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Corrections were made to this workbook through January of 2009. No subsequent modifications were made.

SOCIAL SECURITY PLANNING

QUALIFYING FOR RETIREMENT BENEFITS

To qualify for social security retirement benefits, an individual must be fully insured, which means that he must have 40 quarters, or 10 years of posted earnings. For 2008, the amount of earnings needed to earn a quarter of coverage is $1,050. The maximum number of quarters of coverage available in one year is four; therefore, an employee earning $4,200 in 2008 will receive credit for four quarters of coverage.

Note. The Food, Energy, and Conservation Act of 2008 allows taxpayers electing the optional method of reporting net earnings from self-employment to increase the amount of earnings credited for self-employment to the amount needed for four quarters of social security coverage ($4,200 in 2008). This allows the self-employed taxpayer to get credit for four quarters during each year.

Observation. In advising clients about retirement issues, one of the first questions practitioners should ask is "How many quarters have you paid into social security?" This information can be obtained by filing Form SSA-7004-SM or going on the web at **www.ssa.gov** and requesting a statement of earnings. Each taxpayer age 25 or older receives this statement automatically approximately two to three months prior to his birthday each year.

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ESTIMATING SOCIAL SECURITY BENEFITS

The Social Security Administration (SSA) adjusts earnings to account for the change in general wage levels during a worker's years of employment by applying an indexing factor. The factors, as shown in the following table, can be used to calculate estimated social security retirement benefits:

2008 Indexing Factors

Year	Factor	Year	Factor	Year	Factor
1951	13.8082175	1970	6.2479648	1989	1.9229988
1952	12.9994114	1971	5.9490433	1990	1.8380943
1953	12.3115619	1972	5.4180675	1991	1.7720575
1954	12.2483585	1973	5.0990230	1992	1.6852279
1955	11.7074398	1974	4.8129206	1993	1.6708581
1956	10.9420925	1975	4.4782491	1994	1.6271859
1957	10.6135041	1976	4.1891827	1995	1.5644759
1958	10.5208258	1977	3.9523132	1996	1.4915320
1959	10.0242258	1978	3.6615479	1997	1.4092981
1960	9.6456832	1979	3.3670059	1998	1.3392059
1961	9.4577147	1980	3.0887868	1999	1.2685137
1962	9.0067134	1981	2.8062971	2000	1.2020409
1963	8.7911246	1982	2.6598655	2001	1.1740327
1964	8.4459588	1983	2.5363082	2002	1.1623754
1965	8.2965729	1984	2.3954907	2003	1.1346387
1966	7.8267704	1985	2.2976007	2004	1.0842351
1967	7.4138016	1986	2.2313712	2005	1.0459631
1968	6.9370199	1987	2.0975980	2006	1.0000000
1969	6.5580224	1988	1.9991378	2007	1.0000000

Note.

- The two most recent years are not indexed.
- Benefit estimates done with the indexing factors shown here may not agree with Social Security's computations due to rounding.
- The first year for which earnings were indexed was 1951; therefore, this is the first year in the preceding table.

Step 1. Multiply the taxpayer's actual earnings for each year by the indexing factors listed above. This gives the value of earnings in current dollars.

Step 2. Determine the 35 years in which the taxpayer had the highest indexed earnings, and add these figures. If the taxpayer worked less than 35 years, then count all years that the taxpayer worked.

Step 3. Divide the result from Step 2 by 420 (the number of months in 35 years) and round down to the next lowest dollar. This figure is the average indexed monthly earnings (AIME).

Step 4. **a.** Multiply the first $711 of AIME by 90%.

b. Multiply the amount of AIME between $711 and $4,288 by 32%.

c. Multipy the amount of AIME above $4,288 by 15%.

Step 5. Add a, b, and c from Step 4 together and round down to the next lowest dollar. This is the estimated monthly retirement benefit at normal retirement age (NRA), also known as full retirement age (FRA). This figure is also referred to as primary insurance amount (PIA).

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NORMAL RETIREMENT AGE

It is important to determine a taxpayer's normal retirement age because that is the age at which the taxpayer receives full social security benefits. The normal retirement age is shown in the following table:

Year of Birth	Normal Retirement Age	Year of Birth	Normal Retirement Age
1937 or earlier	65	1955	66 and 2 months
1938	65 and 2 months	1956	66 and 4 months
1939	65 and 4 months	1957	66 and 6 months
1940	65 and 6 months	1958	66 and 8 months
1941	65 and 8 months	1959	66 and 10 months
1942	65 and 10 months	1960 and later	67
1943–1954	66		

Receiving Benefits before Normal Retirement Age. If the worker elects to start receiving benefits 36 or fewer months before normal retirement age, the reduction in benefits is calculated at the rate of .00555 (or 5/9 of 1%) per month.

If the worker elects to start receiving benefits more than 36 months before NRA, the reduction in benefits is .00555 (5/9 of 1%) for each of the first 36 months and then .00417 (or 5/12 of 1%) per month for months in excess of 36.

Taxpayers born between 1943 and 1954 receive 75% of their PIA if they elect to start receiving benefits at age 62. This percentage gradually decreases for taxpayers born after 1954 but before 1960. Taxpayers born in 1960 and later years receive 70% of their PIA if they elect to start receiving benefits at age 62.

Additionally, individuals in the following classifications receive 50% of the PIA:

1. Spouse of a worker receiving benefits at normal retirement age
2. Spouse caring for a qualified child (A "qualified child" is defined as a child under age 16 or disabled.)
3. Child of a retired, deceased, or disabled worker (This category applies to a child under age 18, or under age 19 if a full-time elementary or high-school student.)

Note. A "qualifying divorced spouse" is treated the same as a spouse or widow(er). The definition of "qualifying" is someone who was married to the worker for at least 10 years. Benefits for the divorced spouse are lost if the divorced spouse remarries. If the divorced spouse later becomes single again, then that person is requalified.

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HUSBAND/WIFE ISSUES

There has been criticism of our current social security system because it favors the traditional family, with the husband as the wage earner and the wife as a homemaker. In today's society, with 46% of the workforce being women,[1] this criticism is valid. A married worker with a nonworking spouse pays the same amount of social security tax as a married worker with a working spouse. Under the current rules, the nonworking spouse is entitled to 50% of the PIA of the worker although the nonworking spouse paid zero into the social security system. The working spouse can collect benefits based on her own earnings or she can claim 50% of her husband's earnings, whichever is greater.

Example 1. Joe is married and his wife, Mary, does not work outside the home. He is currently entitled to $1,800 per month in social security benefits at age 66. His wife is also entitled to $900 per month. With average earnings per year, Joe has paid approximately $130,000 in social security taxes over his lifetime. If Joe and Mary receive benefits for 25 years, they will be paid $810,000 plus cost-of-living increases.

1. U.S. Census 2000

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Example 2. Use the same facts as **Example 1,** except Mary worked outside the home and is currently entitled to receive $1,000 per month. Joe and Mary will receive $840,000 over the same 25 years. In this case, Joe would still have paid $130,000 in social security taxes while Mary would have paid approximately $70,000 in social security taxes.

