-employed ministers, although self-employed ministers may contribute to plans set up by their denominations. These types of plans share many attributes with 401(k) plans.

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14. Timothy Middleton, "A Government Retirement Plan That Gets It Right," *MSN Money*, posted March 1, 2005, at moneycentral.msn.com/content/P109805.asp?Printer

Individual 403(b) accounts may be funded through an annuity contract provided by an insurance company, a custodial account invested in mutual funds, or a retirement income account set up for church employees, invested in either annuities or mutual funds. The following types of contributions may be made to 403(b) accounts:

- Employee elective deferrals, either salary reduction or designated Roth contributions
- Non-Roth after-tax employee contributions
- Non-elective employer contributions — either mandatory, discretionary, or matching
- A combination of any of the above three contribution types

IRC §457 Plans

A §457 plan is a deferred compensation plan available to employees of certain state and local governments and nongovernmental agencies that are tax-exempt under IRC §501. They can be either eligible plans under IRC §457(b) or ineligible plans under IRC §457(f). Eligible §457(b) plans allow employees of sponsoring organizations to defer up to $15,000 of earnings in 2006. There is no limit on ineligible plan contributions. However, these contributions are taxable to the employee when there is no substantial risk of forfeiture.

PRIVATE SECTOR EMPLOYER-SPONSORED PLANS

There are numerous variations of private sector employer-sponsored retirement plans, but most qualified plans fall into three basic categories:

- Defined benefit plans
- Defined contribution plans
- Hybrid plans

Defined Benefit Plans

Defined benefit plans promise a fixed, pre-established benefit at retirement, such as $500 a month. The amount of the benefit is often based on a set percentage of pay multiplied by the number of years the employee worked for the employer (e.g., 1% of an employee's average salary over the last five years of employment for every year of service).

For many, the concept of a defined benefit plan is synonymous with the term **pension.** Defined benefit plans also have been likened to "golden handcuffs," because these types of plans provide generous retirement benefits only to employees who stay with the same employer throughout their lives.

Both employers and employees can contribute to defined benefit plans, although usually these types of plans are funded solely by the employer. The plan document specifies whether voluntary employee contributions are allowed or mandatory employee contributions are required. Regardless of how a plan is funded, employers assume the risk with defined benefit plans, since they must make contributions adequate to guarantee the benefits they have promised.

Employers are subject to minimum funding requirements and must make contributions on a quarterly basis or pay an interest penalty. The annual individual benefit paid to a participant in a defined benefit plan cannot exceed the lesser of 100% of the participant's average compensation for his highest three consecutive calendar years or $175,000 in 2006.

Defined benefit plans are often designed to compliment social security benefits, sometimes providing retirees with an option to receive increased payments in the "gap years" between early retirement and the onset of social security. Payments then decrease when the participant begins to draw social security. This arrangement usually benefits retirees because it provides a steady income stream and may even lower a retiree's tax bill when the percentage of his income shifts from taxable pension payments to partially taxable — or perhaps tax-exempt — social security benefits.

Defined Contribution Plans

Defined contribution plans do not promise a specific benefit amount at retirement. In these plans, employees, employers, or both contribute to individual employee accounts, sometimes at a set rate, such as 5% of salary annually. The employee assumes the risk with this type of plan since the actual benefit depends on the amount invested and the investment performance of the funding vehicle.

Limitations. In 2006, an employer can **contribute** to each participating employee's account the lesser of 100% of the participant's compensation or $44,000. Catch-up contributions are not subject to this limit. However, an employer only may **deduct** up to 25% of the compensation paid or accrued during the year to eligible participating employees.

The following rules apply when computing this **deduction** limitation:

- Participants' elective deferrals are not subject to this limitation.
- Compensation includes any employee elective deferral amounts.
- The 2006 maximum compensation that can be taken into account for each employee is $220,000.

Employees also may be permitted to make nondeductible contributions in addition to an employer's contributions, if the contributions satisfy the nondiscrimination tests of IRC §401(m).

Funding. Defined contribution plans can be funded by either of the two following arrangements:

1. **Profit-Sharing Plans.** Profit-sharing plans allow employers to make discretionary contributions based on business performance. This type of plan gives employers flexibility since it does not lock them into set retirement plan payments, but instead allows contributions to match the cash flow of a business. Contributions are made solely by the employer based on a set formula that allocates a portion of the employer's profits to each eligible employee's individual account.

   Profit-sharing plans may be established by sole proprietorships, partnerships, limited liability corporations (LLCs), or incorporated businesses, including subchapter S corporations. Unlike 401(k) contributions, profit-sharing plan contributions are exempt from FICA tax.

   Participant loans and in-service withdrawals are permitted with profit sharing plans, but nonqualified withdrawals may be subject to a 10% early distribution penalty. Any eligible employee at least age 21, who has provided a designated period of service to the employer not to exceed two years, must be allowed to participate in a profit sharing plan. Union employees and nonresident aliens who have no U.S. source of income may generally be excluded.

   If the designated participation waiting period is one year or longer, an employee must normally work 1,000 hours during the 12-month period beginning on the date of employment and satisfy the plan's service requirement in order to enter the plan. Vesting is immediate. If the waiting period is less than one year, all eligible employees must be included, regardless of the number of hours worked during the year, but a graduated vesting period may be used.

2. **Money Purchase Plans.** In money purchase plans, employers are required to make fixed, annual contributions. This plan also may allow voluntary employee contributions. The employer's contribution amount is unrelated to business profits, but may be stated as a percentage of a participant's compensation. Self-employed participants may contribute a fixed contribution amount regardless of the net profit of their business. An excise penalty applies if an employer fails to meet the plan's minimum annual funding requirement.

   Any size business may establish a money purchase plan. A business may sponsor other retirement plans in addition to its money purchase plan. Plans can be simple or complex but cannot discriminate in favor of highly compensated employees. Participants are allowed to take out loans against their account balances, but in-service withdrawals are prohibited.

Types. The following are specific types of private-sector defined contribution plans:

1. **IRC §401(k) Plans.** 401(k) plans are funded primarily by employees' elective pretax contributions, but employers can also make tax-deferred matching contributions. These types of plans are also referred to as "**cash or deferred arrangements" (CODAs)**. To be considered a qualified CODA, a 401(k) plan must be profit-sharing plan or a money purchase plan in existence on June 27, 1974, that included a salary reduction arrangement on that date. Any size business may establish a 401(k) plan.

   In addition to matching contributions, employers also can make non-elective contributions to participating employees' accounts, without giving them the option to take cash instead. Contributions are tax-deferred for federal income tax purposes, but subject to social security, Medicare, and federal unemployment tax in the year earned.

   Participants are limited to an aggregate total of $15,000 in elective deferral contributions in 2006, with an additional $5,000 contribution allowed for participants age 50 and over. When computing this annual limitation, all elective deferrals must be considered, with the exception of §457 plan contributions.

   If there is an excess deferral, the excess and any income attributed to the excess must be withdrawn from the participant's account by the due date of his return, without extensions. Excess deferrals that are not withdrawn are taxed twice – once when contributed and once when withdrawn – and are subject to a 10% excise tax. Excess contributions also may cause a plan to be disqualified.

   Employees are always 100% vested in their own salary deferral contributions, but employer contributions may be vested on a graduated schedule. Plan loans and in-service withdrawals are permitted, but early distributions may be subject to a 10% penalty. 401(k) funds are subject to required minimum distribution rules.

   Typically, a 401(k) plan is open to both employees and employers (i.e., owners and managers). However, the following employees may be excluded from a 401(k) plan:

   - Employees under age 21
   - Employees who have not completed a year of service for the plan's sponsor
   - Employees covered by a collective bargaining agreement, if retirement benefits were the subject of good faith bargaining

   Nondiscrimination rules apply to 401(k) plans to prevent the plans from providing benefits in favor of highly compensated employees. Traditional 401(k) plans are subject to annual testing to assure that the amount of contributions made on behalf of rank-and-file employees is proportional to contributions made on behalf of highly compensated employees.