Observation. It is interesting to note that Mary pays $70,000 in social security taxes for which the couple receives only $30,000 in additional benefits over the 25 years.

DELAYING BENEFITS

Social security benefits are increased by a certain percentage (depending on date of birth) if a taxpayer delays retirement beyond full retirement age. The benefit increase no longer applies once a taxpayer reaches age 70, even if she continues to delay taking benefits.

Increase for Delayed Retirement

Year of Birth	Yearly Rate of Increase	Monthly Rate of Increase
1933–1934	5.5%	11/24 of 1%
1935–1936	6.0%	1/2 of 1%
1937–1938	6.5%	13/24 of 1%
1939–1940	7.0%	7/12 of 1%
1941–1942	7.5%	5/8 of 1%
1943 or later	8.0%	2/3 of 1%

Example 3. Early Retirement versus Delaying Benefits. Amelia was born in November 1942. She will reach full retirement age in September 2008. She checks her earnings over her working years and estimates that she is eligible for the following monthly payments depending on her age at retirement:

Age 62 (reduced by 46 months)	$ 758
At full-retirement age (65 years and 10 months)	1,000
Age 70 (benefits delayed 50 months)	1,312

Age 62 versus Full-Retirement Age. Had a choice been made to receive benefits at age 62 instead of full-retirement age, Amelia's break-even point would have been age 77 years and 10 months.

The total benefits she would have received during the 190 months from age 62 through age 77 years and 10 months is $144,020 (190 × $758). She would have received approximately the same amount if she waited to age 65 years and 10 months (NRA) to draw benefits. The total she would receive for the 144 months from full-retirement age through age 77 and 10 months would be $144,000 (144 × $1,000).

If Amelia lives beyond age 77 years and 10 months, her total lifetime benefits will be greater if she waits until full-retirement age to start receiving benefits.

Age 62 versus Age 70. If Amelia waits until age 70 and begins receiving payments of $1,312, her break-even point compared to starting her benefits at age 62 is age 80 years and 11 months.

The total benefits Amelia would have received during the 227 months from age 62 through age 80 and 11 months would have been $172,066 (227 × $758). If she decides to wait until age 70 to receive benefits, the total she will receive during the 131 months from age 70 through age 80 and 11 months will be $171,872 (131 × $1,312).

If she lives beyond age 80 years and 11 months, her total lifetime benefits will be more if she did not start receiving them until age 70.

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Full-Retirement Age versus Age 70. In a comparison of Amelia's benefits at full-retirement age and at age 70, her break-even point is age 83 years and 4 months.

The total benefits she will get during the 210 months from age 65 and 10 months through age 83 and 4 months will be $210,000. If she waits until age 70 to draw benefits, the total benefits she will get during the 160 months from age 70 through age 83 years and 4 months will be $209,920 (160 × $1,312).

SUGGESTIONS TO MINIMIZE SOCIAL SECURITY TAX

Tax practitioners who understand how social security tax and benefits are computed can better assist their clients in paying the minimum amount of social security tax due while maximizing the benefits they are eligible to receive.

Examples of strategies to minimize social security taxes due include:

- **Employing the Taxpayer's Child under Age 18.** This allows for a deduction on Schedule C or F, which reduces both taxable income and SE tax of the parent and does not create social security tax liability for the child. This is only available for a sole proprietor or for a 2-person partnership consisting of the child's parents. In this situation, the child is also allowed to contribute to a Roth or a traditional IRA.
- **Employing a Spouse.** This allows for a deduction on Schedule C or F, which reduces the SE tax for the owner. It does, however, require the spouse to pay FICA and the employer to match the FICA. Still, there are several reasons to implement this strategy, including:
  1. It allows the Schedule C or F filer to offer health insurance to all employees and their dependents; and the owner may elect, on a discriminatory basis (unless state law or another provision does not allow discrimination), for whom he will pay the premium. This deduction is taken on Schedule C or F, thereby reducing the amount of income subject to SE tax.
  2. The spouse stays currently insured for disability purposes.
  3. An employer may offer a medical reimbursement plan for all employees (and, oftentimes, the spouse is the only employee). This is a deduction also taken on Schedule C or F, which reduces the amount of net income subject to SE tax. This will not work for an S corporation, however, because of the related-party rules.
  4. An employer may establish a retirement plan through the business for all employees. Again, the employer's share of any matching contribution is taken as a deduction on Schedule C or F, reducing net income for purposes of computing SE tax.
- **Incorporate and Rent Property to the Business.** In this situation, all real estate should be held in the individual's name. Income received from renting property to the business is exempt from SE tax.

> **Note.** Farmland that is cash rented to an entity in which the landowner is actively participating triggers SE tax. (See discussion of the *Mizell* case in Chapter 14, "Agricultural Issues and Rural Investments.")
>
> See the "Home Office Deduction" section in Chapter 10, "Small Business Issues," for information about nondeductibility of rental expenses for rental income paid to the sole shareholder of an S corporation.

- **Utilize §179.** This strategy reduces the net profit on Schedule C or F. When the asset on which §179 expense was taken is sold, the gain is recognized on Form 4797, *Sales of Business Property*, and is not subject to SE tax. If the taxpayer retains the asset and the business use falls to below 50%, the §179 expense must be recaptured and reported on Form 4797, Part IV. It is then carried back to the original schedule on which it was deducted (i.e., Schedule C or F).

> **Note.** See Chapter 3, "Form 4797," for additional information on Form 4797 and the §179 expense deduction.

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APPEALING THE DENIAL OF SOCIAL SECURITY DISABILITY BENEFITS

The SSA wants to ensure that every decision made about a social security or supplemental security income (SSI) claim is equitable and fully documented. Thus, when a decision is made on an individual's claim, the SSA sends an explanatory letter. These decisions can be appealed. When an appeal is requested, the SSA looks at the entire decision — even those parts that were in favor of the party making the appeal.

If an individual wishes to appeal an SSA decision, the person must make a request in writing within 60 days from the date of receiving a letter of denial of benefits. The assumption is that the letter was received five days after the date on the letter, unless there is proof that it was received later.

If a claim for social security disability benefits or SSI was denied for medical reasons, an appeal may be requested online at **www.socialsecurity.gov/disability/appeal.**

Levels of Appeal

Generally, there are four levels of appeal. They are:

- Reconsideration,
- Hearing by an administrative law judge,
- Review by the Appeals Council, and
- Federal Court review.

Reconsideration. A reconsideration is a complete review of a claim by someone who did not take part in the initial decision. All evidence submitted when the original decision was made is reviewed, plus any new evidence.

Most reconsiderations involve a review of files without the need for the person making the appeal to be present. However, some circumstances warrant the presence of the appellant. For example, when appealing a decision that an individual is no longer eligible for disability benefits because the person's medical condition has improved, a face-to-face meeting with an SSA representative may help bring about a favorable result to the appeal.