   Safe Harbor 401(k) Plan. Under a safe harbor 401(k) plan, employers can avoid discrimination testing by choosing to match each participating employee's contributions dollar-for-dollar up to 3% of compensation, and 50¢ on the dollar for each employee's next 2% of contributions. Alternatively, an employer may make a nonelective contribution equal to 3% of compensation to each eligible employee's account, but either matching contributions or nonelective contributions must be made each year. Employees become fully vested immediately in the balance of their accounts.

2. **Employee Stock Ownership Plans (ESOPs).**[15] An employee stock ownership plan (ESOP) is a retirement plan in which an employer contributes company stock to a trust fund for the benefit of its employees. Contributions can be made either in cash that is used by the plan to buy employer securities or directly in the form of employer securities.

   When employer securities are contributed directly, the employer may take a deduction for the full value of the stock contributed. By doing so, the employer actually increases its cash profits by the value of the taxes saved through the deduction.

   An arrangement called a **leveraged ESOP** allows a plan to borrow funds from a bank or other lender, and use the proceeds to buy employer securities. Since contributions to a tax-qualified employee benefit plan are deductible, the employer can deduct contributions to the ESOP which are used to repay not only the interest on the loan, but also the loan's principal. This makes the ESOP an attractive form of debt financing for the employer from a cash flow perspective.

   A sponsor can deduct contributions up to 25% of covered payroll, plus any dividends on ESOP stock that are used to repay the leveraged loan. Interest payments on the loan are deductible without limitation.

   An additional ESOP incentive allows a shareholder of a closely-held company to sell stock to the plan and defer federal income taxes on the gain from the sale. In order to qualify for this "rollover," the ESOP must own at least 30% of the company's stock immediately after the sale, and the seller(s) must reinvest the proceeds from the sale in the securities of domestic operating corporations within 15 months – either three months before or 12 months after the sale.

   The seller, certain relatives of the seller, and 25% shareholders in the company are prohibited from receiving allocations of stock acquired by the ESOP through a rollover. Generally, the ESOP may not sell the stock acquired through a rollover transaction for three years. To qualify for rollover treatment, the stock sold to the ESOP must be common or convertible preferred stock of a closely-held domestic corporation and must have been owned by the seller for at least three years.

Hybrid Plans

Hybrid plans combine features of both defined benefit and defined contribution plans, generally by specifying the amount of a contribution similar to a defined contribution plan, but promising benefits like a defined benefit plan. Risks are generally assumed by the plan sponsor.

Hybrid plans grow throughout an employee's career and allow employees to see that growth through individual account balances. Benefits are usually paid as a lump sum upon termination of employment, making the accounts portable and desirable to mobile employees.

The two most common hybrid plans are the following:

1. **Cash Balance Plan.** A cash balance plan is funded by annual employer contributions earning a defined rate of interest. An employer credits a participant's account with a "pay" credit based on the employee's compensation and an interest credit. The growth of the account depends on pay credits that the employer contributes, not on profit sharing.

   A cash balance plan offers more portability than traditional pension plans since a participant can take the vested balance in the account as a lump sum whenever he terminates employment or convert the balance to an annuity. The participant's age does not reduce the amount of the payment.

15. ESOPs should not be confused with employee stock options plans, which are not retirement plans. Employee stock options plans grant employees the right to buy their company's stock at a set price within a certain period of time.

2. **Pension Equity Plan.** A pension equity plan is a defined benefit pension plan in which an employee is credited with points based on age, service, or a combination of both. On termination of employment, a participant's final average compensation is multiplied by accumulated points to determine an account balance. This balance may be distributed as a lump sum or converted to an annuity.

SELF-EMPLOYED RETIREMENT PLANS

Savings Incentive Match Plan for Employees (SIMPLE)

A savings incentive match plan for employees (SIMPLE) provides employers with a simplified way to fund employee pension plans. SIMPLE plans must be maintained on a calendar year basis and can be established as either a SIMPLE IRA or a SIMPLE 401(k).

SIMPLE IRA. A SIMPLE IRA plan is a flexible, easy-to-administer retirement plan generally funded by employer contributions. However, employees also may elect to make pretax contributions. Employee salary reduction contributions are limited to $10,000 for 2006, but employees age 50 and over may contribute an additional $2,500. The amount contributed to a SIMPLE IRA is included when computing the overall limitation of $15,000 for elective deferrals.

Employers are required to make either dollar-for-dollar matching contributions up to 3% of compensation or to make nonelective contributions of 2% of each employee's wages up to a maximum wage of $220,000. The matching employer contribution cannot be lower than 1%. An employer may only lower the matching percentage below 3% two calendar years out of the 5-year period ending with the calendar year the reduction is effective.

Employers must deposit an employee's salary reduction contribution within 30 days from the end of the month the amount would have been paid to the employee. Matching or non-elective contributions must be made by the due date of the employer's return, including extensions. Contributions may be deducted on the return for the tax year to which they apply (e.g., a sole proprietor with a calendar tax year may deduct contributions made by April 15, 2007, on his 2006 return).

To be eligible to establish and maintain a SIMPLE IRA, an employer must have 100 or fewer **eligible** employees. Also, the employer may not maintain any other qualified pension plans, other than a plan for collective bargaining employees. Self-employed individuals with earned income and leased employees are included as employees.

An eligible employee includes any employee who received at least $5,000 in compensation during any two years preceding the current calendar year and is reasonably expected to receive at least $5,000 in the current calendar year. Employers can alter this requirement to make it less restrictive (e.g., allow employees to participate if they worked only one year and earned only $3,000), but no harsher restrictions may be imposed.

SIMPLE 401(k). A SIMPLE 401(k) is a qualified retirement plan that is subject to the same rules that apply to traditional 401(k) plans, with the exception of the nondiscrimination and top-heavy rules. A SIMPLE 401(k) plan must meet **all** of the following conditions:

1. The plan must allow employees an option to defer up to $10,000 in earnings per year in 2006, with a catch-up contribution provision of $2,500 for participants age 50 or older.
2. The plan document must require the employer to fund the plan with either of the following contribution types:
   - A **matching** contribution up to 3% of an employee's compensation
   - A nonelective contribution of 2% of compensation for each eligible employee to whom the employer paid at least $5,000 during the year

Observation. Since an employer is limited to matching up to $220,000 of compensation per employee, the maximum 3% match would be limited to $6,600 per employee.

3. The plan must prohibit any other types of contributions.
4. The employer may not contribute to, and the employee may not benefit from, any other retirement plans maintained by the same employer.
5. Participating employees must maintain nonforfeitable rights to any contributions credited to their accounts.

Simplified Employee Pension Plan (SEP-IRA).

SEP-IRAs provide employers with a simplified method to contribute toward their own and their employees' retirement funds. Employers make SEP contributions directly to individual IRAs set up for each employee, but the accounts are owned and controlled directly by the employees. **Employees** cannot contribute to their own SEP accounts.

To establish a SEP, an **employer** must satisfy all of the following requirements:

- Establish and adopt a formal, written plan, using either an approved self-designed plan, a prototype plan offered by a qualified financial institution, or the IRS model plan provided on Form 5305-SEP, *Simplified Employee Pension — Individual Retirement Accounts Contribution Agreement*
- Provide each eligible employee with information about the plan, including a copy of the plan and instructions for participation
- Establish an individual SEP-IRA account for each eligible employee at a bank, insurance company, or other qualified financial institution

At a minimum, an **eligible employee** is defined as an individual who has:

- Attained age 21,
- Worked for the sponsor in at least three of the last five years, and
- Received at least $450 in compensation from the sponsor in 2006.