Hearing. If the reconsideration decision is not favorable, a hearing may be requested. The hearing is conducted by an administrative-law judge who had no part in either the original decision or the reconsideration of the case. The hearing is usually held within 75 miles of the appellant's home. Proper notice is given by the administrative-law judge as to the time and place of the hearing.

Before the hearing, the judge's office may ask for additional evidence and clarification regarding certain claim information. The appellant is allowed to look at the information in the case file and then give updated information, if necessary.

If an appellant decides not to attend a hearing or is unable to do so, notice in writing explaining the reason for not attending the hearing must be given as soon as possible. The appellant does not have to attend unless the administrative-law judge believes such attendance is necessary to decide the case. The judge may be willing to make alternative arrangements, such as changing the time or place of the hearing. However, it is necessary to show good cause in order to prompt the administrative-law judge to make other arrangements. In certain situations, the hearing may be held by videoconference rather than in person. Prior notification is given if this format is to be used.

At the hearing, the administrative-law judge questions the appellant and any witnesses, such as medical or vocational experts.

After the hearing, the judge makes a decision based on all the information in the case, including any new information he received. The judge's office then sends the appellant a letter and encloses a copy of the judge's decision.

Appeals Council. If the appellant disagrees with the hearing decision, a review by SSA's Appeals Council may then be requested.

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The Appeals Council looks at all requests for review, but it may deny a request if it believes the hearing decision was correct. If the Appeals Council decides a review is warranted, it either decides that case itself or returns it to an administrative-law judge for further review.

If the Appeals Council denies a request for review, it sends a letter explaining the reasons for the denial. If the Appeals Council decides to review a case and make a decision itself, it sends a copy of the decision to the appellant. When the Appeals Council returns a case to an administrative-law judge, it sends the appellant a letter and a copy of the order.

Federal Court. If the appellant disagrees with the Appeals Council's decision or if the Appeals Council decides not to review the case, a lawsuit can be filed in a federal district court. The letter that is sent out regarding the Appeals Council's action also provides information about how to ask a court to rule on the case.

In some circumstances, an appellant may ask the SSA to continue paying benefits during the appeal process. A continuation-of-benefits request can be made when appealing the SSA's decision that:

- A person can no longer get social security disability benefits because their medical condition is not disabling,
- Eligibility for SSI payments has been terminated, or
- SSI payments should be reduced or suspended.

In order for benefits to continue, a response must be made within 10 days of the receipt of the SSA letter. If an appeal is turned down, any money received for which eligibility was denied may have to be repaid.

TYPES OF RETIREMENT PLANS

There are two categories of qualified retirement plans — defined-benefit and defined-contribution plans.

DEFINED-BENEFIT PLANS

Defined-benefit plans are the traditional pension plans that provide retirees with definitely determinable benefits. These benefits are provided to each participant according to a formula, which is usually based on age at retirement, average compensation, and years of service.

For 2008, the maximum annual benefit for a participant under a defined-benefit plan is the smaller of:

- $185,000, or
- 100% of the participant's average compensation for his highest three consecutive calendar years.

Benefits under a defined-benefit plan generally can be paid only after retirement. They are usually provided in the form of an annuity for the life of the retired participant or the joint lives of the retired participant and spouse.

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> **Note.** See Chapter 16, "Tax Rates and Useful Tables," for a complete summary of retirement-plan contribution and catch-up contribution limitations.

Defined-Benefit 401(k) Plan

Under the provisions of the Pension Protection Act of 2006, employers with at least two and no more than 500 employees can establish a combined defined-benefit/401(k) plan (DB/K plan) for plan years beginning after December 31, 2009.

The assets of the DB/K must be held in a single trust and must be clearly identified and allocated to the defined-benefit plan and the applicable defined-contribution plan to the extent necessary for the separate application of the Code and the Employee Retirement Income Security Act.[2]

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2. Treas. Reg. §1.408a-4, Q&A 12

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DEFINED-CONTRIBUTION PLANS

These plans allow contributions that are discretionary or based upon a formula provided in the plan document. In this type of plan, the amount of benefits the employee will receive is unknown until the participant actually begins receiving benefits. This is because these amounts vary based upon the level of employee and employer contributions over the years as well as investment performance. Defined contribution plans take many forms, which include §§401(k), 457, and 403(b) plans along with the various types of IRAs.

Elective contributions to these plans are generally excluded from a participant's current income for the year. They are considered pretax dollars for purposes of the individual's income tax. **However, elective contribution amounts are not excluded from wages for purposes of FICA or OASDI taxes.** Elective contributions are always nonforfeitable.

Each employee's elective contributions must be maintained in an individual account and accounted for separately from other types of contributions.[3] Employer contributions must be designated as such.[4]

§401(k) Plans

A 401(k) plan is a defined-contribution plan arrangement that permits employees to make an election to receive cash currently or defer receiving part of their wages by contributing the funds to a retirement account. Employers may choose to make matching, nonelective, and/or profit-sharing contributions to employee accounts. Employer contributions to a qualified retirement plan are not includable in gross income of employees until those funds are distributed.

Example 4. Sally, an Illinois resident, is single and claims no withholding allowances. She has a weekly gross salary of $1,000. As illustrated below, Sally's net pay is only reduced by $72, even though she has elected to contribute $100 to her 401(k) plan.

	$100 Elective Contribution	No Elective Contribution
Gross	$1,000	$1,000
Elective contribution	(100)	0
Taxable income	$ 900	$1,000
Federal withholding	(146)	(171)
State withholding	(27)	(30)
FICA and OASDI	(77)	(77)
Net pay	$ 650	$ 722

An employee under age 50 may elect to contribute up to a maximum of $15,500 to his 401(k) account for 2008. An employee age 50 or older may elect up to an additional $5,000 catch-up contribution.

For 2008, the maximum compensation that can be factored into the equation used for figuring contributions and benefits is $230,000 per employee; the maximum addition to an employee's 401(k) account (by both the employee and employer) is the lesser of $46,000 or 100% of compensation.

For employers, the maximum deductible amount for 2008 is 25% of each employee's wages. If more than 25% of an employee's wages is contributed to the plan, the employer may carry over the excess and deduct it in subsequent years, always subject to 25% of the wages for that year.[5]

Section 401(k) plans must meet special nondiscrimination tests. These can be satisfied by complying with the actual-deferral-percentage (ADP) test, the ADP safe-harbor provisions, the automatic enrollment safe-harbor requirements, or the SIMPLE 401(k) provisions.[6]

3. Treas. Reg. §1.401(k)-1(e)(3)(i)
4. Treas. Reg. §1.401(k)-1(a)(4)(ii)
5. IRC §404(a)(3)(A)
6. IRC §401(k)(3)(C), Treas. Reg. §1.401(k)-1(b)(1)(ii)

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Catch-Up Contributions in Certain Employer Bankruptcies. If the taxpayer participated in a 401(k) plan and the employer who maintained the plan files for bankruptcy, the taxpayer may be able to contribute an additional $3,000 into an IRA. For this provision to apply, **all** of the following conditions must be met:

1. The taxpayer must have been a participant in a 401(k) plan under which the employer matched at least 50% of employee contributions to the plan with stock of the company.
2. The taxpayer must have been a participant in the plan six months before the employer filed for bankruptcy.
3. The employer (or a controlling corporation) must have been a debtor in a bankruptcy case in an earlier year.
4. The employer (or any other person) must have been subject to indictment or conviction based on business transactions related to the bankruptcy.

If the taxpayer chooses to make additional contributions under this provision, she cannot use the higher contribution and deduction limits for individuals who are age 50 or older.

§457 Plans

Employees of state or local government agencies may enter into a deferred compensation agreement with their employer to defer up to 100% of their compensation, subject to an annual limitation for 2008 of $15,500 for employees under age 50. This limitation is the sum of employee deferrals plus employer contributions. **This dollar amount is in addition to any other contributions made to other types of retirement plans.**

As long as the plan satisfies eligibility requirements, deferred compensation is not taxed to an employee until it is distributed. IRC §457 governs these types of plans.

Example 5. Seth is employed by the State of Illinois and participates in a §457 plan as well as a §403(b) plan. Seth earns $50,000 per year. He may participate in a §457 plan and defer up to $15,500. Seth may also participate in a §403(b) plan and contribute up to $15,500 to that qualified retirement plan.

Catch-Up Provision. There is also a catch-up provision allowed under §457. The general catch-up provision is the statutory amount applicable to qualified plans, or $5,000 for 2008. However, there is a special catch-up amount available to §457 plans. An eligible plan may provide that, for one or more of the employee's last three tax years ending before the employee attains normal retirement age under the plan, the plan ceiling is an amount not in excess of the lesser of:

- Twice the applicable dollar amount in effect for that tax year, or
- The sum of the plan ceiling for the tax year plus the plan ceiling for any prior year or years that have not been previously used.

Example 6. Sam is age 61 and is employed by the State of Illinois. The state's plan specifies that normal retirement age is 65. He wants to defer as much as possible in 2008 under the §457 plan. He earns $50,000 per year. The maximum that he may defer is $20,500 (the $15,500 annual limit plus the $5,000 catch-up provision for employees over 50). He does not qualify for the special provision noted above because he is not in the last three years prior to normal retirement age.

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Example 7. Luella is 64 in 2008. She is employed by the State of Illinois. Luella qualifies for the special catch-up provision for §457 plans. For 2008, she can contribute the **lesser** of:

- Twice the amount of the deferral limit ($15,500 × 2 = $31,000), or
- Sum of the plan ceiling for the tax year ($15,500) plus any plan ceiling not used in prior years.

Let's assume she made the following contributions during the last three years:

	2006	2007	2008
§457 plan ceiling	$15,000	$15,500	$15,500
Actual contribution	(14,000)	(5,000)	(15,500)
Unused limit	$ 1,000	$10,500	$ 0

Luella's special catch-up contribution for 2008 is a maximum of $27,000 ($1,000 + $10,500 + $15,500). This is greater than the otherwise applicable maximum contribution amount of $20,500 available to employees over age 50 because she is in the last three years before normal retirement age.

Luella is not allowed an additional $5,000 catch-up amount for employees age 50 or older because of the coordination rules, which allow only the higher limitation amount.[7]

A taxpayer who participates in a §457 plan is **not** treated as an active participant in a qualified retirement plan for purposes of the rules pertaining to deducting contributions to an individual retirement arrangement (IRA).

§403(b) Plans

Public schools and certain tax-exempt organizations can use §403(b) plans to fund their employees' retirement. These types of plans have generally focused on tax-sheltered annuities (TSAs) that may be funded by various methods.

Annuity contracts must be purchased from a state-licensed insurance company, and the custodial accounts must be held by a bank or IRS-approved nonbank trustee/custodian.

The maximum contribution to a §403(b) plan for 2008 is $15,500, with an additional $5,000 contribution available for taxpayers who are age 50 or older. However, the deferral limit for a §403(b) plan must be aggregated with the deferral limit allowed for a §401(k) plan to arrive at the total allowed for an individual during the calendar year.

Special TSA Catch-Up for Certain Organizations. For tax years beginning **after** December 31, 2008, special catch-up rules apply for qualified employees of the following qualified organizations:

- Educational organizations
- Hospitals
- Health and welfare service agencies
- Church-related organizations
- Tax-exempt organizations controlled by or associated with a church or a convention or association of churches

7. IRC §414(v)(6)(C); IRC §457(e)(18)

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A qualified employee is an employee who has completed at least 15 years of service with a qualified organization. For qualified employees, the elective deferral limitation is increased by the lesser of:

- $3,000;
- The excess of $15,000 less the total special TSA catch-up elective deferrals made for the qualified employee by the qualified organization for prior years; or
- The excess of $5,000 multiplied by the number of years of service with the qualified organization minus the total elective deferrals made for the qualified employee by the qualified organization for prior years.[8]

When an employee is eligible for both an age 50 catch-up and the special TSA catch-up, the contributed amount is first attributed to the special TSA catch-up, and then to the age 50 catch-up.[9]

Designated §401(k) or §403(b) Roth Accounts

An employee may elect to direct his §401(k) or §403(b) contributions to a designated employer-sponsored Roth account. These are elective contributions that, unlike pretax elective contributions, are currently includible in the employee's gross income. The following requirements must be met in order to make contributions to a Roth account:

- Separate accounting must be maintained for the designated Roth contributions and any gains or losses.
- Separate records must be kept for each account.
- Employees must be given the option of electing pretax contributions in addition to the designated Roth accounts.
- Only designated Roth and rollover contributions may be made to designated Roth accounts.

The plan administrator is responsible for accounting and maintenance of the records for each employee's contributions.

Designated Roth contributions are irrevocable at the time the election is made. They cannot be moved to a traditional §401(k) or §403(b) plan at a later date.

IRAs

Traditional IRAs. An IRA can be in the form of an individual retirement account or an individual retirement annuity. Most financial institutions — such as banks, brokerage houses, and mutual fund companies — offer individual retirement accounts. These funds can be placed in any type of investment other than collectibles or property for the personal use of the owner or his family. The choices, however, vary according to the type of institution that holds the IRA funds.

Each year, individuals under age 70½ can contribute up to the lesser of their compensation or the applicable annual dollar limit to an IRA. IRA contributions must be made by the due date of the individual's income tax return, not including extensions. For 2008, the contribution limit is $5,000 per individual. In the case of a married couple filing a joint return, the taxpayers are allowed to use either spouse's compensation in order to contribute to the IRA. Thus, an IRA may be funded for both husband and wife, even if only one spouse had income for the year.

Individuals who are at least 50 years old by the end of the year may make additional catch-up contributions. For 2008, this IRA catch-up provision is $1,000.

Contributions to traditional IRAs are fully deductible if the taxpayer and the taxpayer's spouse are not eligible to participate in an employer-sponsored retirement plan and are not age 70½ by the end of the tax year. The deductible contribution is reduced if the taxpayer is eligible to participate in an employer-sponsored plan and if the taxpayer's modified adjusted gross income (MAGI) falls within certain ranges, based on the taxpayer's filing status.