Employers may use less restrictive requirements to determine which employees are eligible to participate in the plan. Plans may exclude employees covered by a union agreement whose retirement benefits were bargained for in good faith and nonresident alien employees who have no U.S. compensation from the sponsor.

SEPs may be established up to the due date, including extensions, of a business' income tax return for that year. Plan sponsors do not need to file Form 5500, *Annual Return/Report of Employee Benefit Plan*. However, sponsors should complete Form 5305-SEP, *Simplified Employee Pension — Individual Retirement Accounts Contribution Agreement*. This form is held by the plan sponsor. Copies must be provided to plan participants, but the form is not submitted to the government.

Contributions must be made by the due date of the employer's return, including extensions. For example, a calendar-year sole-proprietor may make contributions for tax year 2006 until October 15, 2007, if he files for an extension. For 2006, annual sponsor contributions deposited into an employee's SEP-IRA cannot exceed the **lesser** of:

- 25% of compensation, or
- $44,000 (subject to annual cost-of-living adjustments for later years).

These limits apply in the aggregate to all contributions made by a sponsor on behalf of an employee to all defined contribution plans. Employers may consider up to $220,000 of an employee's compensation when applying the contribution percentage rate. **The contribution rate must be uniform for all employees, including sole proprietors.** Contributions must be made in cash; property cannot be contributed.

Sole proprietors and partners may participate in SEP accounts even if they are already covered by an employer-sponsored pension plan. However, self-employed participants must recompute their compensation before applying the contribution percentage rate in order to determine their allowable contribution. This recomputed compensation must reflect the employer's net SE income reduced by both of the following:

1. The employer's adjustment for half of SE tax
2. The employer's allowable SEP contribution

However, since an employer's contribution is based on recomputed compensation multiplied by the applicable contribution rate, a circular reference is created. To eliminate this circular reference, self-employed taxpayers can determine the amount of their contributions by using the following worksheet:

2006 SEP-IRA Contribution Worksheet for Self-Employed

Step 1.	**Net Self-Employment Income**	___________
Step 2.	**Adjustment for ½ Self-Employment Tax**	___________
Step 3.	**Adjusted Net Self-Employment Income** (Subtract Step 2 from Step 1)	___________
Step 4.	**Uniform Contribution Percentage Rate (0–25%)**	___________
Step 5.	**Contribution Factor** (Add 100% to Step 4 rate)	___________
Step 6.	**Adjusted Earned Income** (Divide Step 3 by Step 5, round down)	___________
Step 7.	**2006 Maximum Compensation Threshold**	$220,000
Step 8.	**Recomputed Compensation** (The lesser of Steps 7 or 8)	___________
Step 9.	**Preliminary Contribution Amount** Multiply Step 4 by Step 8, round **down** to the closest dollar)	___________
Step 10.	**2006 Maximum Dollar Contribution Limitation**	$44,000
Step 11.	**Allowable SEP-IRA Contribution** (The lesser of Steps 9 or 10)	___________

Example 5. Rachel is self employed with a Schedule C net income of $800,000, which reflects SEP contributions for her employees at a rate of 10%. Rachel's 2006 SE tax adjustment is $16,553. Her allowable SEP-IRA contribution is limited to $22,000, calculated as follows:

2006 SEP-IRA Contribution Worksheet for Self-Employed

Step 1.	**Net Self-Employment Income**	$800,000
Step 2.	**Adjustment for ½ Self-Employment Tax**	$16,553
Step 3.	**Adjusted Net Self-Employment Income** (Subtract Step 2 from Step 1)	$783,447
Step 4.	**Uniform Contribution Percentage Rate (0–25%)**	10%
Step 5.	**Contribution Factor** (Add 100% to Step 4 rate)	110%
Step 6.	**Adjusted Earned Income** (Divide Step 3 by Step 5, round down)	$712,224
Step 7.	**2006 Maximum Compensation Threshold**	$220,000
Step 8.	**Recomputed Compensation** (The lesser of Steps 7 or 8)	$220,000
Step 9.	**Preliminary Contribution Amount** Multiply Step 4 by Step 8, round **down** to the closest dollar)	$22,000
Step 10.	**2006 Maximum Dollar Contribution Limitation**	$44,000
Step 11.	**Allowable SEP-IRA Contribution** (The lesser of Steps 9 or 10)	**$22,000**

Example 6. Thomas is self employed with a Schedule C net income of $80,000. His net profit reflects SEP contributions made for his employees at a rate of 25%, and his adjustment for half of his SE tax is $5,652. His allowable SEP contribution is $14,869, calculated as follows:

2006 SEP-IRA Contribution Worksheet for Self-Employed

Step 1.	**Net Self-Employment Income**	$80,000
Step 2.	**Adjustment for ½ Self-Employment Tax**	$5,652
Step 3.	**Adjusted Net Self-Employment Income** (Subtract Step 2 from Step 1)	$74,348
Step 4.	**Uniform Contribution Percentage Rate (0–25%)**	25%
Step 5.	**Contribution Factor** (Add 100% to Step 4 rate)	125%
Step 6.	**Adjusted Earned Income** (Divide Step 3 by Step 5, round down)	$59,478
Step 7.	**2006 Maximum Compensation Threshold**	$220,000
Step 8.	**Recomputed Compensation** (The lesser of Steps 7 or 8)	$59,478
Step 9.	**Preliminary Contribution Amount** Multiply Step 4 by Step 8, round **down** to the closest dollar)	$14,869
Step 10.	**2006 Maximum Dollar Contribution Limitation**	$44,000
Step 11.	**Allowable SEP-IRA Contribution** (The lesser of Steps 9 or 10)	**$14,869**

For sole proprietors or partners whose modified self-employment income does not approach the threshold amount, a shortcut may be used:

1. Determine the net self-employment income from Schedules C or F (or a partner's K-1).
2. Subtract the self-employment tax adjustment shown on Form 1040, page 1 (i.e., half of SE tax).
3. Multiply the result of Steps 1 and 2 by the following fraction. Round the resulting contribution down to the nearest whole dollar amount.

$$\frac{\textbf{Contribution rate for employees}}{\textbf{1 + Contribution rate for employees}}$$

This shortcut is mathematically expressed by the following formula:

$$\textbf{SEP-IRA Contribution} = (\textbf{Net Se Income} - \textbf{SE Tax Adjustment}) \times \frac{\textbf{Contribution Rate}}{\textbf{1 + Contribution Rate}}$$

The following chart converts this fraction into a percentage rate.

Employee Rate	Owner's Rate	Employee Rate	Owner's Rate
1.00%	0.9901%	14.00%	12.2807%
2.00%	1.9608%	15.00%	13.0435%
3.00%	2.9126%	16.00%	13.7931%
4.00%	3.8462%	17.00%	14.5299%
5.00%	4.7619%	18.00%	15.2542%
6.00%	5.6604%	19.00%	15.9664%
7.00%	6.5421%	20.00%	16.6667%
8.00%	7.4074%	21.00%	17.3554%
9.00%	8.2569%	22.00%	18.0328%
10.00%	9.0909%	23.00%	18.6992%
11.00%	9.9099%	24.00%	19.3548%
12.00%	10.7143%	25.00%	20.0000%
13.00%	11.5044%		

Although this shortcut seems to produce a disparity between the employee's contribution rate and the rate applied to self-employed taxpayers, the calculation results in the same contribution amount as determined by the longer method.

Example 7. The facts are the same as in **Example 6,** except the allowable contribution is calculated via the short-cut method.

Step 1	Net SE tax	$80,000
Step 2	SE tax adjustment	(5,652)
	Adjusted SE income	$74,348
Step 3	Multiply by owner's rate (25% ÷ 125% = 20%)	× 20%
	Allowable SEP contribution	$14,869

Caution. This shortcut should only be used to calculate the contribution of SE taxpayers whose income is well below the maximum compensation threshold.