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8. Treas. Reg. §1.403(b)-4(c)(3)(i)
9. Treas. Reg. §1.403(b)-4)(c)(3)(iii)

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MAGI is calculated as **adjusted gross income plus:**

- Traditional IRA deduction
- Student loan interest deduction
- Tuition and fees deduction
- Domestic production activities deduction
- Foreign earned income exclusion and/or housing exclusion
- Foreign housing deduction
- Excludable qualified savings bond interest
- Excluded employer provided adoption benefits

Taxpayer Covered by Employer's Plan	MAGI Phaseout Range
Married filing jointly (MFJ), qualifying widow(er) (QW)	$85,000–105,000
Single or head of household (HoH)	53,000– 63,000
Married filing separately (MFS)	N/A

If a couple is married filing jointly and only one of the spouses is eligible to participate in an employer's qualified retirement plan, deductible contributions are limited for the non-covered spouse if the MAGI of the tax return exceeds $159,000.

Taxpayer Covered by Employer's Plan	MAGI Phaseout Range
Married filing jointly — one spouse not covered	$159,000–169,000

If an active participant's MAGI exceeds the applicable dollar amount, the deductible contribution is calculated as follows:

Step 1. The applicable MAGI limit is subtracted from the taxpayer's MAGI.

Step 2. The result of Step 1 is divided by the total amount of the phaseout range ($10,000 single, HOH; $20,000 MFJ, QW; $10,000 MFJ — one spouse not covered).

Step 3. The IRA full-contribution limit is multiplied by the percentage calculated in Step 2.

Step 4. The result of Step 3 is subtracted from the IRA full-contribution limit.

Example 8. Ted is age 45 and single. He earns $60,000 per year from his job. He has no other income on his return and is covered by his employer's retirement plan. He may contribute $5,000 to his IRA for 2008 but may only deduct $1,500, calculated as follows:

Step 1. $60,000 MAGI – $53,000 limitation = $7,000

Step 2. $7,000 ÷ $10,000 phaseout range for singles = 70%

Step 3. $5,000 contribution limit × 70% = $3,500

Step 4. $5,000 – $3,500 = $1,500 deductible contribution

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Example 9. Reese is age 45 and married. He earns $160,000 per year from his job. Reese and his wife, Cynthia, have no other income on their joint return. They may each contribute $5,000 to an IRA for 2008. However, Reese is not allowed to deduct his contribution because he is an active participant in an employer's retirement plan and the MAGI on the couple's joint return exceeds the top end of the phaseout range ($105,000).

Cynthia can deduct $4,500, calculated as follows:

Step 1. $160,000 MAGI – $159,000 limitation = $1,000

Step 2. $1,000 ÷ $10,000 phaseout range (MFJ from second table above) = 10%

Step 3. $5,000 contribution limit × 10% = $500

Step 4. $5,000 – $500 = $4,500 deductible contribution

Distributions. Following is a quick review of the rules regarding taxability of distributions from traditional IRAs. Tax practitioners can advise their clients about ways to minimize current taxation by adhering to these rules. Distributions from traditional IRAs are included in gross income of the payee under the annuity rules.[10] In applying these regulations, there are three special requirements that must be considered:

1. All IRAs are treated as one contract.
2. All distributions during one year are treated as one distribution.
3. The value of the contract, income on the contract, and investment in the contract are computed as of the end of the calendar year in which the tax year begins.[11]

A taxpayer may **not** designate a particular distribution as being from the taxpayer's nondeductible contributions. The taxpayer must compute the taxable portion of the distribution using the same ratio as the individual's total nondeductible IRA contributions bears to the aggregate balance of all IRAs of the taxpayer.

Example 10. Phyllis made a $4,000 IRA contribution for the 2007 tax year, of which $500 was nondeductible. In 2008, Phyllis made a $5,000 contribution to a traditional IRA, all of which was nondeductible. At the end of 2008, the balance in her IRA accounts was $10,000. If she withdraws $1,000 in 2009, she will have to include $450 in gross income in 2009, computed as follows:

Nondeductible contributions/IRA balance	$5,500 ÷ $10,000 = 55%
Return of nondeductible portion	55% × $1,000 = $550
Taxable distribution	$1,000 – $550 = $450

Roth IRAs. The primary difference between a traditional IRA and a Roth IRA is that the tax treatment of the contributions and distributions is reversed. Contributions to a traditional IRA are deductible if the AGI limits are met. Contributions to a Roth IRA are never deductible. Distributions from a traditional IRA are taxable if contributions were deducted. Distributions from a Roth IRA are never taxable if basic requirements are met.

A Roth IRA must be established and contributions made by April 15 following the year for which the contribution applies. Unlike a traditional IRA, contributions to a Roth IRA can be made after an individual reaches age 70½; and balances can remain in a Roth IRA for the length of the account holder's life.

10. IRC §§408(d)(1) and 72

11. IRC §408(d)(2)

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Contributions to a Roth IRA are based upon filing status and modified AGI (MAGI) of the taxpayer, as shown in the following table:

	MAGI		
Filing Status	**Full Contribution Allowed**	**Contribution Limit Reduced**	**No Contribution Allowed**
MFS (lived with spouse)	N/A	Greater than $0 but less than $10,000	$10,000 or more
Single, HoH, MFS (did not live with spouse)	Less than $101,000	At least $101,000 but less than $116,000	$116,000 or more
MFJ, QW	Less than $159,000	At least $159,000 but less than $169,000	$169,000 or more

If the MAGI is between the full-contribution MAGI limit and the maximum MAGI limit, the contribution is phased out over a $10,000 range for taxpayers in the MFJ and MFS (lived with spouse) categories. It is phased out over a $15,000 range for the Single/HoH category. The allowable Roth IRA contribution for taxpayers whose MAGI is in excess of the full-contribution MAGI limit and below the maximum MAGI limit is calculated as follows:

Step 1. The taxpayer's MAGI is subtracted from the applicable MAGI limit.

Step 2. The result of Step 1 is divided by the applicable phaseout range.

Step 3. The Roth IRA full-contribution limit is multiplied by the percentage calculated in Step 2 to determine the allowable Roth IRA contribution.

Example 11. Miguel is single, and his 2008 MAGI is $102,000. He may contribute $4,667 to his Roth IRA.

Step 1. $116,000 limitation – $102,000 MAGI = $14,000

Step 2. $14,000 ÷ $15,000 phaseout range= 93.33%

Step 3. $5,000 contribution limit × 93.33% = $4,667

Modified AGI. MAGI for Roth IRA purposes is defined as **AGI** —

Minus:

- Income resulting from the conversion of a traditional IRA to a Roth IRA or a minimum required distribution from an IRA (if figuring MAGI for conversion purposes)

Plus:

- Traditional IRA deduction
- Student loan interest deduction
- Tuition and fees deduction
- Domestic production activities deduction
- Foreign earned income exclusion and/or housing exclusion
- Foreign housing deduction
- Excludable qualified savings bond interest
- Excluded employer provided adoption benefits

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New Rollover Rules. Effective January 1, 2008, distributions from tax-qualified retirement plans, tax-sheltered annuities, and §457 plans can be rolled over directly to a Roth IRA, subject to the restrictions that currently apply to rollovers from a traditional IRA into a Roth IRA.