Salary Reduction Simplified Employee Pension Plan (SARSEP). A SARSEP is a SEP that was established before 1997 that includes a salary reduction arrangement. Although new SARSEPs may no longer be established, existing SARSEPs may continue to be funded if they satisfy **all** the following requirements:

- There were 25 or fewer employees eligible to participate in the SARSEP in the preceding year.
- At least 50% of the eligible employees elect to make salary reduction contributions in the current year.
- The elective deferrals of highly compensated employees meet the SARSEP deferral percentage limitation, computed by averaging the deferral percentages for the non-highly compensated employees for the year, then multiplying the result by 1.25. This deferral percentage limitation must be computed each year.

A highly compensated employee is an individual who:

- Owned more than 5% of the sponsor's business at any time during the current or the preceding year, or
- Was paid more than $100,000 in compensation in the preceding year and, if provided by the SARSEP document, was in the top 20% of employees when ranked by compensation.

Employers are required to deposit employees' elective SARSEP deferrals into the employees' accounts by the 15th day of the month in the month following the deferral. For example, January salary reduction deferrals must be deposited by February 15.

INDIVIDUAL RETIREMENT ARRANGEMENTS

Although individual retirement arrangements are most often established independently of employer-sponsored plans, employers may also set up and fund IRA-type accounts for their employees, or withhold and deposit an employee's authorized contribution through payroll deduction. IRAs can be established at many different financial institutions, including banks, insurance companies, and brokerage firms.

Traditional IRA

A traditional IRA is a personal savings plan that offers tax advantages for retirement savings. Eligible IRA contributions are generally deducted from a taxpayer's adjusted gross income in the year for which the contribution is designated and taxed in the year distributed. Contributions can be made until the due date of the taxpayer's return, not including extensions.

To contribute to an IRA, taxpayers must be under the age of 70½ at the end of the tax year and must have taxable compensation, such as wages, salaries, commissions, tips, bonuses, net income from self–employment, taxable alimony, or separate maintenance payments. Spousal IRAs can be set up for the benefit of nonworking or low-earning spouses.

The 2006 contribution limit for traditional IRAs is the lesser of $4,000 or the taxpayer's taxable compensation for the year, with a $1,000 catch-up contribution allowed for taxpayer's age 50 or older before 2007. Contributions to a traditional IRA account may be fully or partially tax deductible, or nondeductible, depending on a taxpayer's modified adjusted gross income (MAGI) and participation status in an employer-sponsored retirement plan.

The 2006 contributions of **active participants** in employer-sponsored plans will be phased out for filers in the following income ranges:

Filing Status	MAGI
Married filing jointly* and qualifying widow(er)	$75,000–$85,000
Single or head of household	50,000–60,000
Married filing separately	0–10,000

*This phaseout range applies only to covered participants in employer-sponsored plans. A separate phaseout range applies when only one spouse is covered.

Taxpayers with income exceeding the above limits can still make contributions to an IRA but cannot deduct the contribution from modified adjusted gross income. Regardless of the deductibility of the contributions, earnings on the amounts deposited in an IRA are not taxed until they are distributed.

Roth IRA

A Roth IRA differs from a traditional IRA in that contributions are not deductible in the year made and qualified distributions can be withdrawn tax-free.

To be considered qualified, distributions must be withdrawn **at least five years after the tax year of the participant's first contribution and one of the following circumstances must apply:**

- The participant must be age 59½ or older,
- The participant must be disabled,
- The proceeds must be paid to a beneficiary after the participant's death, or
- The participant must use the proceeds to buy, build, or rebuild a first home.

ADVANTAGES AND DISADVANTAGES OF VARIOUS RETIREMENT PLANS

Experts advise participants to base their retirement planning strategy on three income sources:

1. Social security
2. Employer-provided pensions
3. Personal savings.

This approach has been compared to a three-legged stool – all three sources are necessary to create a functional, balanced income stream at retirement. However, there is no "one size fits all" approach to retirement planning. The variety of retirement plans available is evidence that no plan is right for everybody.

EMPLOYER'S PERSPECTIVE

More than one million small businesses with fewer than 100 employees offer retirement plans.[16] In addition to providing retirement income for their employees, employers gain several advantages by offering pension plans, including:

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- The opportunity to accumulate tax-deferred retirement savings for themselves
- Assistance with attracting and retaining qualified employees
- Reduced taxable business income resulting from contributions

The following chart highlights some of the advantages and disadvantages of various plans from an employer's viewpoint.

16. U.S. Small Business Administration, *Choosing a Retirement Solution for Your Small Business*, Publication 3998 (Rev. 9-2005)

Retirement Plan Advantages and Disadvantages for Employers

Plan Type	Advantages	Disadvantages
Defined benefit plans	• Offers an attractive recruitment benefit because it provides retirement income security for employees • Allows businesses to take larger tax deductions due to higher annual benefit limitations on contributions	• Employer assumes risk of investment performance by guaranteeing employees a fixed benefit upon retirement • No flexibility regarding contributions • Contribution amounts must be determined by an actuary • More complex and expensive to establish and maintain • Requires annual filing of Form 5500, *Annual Return/Report of Employee Benefit Plan,* and Form 5500, Schedule B, *Actuarial Information*
401(k) plans	• Recruitment incentive • No required annual contribution, unless the plan document provides for a required matching contribution	• Administrative burden on employer (e.g., setting up and maintaining the plan; educating employees; and processing contributions, withdrawals, loans, etc.) • Costs may be higher than other plans • Requires annual, complicated, nondiscrimination testing to ensure that the plan does not discriminate in favor of highly compensated employees
Designated Roth plans	• Diversified offerings may encourage retirement plan participation • May attract highly compensated employees • Allows self-employed individuals to contribute more than with a SEP-IRA plan	• Separate recordkeeping and reporting requirements • Too new — regulations unclear • Requires employers to maintain two separate plans • Too many plan choices could deter participation Internal concerns: • Plan document must be amended to add Roth option • Company handbooks may require updating • Places additional strain on payroll and human resources personnel • Requires employee notification and education

Retirement Plan Advantages and Disadvantages for Employers (continued)

Plan Type	Advantages	Disadvantages
SEP plans	• Less complex and costly to establish and administer than many other plans (i.e., does not require Form 5500 to be filed) • Allows discretionary employer contributions • Allows self-employed individuals to save additional funds for retirement since they can contribute to a SEP-IRA even if covered by another plan(s) • Flexible establishment and contribution period (i.e., contributions allowed up to due date of return, including extensions)	• Requires employer to make pro rata contributions on behalf of all eligible employees • Employees are 100% vested immediately
SIMPLE IRA plans	• Less complex and costly to establish and administer than many other plans (e.g., no discrimination testing required) • Plan document may allow for elective employee contributions	• Requires employer to make either matching contributions or nonelective contributions annually • Employees become immediately vested in 100% of their account balances • Availability of plan option restricted to sponsors with 100 or fewer employees • Restricts employers' other plan options since no other plan may be offered in conjunction with a SIMPLE plan
ESOPs	• May increase productivity and motivation of employee stockholders • Increases cash flow for company through sale of stock to trust • Owner may defer tax if selling 30% of company stock to trust • Allows graduated vesting schedule • Forfeitures may reduce required employer contributions • Allows for contributions exceeding 25% of payroll	• ESOPs are complex to administer since they are subject to many layers of regulations and restrictions • Employees gain voting rights, offering few advantages to S corporations

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EMPLOYEE'S PERSPECTIVE

Employment decisions often are based on a comparison of the benefits packages potential employers offer. A single employer may offer more than one retirement option to employees. The decision an employee makes on how to save for retirement can greatly influence his quality of life in his retirement years.

One decision workers face is whether it is better to accumulate retirement savings with pretax or after-tax income. The following chart provides an overview of some of the advantages and disadvantages of various plans from the employee's viewpoint.

Retirement Plan Advantages and Disadvantages for Employees

Plan Type	Advantages	Disadvantages
Defined benefit plans	• Guaranteed source of income offers security to employees • Allows employees to more accurately forecast other retirement income needs by having a fixed source to rely on • May offer early retirement option to increase benefit payments in "gap years" before the onset of social security payments	• Fixed income does not respond to inflation • Employee generally does not contribute to plan; therefore, there is no portability if employee leaves employer before vested in plan • Employer may go bankrupt or cease business requiring the Pension Benefit Guaranty Corporation to step in
401(k) plans	• Allows larger contributions than IRAs • Lack of income eligibility limitations allows highly compensated employees to participate • Matching employer contributions if required by the plan document • Offers some liquidity through loans and hardship withdrawals	• Early withdrawals may be subject to penalty • Administrative fees may erode nest egg
Designated Roth plans	• Offers flexible tax-free income stream in retirement years • Allows larger contributions than Roth IRA • Opens Roth opportunity to high income taxpayers • Protects against future unknown rate hikes • May lower taxes on social security benefits • Allows tax-free income to be passed to heirs • May provide matching employer contributions • Offers some liquidity through loans and hardship withdrawals	• Reduces current year tax benefits • Tax rates could decrease in retirement years • Separate account doubles paperwork, may cause confusion • Early withdrawals may be subject to penalty
SEP plans	• Higher contribution limits than IRAs • Immediate vesting makes funds highly portable	• Employer contributions are discretionary
SIMPLE IRA plans	• Higher contributions allowed as compared to traditional IRAs • Immediate 100% vesting in employer's contributions • Plan may allow elective employee contributions	• Contribution limitations are lower than traditional elective deferral plans
ESOPs	• Allows employees to share in employer's success • Allows employees to have say in company through stock voting rights	• Value of retirement account is subject to market fluctuations • Vesting may be gradual, providing less portability

ROLLOVERS

The following chart illustrates which types of retirement accounts can be rolled from or rolled to another type of retirement account. The chart can be found on the IRS website at **www.irs.gov/pub/irs-tege/rollover_chart.pdf**.

ROLLOVER CHART

ROLL FROM	ROLL TO: IRA	SEP-IRA	SIMPLE IRA	Roth IRA	457(b)	403(b)	Qualified Plan	Designated Roth Account
IRA	YES	YES	NO	YES, must include in income.	YES, must have separate accounts.	YES	YES	NO
SEP-IRA	YES	YES	NO	YES, must include in income.	YES, must have separate accounts.	YES	YES	NO
SIMPLE IRA	YES, after two years.	YES, after two years.	YES	YES, after two years. Must include in income.	YES, after two years. Must have separate accounts.	YES, after two years.	YES, after two years.	NO
Roth IRA	NO	NO	NO	YES	NO	NO	NO	NO
457(b)	YES	YES	NO	NO, not directly.	YES	YES	YES	NO
403(b)	YES	YES	NO	NO, not directly.	YES, must have separate accounts.	YES	YES	NO
Qualified Plan	YES	YES	NO	NO, not directly.	YES, must have separate accounts.	YES	YES	NO
Designated Roth Account	NO	NO	NO	YES	NO	NO	NO	YES, if a direct trustee to trustee transfer.

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PENSION RIGHTS OF RESERVISTS AND GUARD

Since September 11, 2001, over half a million members of the National Guard and Reserve have been mobilized to fight the war on terror. As more civilian service members are called to duty to protect our nation's borders against illegal immigration, the number of activated civilian soldiers will continue to increase. It is important for employers to recognize their obligations to these activated employees.

THE UNIFORMED SERVICES EMPLOYMENT AND REEMPLOYMENT RIGHTS ACT

The Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA)[17] provides job and benefit security for qualified, activated members of the uniformed services.[18] USERRA requires employers to reinstate returning service members to the same or comparable jobs with the same pay, benefits, and status they would have attained had they not been deployed.

17. 38 U.S.C. §§4301–4333

18. USERRA protection also extends to members of the National Disaster Medical System under 42 U.S.C. 300hh–11(e)(3).

Employers must refrain from discrimination and retaliation against service members or their spouses who request USERRA's job and benefit protections. Employers are required to notify employees of their rights under the act.[19] Compliance enforcement is administered by the U.S. Department of Labor, Veterans' Employment and Training Service (VETS).

To be eligible for USERRA's reemployment protection, service members must:

- Have five years or less of cumulative uniformed service while with their present employer,
- Give advance notification to their employer, either verbally or in writing, of their impending activation,
- Return to work or apply for reemployment in a timely manner after deactivation, and
- Have not been separated from uniformed service with a disqualifying discharge or under less than honorable conditions.

USERRA and Military Differential Pay

USERRA puts employers in a catch-22 situation as far as employee benefits are concerned. Although the IRS considers the employer–employee relationship to be severed when an employee is called to active duty,[20] USERRA requires employers to extend benefits such as pension and health insurance coverage to activated "nonemployees" during their absence, as if there were no break in service.

Under Revenue Ruling 69-136, differential payments[21] made by a company to its former employees while they are in military service are not considered "wages" subject to income tax withholding, although the payments are still taxable to the employee. Therefore, these payments are not subject to payroll taxes imposed by the Federal Insurance Contributions Act (FICA) or the Federal Unemployment Tax Act (FUTA).

Payers should not report differential payments on Form W-2, but instead should report these payments on Form 1099-Misc, Box 3, as other income. Recipients should report these payments on Form 1040, line 21.[22] Since employers are not required to withhold income tax from differential payments, service members receiving such income may be required to make estimated federal and state income tax payments.

Benefits Continuation

In contrast, the basic rule regarding benefits is that employers must treat reemployed service members as if they had never broken service and fund their pension plans as if they had been in continuous employment. USERRA states:

Each period served by a person in the uniformed services shall, upon reemployment under this chapter, be deemed to constitute service with the employer or employers maintaining the [pension] plan for the purpose of determining the nonforfeitability of the person's accrued benefits and for the purpose of determining the accrual of benefits under the plan.[23]

Employers must make any nonelective employer contributions that would have been required during an activated employee's military service period when the service member is reemployed. Employers are also required to match any make-up contributions that employees make to their retirement plans upon reinstatement.

19. 38 U.S.C. 4334(a), *Veterans Benefits Improvement Act of 2004*, December 10, 2004. Text of the notice may be viewed at www.dol.gov/vets/programs/userra/poster.htm.

20. Rev. Ruling 69–136

21. Differential payments are voluntary payments representing the difference between a former employee's regular salary and active duty military salary.

22. For more information on this subject, see the "Military Pay Differential Supplement" posted under the Supplement heading on the home page of the University of Illinois Tax School's website at www.ace.uiuc.edu/TaxSchool.

23. 38 U.S.C. §4318(a)(2)(B)

To calculate the pension funding allocations and make-up contributions, employers must assume rehired employees earned compensation at the same rate they would have received during their deployment, or if that compensation rate is not reasonably certain, at a rate equivalent to the employee's average compensation during the 12-month period immediately preceding the qualified military service.[24] If the employee did not work for the employer for a full 12-month period before deployment, the compensation rate should be averaged over the period of employment immediately preceding activation.

An employer does not have to fund an activated employee's plan until the rehired employee returns from service. **Both employers and employees may fund makeup contributions over a period up to three times the activated length of service but not to exceed five years.** However, employers must make matching contributions as soon as the rehired employee makes up his elective contributions. An employer is under no obligation to make up any investment earnings on these delayed contributions or to reallocate any plan forfeitures distributed to other participants during the activated employee's absence.

Make-up contributions are subject to the same limitations that would have applied during the service member's activation period. The returning service member can designate the specific year he wishes his make-up contributions to apply.