Roth versus Traditional IRA

The ability to eventually take tax-free withdrawals from a Roth IRA makes the conversion of a traditional IRA to a Roth seem attractive. However, this is a decision that has no "one size fits all" answer. Each taxpayer should analyze the options based on his individual circumstances. The conversion depends on a number of factors, including today's tax rates versus future tax rates, how the taxes on the conversion will be paid, the size of the estate, plans for the estate, and who the beneficiaries are for the IRA.

Example 12. Kent, age 35, has $50,000 in a traditional IRA. He wants to convert to a Roth IRA but does not have the money to pay the taxes. He decides to proceed with the conversion but hold back some of the money in order to pay the applicable taxes.

Kent is in the 15% tax bracket. He owes $7,500 in taxes on the conversion ($50,000 × 15%). He also owes a 10% penalty on the amount he keeps from the conversion to pay the taxes. Including the penalty, Kent needs $8,333 ($7,500 ÷ .90). He can convert the balance of $41,667 to a Roth IRA.

If Kent leaves the money in the Roth IRA for 30 years, assuming an average return of 9%, his balance will be $552,824. If he had not converted and left the money in the traditional IRA, he would have $563,876 after paying taxes at the 15% rate. The Roth conversion did not provide a good opportunity for Kent because he took funds from the IRA to pay the taxes and thus lost the ability to earn a return on that money over the subsequent 30 years.

If Kent had used non-IRA funds to pay the taxes, he would have saved the 10% penalty; and the entire $50,000 would have stayed inside the Roth IRA, earning a tax-free return.

Converting Traditional IRAs to Roth IRAs. In tax years beginning after December 31, 2009, taxpayers can convert (roll over) a traditional IRA to a Roth IRA regardless of the taxpayer's AGI and filing status. If the taxpayer converts in 2010, the income is recognized ratably in 2011 and 2012, unless the taxpayer elects to recognize it all in 2010.[12]

Note. See Chapter 11, "New Legislation," for a discussion of rollovers from other types of retirement plans.

If the taxpayer takes a distribution from a Roth IRA after a conversion and makes the election to include the income ratably over 2011 and 2012, the distribution accelerates the inclusion of income. The amount included in income in the distribution year is increased by the amount distributed. The amount included in 2011 and 2012 is the lesser of:

- Half the amount includable in income as a result of the conversion, or
- The remaining portion of the amount includable in income that was not already included in income.

Example 13. Mary has a traditional IRA with a value of $25,000. It only includes deductible contributions and earnings. She converts the traditional IRA to a Roth IRA in 2010. She includes $12,500 in income both in 2011 and 2012.

If Mary takes a $5,000 distribution from the Roth IRA in 2010 after the conversion, she must include the $5,000 in income in 2010 under the accelerated rule. In 2011, she will include $12,500 (the lesser of half the income from the conversion or the remaining untaxed income from the conversion). In 2012, Mary will have $7,500 to include in income (the remaining untaxed portion of the conversion).

12. IRC §408A(d)(3)(A)(iii)(E)

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In addition to the special treatment afforded to Roth IRAs converted in 2010, the $100,000 AGI limit for conversions is repealed for all tax years beginning after December 31, 2009. There is no sunset on this repeal. By removing this AGI limit for conversions, a taxpayer can make nondeductible contributions to a traditional IRA and then convert it to a Roth IRA without any tax consequence, thereby effectively eliminating the income limit for contributing to a Roth IRA.

Planning Tip. Taxpayers who were previously unable to contribute to Roth IRAs because their AGI was too high and have not been contributing to traditional IRAs because they are covered under a qualified employer plan may wish to start making nondeductible contributions to a traditional IRA in 2008 and 2009. These taxpayers can then convert the traditional IRAs to Roth IRAs in 2010. The biggest problem that will arise is that many taxpayers already have traditional IRAs that they have deducted and, therefore, if they try to convert any dollars into a Roth, the taxable distribution rules discussed earlier apply.

To avoid creating excessive taxable income, an option is to have the taxpayer roll over all **deductible** IRAs, including earnings, into a 401(k) plan (if the plan permits this). Then only nondeductible funds plus earnings remain in the IRA(s). In 2010, the taxpayer can convert the nondeductible funds into a Roth IRA, and the only amount taxable will be the earnings accumulated from the time of the rollover until the time of conversion.

Example 14. Lori has $250,000 in her traditional IRA. She earns $200,000 each year and is covered under her employer's qualified retirement plan.

She makes a nondeductible contribution of $5,000 per year for 2008, 2009, and 2010. Her basis in the traditional IRA is $15,000. The FMV of her IRA is $300,000 in 2010 when she converts it to a Roth IRA. In this situation, she will owe tax on $285,000 ($300,000 minus $15,000).

Example 15. Use the same facts as **Example 14,** except the qualified plan of Lori's employer allows for rollovers from IRAs. In 2010, she rolls over $285,000, pays no tax on the rollover, and then converts $15,000 to a Roth IRA. Because her basis is $15,000, she pays no tax on the conversion to the Roth IRA. Each year, she can continue to make a nondeductible contribution to her traditional IRA and then convert that amount into a Roth IRA. This strategy effectively bypasses the AGI limits for contributing to Roth IRAs.

SIMPLE IRA

A SIMPLE (Savings Incentive Match Plan for Employees) IRA may be established by an employer with 100 or fewer employees who earned at least $5,000 during the preceding year, if the employer maintains no other retirement plan. The plan must be established between January 1 and October 1 of the year for which the plan is being initiated. The only exception to this rule is an employer whose business commences operations after October 1. These new employers are allowed to create a SIMPLE IRA as soon as it is administratively feasible.

A SIMPLE IRA is started by completing Form 5304-SIMPLE or 5305-SIMPLE. A Form 5304 is used when the employer allows the **employees** to choose the financial institutions that will maintain their SIMPLE IRAs. Form 5305 is used when the **employer** designates the financial institution that will maintain the employee SIMPLE IRA accounts. Although a SIMPLE IRA may not be established as a Roth IRA, employees may convert them to Roth IRAs after they have participated in the SIMPLE for two years.

An employer must notify each eligible employee of the following:

- When and how much the employee may contribute to the SIMPLE IRA
- Whether the employer is making matching contributions or nonelective contributions
- A summary description of the SIMPLE IRA
- Notice to the employee that the employee's SIMPLE contributions may be transferred to another account without cost or penalty

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The summary description must be provided to employees at least 60 days before they become eligible to participate in the plan and must be provided to each employee every year that the employer maintains the plan.

An employer must cover all eligible employees. An eligible employee is defined as an employee who meets the following requirements:

- Has received at least $5,000 in compensation during any two years preceding the current calendar year, and
- Reasonably expects to receive at least $5,000 during the current calendar year.

An employer may reduce these restrictions to a lesser degree but may not impose any more restrictive measures than those listed above. There is no income limitation for participation in a SIMPLE. Each employee that meets the above requirements is eligible to contribute.

There is no requirement to submit annual financial reports to the IRS for SIMPLE IRAs. The financial institutions holding the SIMPLE IRAs will provide Form 5498, *IRA Contribution Information,* to all participants and to the IRS each year.

For 2008, an employee may elect to contribute up to $10,500 to a SIMPLE IRA. If the employee is age 50 or older, an additional $2,500 may be contributed.

Employers must make either matching contributions or nonelective contributions for all eligible employees. These contributions are not additional income to the employees. The **matching contribution** is the lesser of:

- The amount the employee has contributed, or
- 3% of the employee's compensation.

Alternatively, the employer may make **nonelective contributions** of 2% of each eligible employee's compensation, regardless of whether employees make elective deferrals. The maximum amount of employee compensation that can be taken into account for employer contribution purposes is $230,000 for 2008; thus, the maximum nonelective employer contribution is $4,600.

Example 16. ABC Manufacturing has 20 employees who are eligible to participate in its SIMPLE IRA. The company chose the matching election for employer contributions. Therefore, only the employees who participate in the plan by contributing to their SIMPLE IRA accounts receive employer contributions.

If ABC Manufacturing chose the nonelective SIMPLE IRA contribution method, the employer makes contributions to all 20 eligible employees based on 2% of their salaries.

Employee contributions must be remitted to the trustee as soon as administratively feasible, but no later than the 15th day of the month following the month of withholding. Employer contributions must be remitted to the trustee no later than the due date of the employer's return, plus extensions.

Observation. It is suggested that employee deferrals be remitted at the same time as payroll tax deposits.

SEP IRA

Any employer is eligible to establish a SEP (Simplified Employee Pension) IRA. However, there are certain requirements to keep the plan qualified. Employers must contribute to the accounts of each employee who meets the following criteria:

1. The employee has reached age 21 by the end of the plan year.
2. The employee has worked for the employer in at least three of the five immediately preceding years.
3. The employee has received at least $500 in compensation from the employer during the year.

The employer may exclude employees that are covered by a collective bargaining agreement and nonresident aliens.

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A SEP IRA may be established prior to the due date, including extensions, of the employer's tax return. To establish a SEP IRA, an employer must prepare a written agreement, provide employees with notice of the plan, and create an account for each eligible employee. The plan document sets forth the participation requirements and the allocation formula for employer contributions.

The employer can establish a SEP plan by adopting Form 5305-SEP, a SEP prototype, or a customized document. If the employer wishes to use a prototype SEP plan, the prototype plan must first be approved by the IRS. If the employer uses a customized document, the employer must obtain a ruling from the IRS to ensure that the plan meets all applicable requirements.

The employer must notify all eligible employees of their program rights under the plan, a list of the eligibility requirements, how contributions will be allocated, and the name of a person to contact for further information. If the employer has chosen to use Form 5305-SEP, the employer must also provide a copy of this completed form to each eligible employee, along with a copy of the 5305 instructions.

Only the employer can make contributions to SEP IRAs. The employer does not incur trustee or administrative fees because each employee controls his own SEP IRA account.

The maximum contribution to a SEP IRA for 2008 is the lesser of:

- 25% of compensation, or
- $46,000.

Contributions must be deposited into employee accounts on or before the due date (including extensions) for filing the employer's federal tax return for the year.

Employers must annually provide each eligible employee with a written statement indicating the amount of the employer contributions made to the employee's SEP IRA. This statement must be provided to the employee by the later of:

- 30 days after the contribution, or
- January 31 following the calendar year for which the contribution was made.

This can be satisfied by reporting the SEP contribution on the employee's Form W-2.[13]

The self-employed taxpayer who contributes to a SEP IRA must make a special calculation to determine the maximum deduction. Compensation for these purposes is net earnings from self-employment, which takes into account both of the following:

- The deduction for half of SE tax
- The deduction for contributions to a SEP IRA

Because the deduction for contributions to the SEP IRA and net earnings are mutually dependent, the deduction for contributions to the SEP IRA is calculated indirectly by reducing the contribution rate specified in the plan. This can be computed by taking the contribution percentage and dividing it by 1 plus the allowable percentage.

1. Plan contribution rate as a decimal (for example, 25% =.25)
2. Rate in line 1 plus 1 (.25 + 1 = 1.25)
3. Line 1 divided by line 2 is the self-employment rate as a decimal (.25 ÷ 1.25 = .20)

The percentage, as computed above, is multiplied by the profit of the business minus half of the self-employment tax **before** deducting the SEP contribution, to arrive at the allowable contribution to a SEP IRA.

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13. Prop. Treas. Reg. §1.408-9(b)(1)

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Nondiscrimination Rules. The plan must not discriminate in favor of any of the following:

- Highly-compensated employees
- Officers
- 10% or greater shareholders
- Self-employed individuals

An employee is a highly-compensated employee if she is a 5% owner or receives compensation in the prior year exceeding $105,000.

Employer contributions are automatically deemed discriminatory in favor of highly-compensated employees unless the contributions bear a uniform relationship to each eligible employee's compensation.[14] The maximum amount of compensation that can be taken into account for each employee is $230,000 in determining whether the plan favors highly-compensated employees. A rate of contribution that decreases as compensation increases is considered uniform.[15]

Example 17. IMI Corporation makes SEP contributions of 10% of each eligible employee's first $30,000 of compensation. It contributes 2% of all compensation above $30,000. IMI's SEP is not considered discriminatory because the rate of contribution decreases as its employees' compensation increases.

Permitted Disparity. The nondiscrimination rules permit a level of disparity in certain circumstances. A SEP plan that is integrated with social security may provide for additional contributions when an employee's income exceeds a certain level.[16] The level at which the contribution increases is called the integration level. The integration level generally means compensation up to the social security wage base.

Example 18. Blue Company provides a SEP plan to all its eligible employees. It contributes 3% of each employee's compensation up to the social security wage base. It also contributes 5% of the employee's compensation in excess of the social security wage base. This plan provides for a permitted disparity.

Top-Heavy Plans. A SEP plan that is top heavy must meet minimum contribution requirements for non-key employees.[17] A plan is considered top heavy if the aggregate accounts of key employees exceed 60% of the aggregate accounts of all employees. However, under SEP plans, employers may choose to use contributions rather than account balances to determine whether they fall under the top-heavy rules.[18]

If subject to the top-heavy rules, the employer must make minimum contributions for the non-key employees equal to the lesser of the following:

- 3% of each non-key employee's compensation
- The percentage at which contributions are made for the key employee with the highest percentage for the year

SEP Plan Year. If the employer's tax year is not a calendar year, a SEP plan may be based on either the employer's tax year or the calendar year. Employer contributions made during a calendar year are deductible for the tax year of the employer within which the calendar year ends. In other words, if the employer's tax year is a calendar year, the employer deducts the contributions made during the tax year/calendar year. If its tax year is not a calendar year but its SEP plan year is, the deduction is taken in the tax year containing the end of the calendar year for which the contributions were made.