If an employee's make-up contributions span several years, employers must report the year and the amount of contributions designated to that year in Box 12 of the employee's Form W-2. The current year contribution does not require a year designation.[25]

Employers report USERRA make-up nonelective contributions, voluntary after-tax contributions, required employee contributions, and employer matching contributions in Box 14 of Form W-2. Employers may opt to provide employees with a separate statement that includes information for boxes 12 and 14, detailing the type of plan, the year(s) to which the contributions relate, and the amounts contributed for each year.[26]

Example 8. Gina I. Jane was working as a sales manager at Sears when her reserve unit was activated on June 30, 2004.[27] Gina was earning $60,000 a year when she was called up, but she was scheduled for a promotion on July 1 that would have boosted her annual salary to $75,000.

Sears offers qualified employees two retirement plans: a noncontributory defined benefit plan and an optional 401(k) plan with a 6% company match. Gina was eligible for and participated in both plans. She elected to defer 10% of her annual salary into her 401(k).

Gina earned $30,000 a year in nontaxable combat pay while serving in Iraq. Sears' company policy provides that employees activated in the Reserve or National Guard will receive military differential pay and benefits continuation for up to 60 months. It also provides employees with merit pay increases during their deployment.

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24. IRC §414(u)(7)

25. 2006 Form W-2 instructions at www.irs.gov/pub/irs-pdf/iw2w3.pdf, page 12

26. Ibid, page 8

27. Although the example is fictitious, Sears does offer its activated employees differential pay and benefits continuation for up to 60 months. Sears Holding Corporation was awarded the Secretary of Defense Employer Support Freedom Award in October 2005 to publicly recognize the company as an employer that provides exceptional support to its employees who are serving in the National Guard and Reserve.

Gina served for 18 months and was deactivated on December 31, 2005. Sears rehired Gina on January 1, 2006. During her deployment, Gina was awarded a merit pay increase of 5% each year, effective every January 1. Sears paid Gina the following differential payments during her tour of duty:

Year	Base Pay	Military Pay	Differential Pay
2004	$37,500*	$15,000	$22,500
2005	78,750**	30,000	48,750

*The 2004 base pay is computed on only the last six months of the year. For the calendar year 2004, Gina would have earned $67,500 in total pay (($60,000 ÷ 12 × 6) + ($75,000 ÷ 12 × 6).

**The 2005 base pay is computed on Gina's $75,000 annual salary after her promotion plus the 5% merit pay increase awarded in her absence ($75,000 × 105% = $78,750).

Question 8A. How much can Gina contribute as make-up contributions to her Sears 401(k) plan when she returns?

Answer 8A. Gina maintains her 10% contribution level, so she can contribute the following amounts as make-up contributions to her Sears 401(k) plan, if she has not made any other elective deferred compensation contributions that would push her over her limit for each year:

Year	Base Pay	Contribution
2004	$37,500	$3,750
2005	78,750	7,875

Question 8B. How much must Sears contribute to Gina's retirement plans when she returns?

Answer 8B. Sears must contribute sufficient amounts to fund Gina's defined benefit plan for the 18 months she was deployed plus contribute make-up amounts to match her 401(k) plan contributions up to 6% of her salary. Assuming Sears must make $5,000 in defined benefit contributions each year to guarantee Gina a monthly pension benefit, Sears must make the following contributions:

Year	Base Pay	6% 401(k) Match	Defined Benefit Contribution	Total Contribution
2004*	$37,500	$2,250	$2,500	$4,750
2005	78,750	4,725	5,000	9,725

*Gina's 2004 W-2 would reflect the other half of the company's contributions.

Question 8C. When must the make-up contributions be made?

Answer 8C. Gina has until June 30, 2010, 4½ years from the time she was deactivated, to make up her 401(k) contributions. This represents three times her deployment period of 18 months. Sears has the same time period to contribute to her defined benefit plan, but it must match Gina's 401(k) contributions as soon as she makes them. Sears does not have to make any contributions until Gina returns from her deployment.

Question 8D. What must Sears report on Gina's 2006 Form W-2?

Answer 8D. Assuming Gina made up all of her 401(k) contributions in 2006, and the company chose to pay all of its defined benefit contributions in the same year, Sears must report the following amounts on Gina's 2006 Form W-2:

Box 1:	Wages	$62,793.50
($82,687.50 wages less $8,269 of Gina's 2006 elective 401(k) deferral and her 2004 and 2005 USERRA make-up contributions of $3,750 and $7,875.)		
Boxes 3 & 5:	Social security and Medicare wages	82,687.50
(Gina's 2006 wages including her 2006 elective 401(k) deferral; since Gina's 2004 and 2005 make-up contributions to her 401(k) were based on "phantom" wages, they are not subject to social security or Medicare tax withholding.)		
Box 12:	Gina's elective 401(k) deferrals, per year:	
	2004 USERRA make-up contribution	3,750
	2005 USERRA make-up contribution	7,875
	2006 Current year contribution	8,269
Box 14:	Sears' defined benefit and matching 401(k) contributions:	
	2004 USERRA make-up contribution	4,750
	2005 USERRA make-up contribution	9,725
	2006 current year contribution	9,961
	(Sears' 2006 contribution is based on a $5,000 defined benefit contribution plan plus 6% of Gina's 2006 salary of $82,687.50.)	

a Control number 123456789	22222	OMB No. 1545-0008	
b Employer identification number (EIN) 37-1234567		1 Wages, tips, other compensation 62793.50	2 Federal income tax withheld 8428.00
c Employer's name, address, and ZIP code Sears 2 N State St. Chicago, IL 60602 (312) 373-6000		3 Social security wages 82687.50	4 Social security tax withheld 5126.63
		5 Medicare wages and tips 82687.50	6 Medicare tax withheld 1198.97
		7 Social security tips	8 Allocated tips
d Employee's social security number 111-22-3333		9 Advance EIC payment	10 Dependent care benefits
e Employee's first name and initial / Last name / Suff. Gina I. Jane 123 American Way Chicago, IL 60602 f Employee's address and ZIP code		11 Nonqualified plans	12a Code D04 3750
		13 Statutory employee ☐ Retirement plan ☒ Third-party sick pay ☐	12b Code D05 7875
		14 Other 04 Pension 4750 05 Pension 9725 Pension 9961	12c Code D 8269
			12d Code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
IL		62793.50	1883.81			

Form **W-2** Wage and Tax Statement 2006 Department of the Treasury—Internal Revenue Service

Copy 1—For State, City, or Local Tax Department

Note. Sears should have issued Gina both a Form W-2 for $30,000 and a Form 1099-Misc. for $22,500 in 2004, but it should have issued her only a Form 1099-Misc. for $48,750 in 2005. Although Gina's combat duty pay from the military is tax-exempt, her military differential pay from Sears is taxable income reported on Form 1040, Line 21, as "other income."

Note. See Chapter 14, "New Legislation" for information on the Heroes Act, which allows make-up IRA contributions for service members who received nontaxable combat pay.

Power of Attorney

Plan documents can be structured to allow participants to designate a power of attorney to change retirement plan investment allocations, apply for hardship withdrawals, or obtain loans while the participant is deployed. These options may provide financial assistance to families of service members who do not receive differential pay while activated. However, there is no specific exception to the 10% early distribution penalty for hardship withdrawals for military families.

Note. See Chapter 14, "New Legislation," for related information included in the Pension Protection act of 2006.

Plan Loans

Plan documents may also provide that existing loan payments be suspended during a participant's deployment. However, payments must be resumed upon deactivation with the payment frequency and amount at least equal to the preactivation schedule. Repayment of the full loan amount, including interest accrued during the period of military duty, must be made by the end of the maximum term for the original loan extended by the length of deployment.

When a service member is activated, he may request under the Servicemember's Civil Relief Act of 2003 (SCRA)[28] that creditors lower his interest rate to no more than 6%. This rule also applies to pension plans with which he has outstanding loans. However, the SCRA provides an exception to the 6% interest rate cap if a plan fiduciary petitions the court to retain a higher rate based on the participant's ability to pay.

Note. Some participants may opt to continue paying the higher interest rate, to allow additional accumulation in their retirement plans.

Thrift Savings Plan Participation

Uniformed service members also may participate in the federal government's Thrift Savings Plan and receive generally the same benefits as civilian employees. However, the contribution rules are different for service members. Individuals that are both federal civilian employees and uniformed service members must maintain separate accounts.

Note. More information on this plan may be found on the Thrift Savings Plan website at **www.tsp.gov**. A pamphlet entitled *Summary of the Thrift Savings Plan for the Uniformed Services* is also available at this website.

28. 50 U.S.C. App. §501 et seq., formerly known as the Soldiers' and Sailors' Civil Relief Act of 1940

REQUIRED MINIMUM DISTRIBUTIONS

All good things must come to an end. Although retirement plans generally provide the advantage of tax-deferred savings on contributions and earnings, as the term "deferred" implies, the advantage has its limitations. For most plan participants, this tax advantage comes to an end at age 70½ when the required minimum distribution (RMD) rules begin to apply.

> **Note.** The term **account owner,** as used in this section, refers to the participating employee or IRA account holder.

BASIC RULES GOVERNING REQUIRED MINIMUM DISTRIBUTIONS

The main goal of the minimum distribution requirement is to convert tax-deferred retirement funds into taxable funds over an account owner's life expectancy.

IRC §401(a)(9) contains the RMD rules, determining when a plan participant must pass from the contribution phase of his retirement journey into the distribution phase. Required minimum distribution rules apply to the following retirement account balances or benefits in existence on or after January 1, 1985:[29]

- All qualified pension, profit sharing, and stock bonus plans including §401(k), Keogh, and employer stock option plans (ESOPs)[30]
- Tax-sheltered annuity plans (TSAs) under IRC §403(b), with the exception of funds that were in a TSA account on 12/31/86 if separately maintained[31]
- Traditional individual retirement accounts (IRAs), individual retirement annuities, simplified employee plans (SEPs), and SIMPLEs[32]
- Certain post-death Roth accounts[33]
- Certain deferred compensation plans for employees of tax-exempt organizations or state and local government plans[34]

Designated Beneficiaries

In IRS terms, a "designated beneficiary" means an individual or individuals or a qualifying trust, named by a participant to receive the remainder of his retirement account after his death. Although a participant may name his estate or a charity as a beneficiary of his retirement plan, only an individual or a qualifying trust can be considered as **designated.**

> **Note.** Only **designated** beneficiaries qualify for the joint life expectancy calculation that may lower the account owner's required minimum distribution amount (discussed later in this section).

29. Treas. Reg. §1.401(a)(9)-1
30. See Treas. Reg. §1.401(a)(9)-2 through §1.401(a)(9)-9 for detailed distribution rules regarding IRC §401(a) plans.
31. See Treas. Reg. §1.403(b)-3 for applicable distribution rules for tax-sheltered annuities.
32. See Treas. Reg. §1.408-8 for applicable distribution rules for IRA plans.
33. See Treas. Reg. §1.408A-6, Q14 for applicable Roth IRA minimum distribution rules.
34. See Treas. Reg. §1.457-6 for applicable minimum distribution rules for IRC §457 plans.

The final date for determining a beneficiary is September 30 of the year following the calendar year of an account owner's death. Although it is obvious that a participant cannot name a beneficiary after his death, this rule allows for a beneficiary to be changed in the event one or more of the named beneficiaries disclaims any benefits. However, during the period between the account owner's death and September 30 of the next year, **a beneficiary cannot be replaced with a nondesignated beneficiary.**

If a designated beneficiary dies after the account owner dies but before September 30 of the year following the owner's death, **and** there is a named successor beneficiary, the distribution period is determined by the age of the deceased beneficiary.[35]

Disclaiming Benefits. A beneficiary who is designated as of the date of the account owner's death may disclaim entitlement to any benefits of the account. The disclaimer must be made in accordance with IRC §2518 and be completed by September 30 of the year following the year of the account owner's death.

Required Beginning Date (RBD)

There are two categories of RMD rules: those applying to living account owners and those applying to beneficiaries of deceased account holders. The rules for both categories center on the key concept of the account owner's **required beginning date (RBD).**[36]

Account owners must take their first minimum distribution by their RBD. Generally, most taxpayers take their first RMD in the year they turn 70½; however, they may delay this first distribution until their RBD, which is the **later** of:

1. April 1 of the year following the year they turn 70½, or
2. For employer-sponsored plans, the calendar year in which they retire.[37]

Plan participants who are 5% owners are restricted to option 1 and must start their RMDs by April 1 of the year following the year they turn 70½, regardless of when they retire. However, governmental and church plans are exempt from this exception since one cannot really own a church or a government.[38]

The RMD is computed by dividing the balance of any applicable retirement account(s) as of December 31 of the preceding year by a life expectancy factor provided by the IRS. All traditional IRA plans must be aggregated when determining the RMD. Roth IRA **account owners** are exempt from minimum distribution rules. However, their **beneficiaries** are subject to mandatory distribution requirements (discussed later in this section).

DISTRIBUTION RULES FOR ACCOUNT OWNERS

In general, an account owner must take distributions sufficient enough to liquidate all nonRoth IRA retirement accounts over the account holder's anticipated life expectancy, which has been projected by IRS actuaries. An account owner can choose to provide for others by stretching his distributions over the joint lives of himself and a designated beneficiary or beneficiaries, most often a spouse.

Previously, the calculation of RMD was a complicated affair, but RMD rules were simplified starting with tax year 2003 distributions. To calculate distributions during an owner's lifetime, an owner divides his account balance as of December 31 by a distribution period factor based on his age. This factor is provided in the **Uniform Lifetime Table**, which can be found in IRS Pub. 590, *Individual Retirement Arrangements (IRAs),* Appendix C, Table III.[39] During a participant's lifetime, the Uniform Lifetime Table is used regardless of whether the account owner is drawing funds based on his own life expectancy or a joint life expectancy.

35. *FAQs Regarding the Required Minimum Distributions*, www.irs.gov/retirement/article/0,,id=96989,00.html
36. IRC§401(a)(9)(C)
37. IRC §401(a)(9)(C)(i)(I), (II)
38. IRC §401(a)(9)(C)(ii), (iv)
39. These projections can be found in the life expectancy tables provided in Treas. Reg. §1.401(a)(9)-9, which are reprinted in IRS Pub. 590.

This uniform lifetime distribution factor must be used by the following account owners:

- Unmarried owners
- Married owners whose spouses are not more than 10 years younger
- Married owners whose spouses are not the sole beneficiaries of their IRAs

However, if an account owner names his spouse as **sole** beneficiary and his spouse is **at least ten years younger,** he can use the **Joint Life and Last Survivor Expectancy Table**, provided in Pub. 590, Appendix C, Table II.[40] This table results in a longer distribution period and lower required minimum distribution requirements.

Caution. The Single Life Expectancy Table found in Pub. 590, Appendix C, Table I, **should not be used** to compute the RMD of a **living** account owner. This table is used solely to calculate RMDs for **beneficiaries.**

Delayed First Distribution

A taxpayer who delays his first RMD until April 1 of the year following his 70½ birthday must take two distributions in that year: the delayed required distribution and the current year distribution. This option to "double-up" is only available in the RBD year. All future distributions must be withdrawn by December 31 of each year.

Note. Although RMDs must be computed on the aggregate value of all traditional IRA accounts, the RMD can be withdrawn from any of these accounts. However, Roth IRA distributions **cannot** be used to satisfy minimum distribution requirements from traditional IRAs.

PENALTY FOR FAILURE TO TAKE AN RMD

The IRS is very serious about the annual distribution requirement. The penalty for failing to take a required minimum distribution is five times more severe than the penalty for early withdrawal of retirement funds. Participants who fail to take their RMDs at least annually are subject to a 50% excise tax each year on the difference between their annual RMD and amount actually distributed.

Example 9. Ken turned 70 on June 30, 2006. He participates in his company's 401(k) plan and also has the following balances in his three IRA plans as of December 31, 2005:

Traditional IRA (bank)	$130,000
Traditional IRA (broker)	70,000
Roth IRA (insurance company)	50,000

Since Ken is still active and healthy, he decides to delay his retirement until he turns 75. He is not a company stockholder. Ken is married and names his wife as sole beneficiary of his retirement accounts. Ken's wife turns 58 in 2006. Since his wife is 12 years his junior, Ken uses the Joint Life and Last Survivor Expectancy Table to stretch his distributions over a longer period.

40. Treas. Reg. §1.401(a)(9)-9, A-3

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Question 9. When is Ken's RBD? How much is his 2006 RMD?

Answer 9. Ken is not required to take his first distribution from his 401(k) plan until December 31, 2011. He can delay this RMD from his employer-sponsored plan until the year he retires since he is not a 5% owner.

However, Ken must take a 2006 RMD from his traditional IRA accounts because these accounts are not employer-sponsored. This distribution is computed on the combined $200,000 balances of his traditional IRA accounts on December 31, 2005. Because he is the account owner, Ken's **Roth IRA** retirement account is **not** subject to minimum distribution rules.

Ken uses his age (70) and his wife's age (58) based on their 2006 birthdays to determine his life expectancy factor under the Joint Life and Last Survivor Expectancy Table. His distribution period is 28.8 years. Ken computes his 2006 RMD by dividing his December 31, 2005, traditional IRA account balances by this life expectancy factor. Ken's must withdraw $6,944 ($200,000 ÷ 28.8 = $6,944) from his traditional IRA accounts to satisfy his 2006 RMD. He may withdraw the money from either account or take a portion of the distribution from both.

Although he will be 70½ on December 30, 2006, Ken does not have to take his first distribution in 2006. He can delay this RMD until April 1, 2007. However, if he opts to delay his first distribution, he must take two distributions in 2007. He must withdraw his 2006 required distribution of $6,944 before April 1, 2007, and his 2007 RMD before December 31, 2007. The 2007 RMD is based on the aggregate value of his traditional IRA accounts as of December 31, 2006.

If Ken fails to take his first RMD before April 1, 2007, he may be subject to an excise tax of $3,472 on money that he never withdrew. This additional tax is computed as 50% of Ken's RMD of $6,944 ($6,944 × 50% = $3,472). In addition, Ken must pay income tax on the distribution when he does withdraw it from his account. Assuming a 25% income tax rate in 2007, if Ken takes his 2006 RMD in May of 2007, it will cost him $5,208 [($3,472 + ($6,944 × 25%)], or 75% of his required distribution.

Example 10. If Ken's birthday fell on July 1, 2006 — just one day later — he could delay his first RMD by one year, until April 1, 2008. This is because he would not turn 70½ until January 1, 2007.

DISTRIBUTION RULES FOR BENEFICIARY AFTER AN ACCOUNT OWNER DIES

The RMD calculation is much more complex for beneficiaries of retirement accounts. If an account owner dies, the rules for determining the beneficiary's RMD are based on the beneficiary's relationship to the owner, whether the beneficiary had begun taking distributions prior to his death, and whether the owner had reached his RBD prior to death.

Spousal Beneficiaries

There are basically only two categories of relationships for designated beneficiaries: spousal beneficiaries or nonspousal beneficiaries. A surviving spouse is treated as the owner of the deceased spouse's account. RMDs are computed on the survivor's life expectancy and RBD, using the distribution factor provided in the **Single Life Expectancy Table** in Pub. 590, Appendix C, Table I.

Spousal beneficiaries are granted special privileges under the Code. If the deceased spouse had not taken his annual RMD before his death, his surviving spouse can opt to take his RMD rather than recalculate her own.[41] If a spouse dies before the year in which he reached age 70½, distributions to the surviving spouse do not need to begin until the year in which the owner would have reached age 70½.

Also, a surviving spouse who is the **sole** beneficiary of a deceased spouse's IRA may elect to roll over any inherited retirement funds. Special provisions also apply to spouses who inherit their deceased spouses' qualified employer-sponsored retirement plans.[42]

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41. IRS Pub. 590, *Individual Retirement Arrangements (IRAs)*

42. IRC §401(a)(9)(B)(iv)

Nonspousal Beneficiaries

Account Owner Dies Before RBD. There are two distribution methods available to nonspousal beneficiaries when a plan participant dies **before his RBD**, depending on whether the beneficiary is a designated beneficiary or not.

1. A **designated beneficiary** may withdraw the balance of the account over his own life expectancy, using the distribution factor provided in the Single Life Expectancy Table.

2. A **nondesignated beneficiary** must withdraw the balance of the account within five years of the participant's death. This 5-year rule also applies to a designated beneficiary if he fails to take his first distribution by December 31 of the year following the year of the participant's death. No distribution is required to be taken prior to the fifth year.

Account Owner Dies On or After RBD. If a plan participant dies **on or after his RBD**, the following distribution methods apply to nonspousal beneficiaries:

1. A **designated beneficiary** may take his required distributions over the longer of the following two options:
   a. The designated beneficiary's life expectancy factor provided in the Single Life Expectancy Table, or
   b. The plan owner's life expectancy factor, using the Single Life Expectancy Table.

2. A **nondesignated beneficiary** must use the Single Life Expectancy Table with the plan owner's life expectancy.

> **Note.** Obviously, the plan owner's life expectancy is "0" after his death. However, for purposes of the beneficiary's RMD calculation, the plan owner's life expectancy is considered to be the owner's age as of his birthday in the year of his death, reduced by one year for each subsequent year following his death.

Multiple Beneficiaries

If multiple beneficiaries are named, the life expectancy of the oldest beneficiary is used to calculate the RMD. The ages of those named as contingent beneficiaries after a named beneficiary's death are not taken into account to determine this distribution factor. Only the age of those beneficiaries who have an income or remainder interest is considered.

To circumvent this multiple beneficiary life-expectancy rule, **separate accounts** can be established that name different beneficiaries. These accounts must be established by the end of the calendar year following the year of the account owner's death. The RMD rules then apply individually to each separate account, starting with the year after the separate accounts are established. All post-death investment gains or losses prior to the establishment of separate accounts must be prorated between these accounts.

Required Minimum Distribution Rules for Inherited Roth IRA Accounts

Although an **account owner** is not required to withdraw funds from his Roth account during his lifetime, the **beneficiaries** of a deceased Roth-account owner may be subject to RMD rules on any undistributed plan balance in the account on the date of the account owner's death. Generally, the RMD rules for Roth IRA beneficiaries are the same as the rules that apply to a traditional IRA beneficiary when the account owner dies before his RBD.

A surviving spouse may delay distributions until her deceased spouse would have turned 70½ or treat the Roth IRA as if it is her own. Designated Roth IRA beneficiaries may take distributions over their personal life expectancies, as calculated in the Single Life Expectancy Table. Nondesignated beneficiaries must withdraw the balance of the account by the end of the fifth calendar year after the owner's death.

Beneficiaries are subject to Roth IRA qualification rules for distributions based on the owner's length of participation in the plan. Qualified tax-exempt distributions are those that are received by a beneficiary after the end of:

- A 5-year period beginning with the first taxable year for which a contribution was made to the Roth IRA set up for the owner's benefit; or
- A 5-year period starting with the year of a conversion contribution from a traditional IRA to the Roth IRA.

Any nonqualified distributions are taxable to beneficiaries. The ordering rules are the same as for account owner distributions; basis is distributed first, followed by earnings. If multiple beneficiaries receive distributions, each beneficiary is taxed on a pro-rata share of any earnings.