14. IRC §408(k)(3)(c)
15. Prop. Treas. Reg. §1.408-8(c)(1)
16. Treas. Reg. §1.401(l)-1
17. IRC §408(k)(1)(B)
18. IRC §416(i)(6)(B)

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Example 19. ABC Company has a SEP IRA plan that is based on a calendar year. ABC's tax year ends June 30. ABC's contributions made during the 2008 calendar year are deductible in its tax year ending June 30, 2009.

SARSEP PLANS

No new SARSEP (Salary Reduction Simplified Employee Pension) plans have been established since December 31, 1996. However, employers can continue to maintain SARSEP plans established prior to that date; and employees hired after December 31, 1996, are still allowed to participate in existing SARSEPs.

Employers operating a SARSEP must meet the following requirements on an annual basis for all eligible employees:

- At least 50% of employees eligible to participate must choose to make elective deferrals for the year.
- There can be no more than 25 employees eligible to participate in the SARSEP at any time during the preceding year.

Caution. Employers must be particularly vigilant about maintaining SARSEP plans in accordance with all applicable regulations. The **IRS has announced a three-fold increase in audits of these plans.**

REQUIRED REPORTING FOR RETIREMENT PLANS

The employer is required to file reports regarding the retirement plan with federal government agencies, including the IRS, Department of Labor, and the Pension Benefit Guaranty Corporation. If required, Form 5500, *Annual Return/Report of Employee Benefit Plan,* must be filed by the last day of the 7th month after the close of the plan year, or July 31 for a calendar-year plan.

The administrator of the retirement plan must report certain information to all plan participants. This information includes a summary plan description; an updated summary plan description; summary annual report; and a statement setting forth the nature, amount, and form of the deferred vested benefit to which a participant is entitled.

Qualified plans are required to be restated on a periodic basis, depending on changes in tax and pension laws. Because of the number of recent qualified plan law changes, a 5-year cycle of restatement was established. The rule provides that no matter what changes in laws occur, a plan sponsor only needs to restate the employer's plan in the 5-year cycle based on the ending digit of the employer's TIN.

If the EIN Ends In...	The Plan's Cycle Is...	Filing Period for Initial 5-Year Cycle
1 or 6	Cycle A	February 1, 2006 through January 31, 2007
2 or 7	Cycle B	February 1, 2007 through January 31, 2008
3 or 8	Cycle C	February 1, 2008 through January 31, 2009
4 or 9	Cycle D	February 1, 2009 through January 31, 2010
5 or 0	Cycle E	February 1, 2010 through January 31, 2011

Note. Form 5500 is not required for all pension plans. For example, most SIMPLE plans are exempt. See Form 5500 Instructions for a list of pension benefit plans excluded from the filing requirements.

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HOW MUCH IS ENOUGH FOR RETIREMENT?

After reviewing the various types of retirement plans available, the big question remaining for practitioners is how best to advise clients on the amount they need to accumulate to live comfortably during retirement. The old rule of thumb was that a retiree needed 70–80% of his pre-retirement income on an annual basis to maintain his standard of living during retirement. However, this is too simplistic a measure to be meaningful. No two retirees have the same goals, plans, and lifestyles, nor do they have the same family obligations and health factors. Consequently, the amount each retiree needs to live well in retirement varies.

A strong note of caution was issued recently by Ernst & Young LLP, in a report for Americans for Secure Retirement. The report said, "...almost three out of five middle-class new retirees can expect to outlive their financial assets if they attempt to maintain their current pre-retirement standard of living. To avoid outliving their financial assets, middle-class retirees will have to reduce their standard of living, on average, by 24%."[19] The report attributed this to many factors, including the inadequacy of savings, longevity, volatile investment returns, and high inflation.

To avoid the tragedy of running out of money before one runs out of life, it is imperative that practitioners help clients plan adequately for retirement. Following are some steps to guide practitioners as they advise clients. This may help clients understand what is needed and feel more confident that they will be able to achieve their retirement goals.[20]

STEP 1 — CALCULATE EXPENSES

The first step is to tabulate monthly living expenses. It is essential to do this for the individual's current conditions and also to estimate post-retirement costs. Budgeting forces a person to examine spending patterns. This can illuminate how one's money could be put to better use.

The practitioner should encourage clients to start thinking about how much income they will need after retirement. This exercise should help motivate clients to stick to their targeted investment plans and to economize in certain areas so that they can reach their goals.

Practitioners should encourage clients to also think about how such things as post-retirement travel plans and health problems can affect their retirement nest egg. To aid this thought process, the following worksheet can be used.[21] All amounts are to be entered in today's dollars.

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19. Ernst & Young LLP for Americans for Secure Retirement, *Retirement Vulnerability of New Retirees: The Likelihood of Outliving Their Assets* (Jul. 2008)

20. The steps that follow have been adapted from worksheets provided on the *Plan Well, Retire Well* website at www.retirewell.uiuc.edu, University of Illinois Extension, College of Agricultural, Consumer and Environmental Sciences.

21. Adapted from Danes, Dippold, Schuchardt, *Ready, Set, Retire: Financial Planning,* PM-1167a. Iowa State University CES (1985)

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2008 Workbook

Monthly Costs	Current Amount	Post-Retirement Amount
Household:		
Rent or mortgage	______	______
Real estate taxes	______	______
Insurance	______	______
Repair and maintenance	______	______
Utilities	______	______
Supplies	______	______
Groceries	______	______
Furniture and appliances	______	______
Transportation:		
Gasoline	______	______
Car payment	______	______
Insurance	______	______
License	______	______
Repairs	______	______
Other	______	______
Medical:		
Insurance	______	______
Medications	______	______
Doctors and dentists	______	______
Eyeglasses, contacts	______	______
Other	______	______
Clothing:		
New clothes	______	______
Dry cleaning, laundry	______	______
Other	______	______
Recreation:		
Newspapers, books, magazines	______	______
Movies, concerts, sports events	______	______
Vacations	______	______
Other	______	______
Personal Care:		
Toiletries	______	______
Beauty and barber shops	______	______
Other	______	______
Taxes and Insurance:		
Federal taxes	______	______
State and local taxes	______	______
Life insurance	______	______
Other	______	______
Savings and Investments:		
Retirement-plan contributions	______	______
Bank savings account	______	______
Other	______	______
Other:		
______	______	______
______	______	______
______	______	______

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STEP 2 — APPLY INFLATION FACTOR

After calculating estimated post-retirement expenses, practitioners should remind their clients how inflation can affect their retirement plans. According to information from the Bureau of Labor Statistics, the consumer price index (CPI) for all urban consumers (a commonly-used measure of inflation) in recent years has ranged from 1.6% in 2001 to 4.1% in 2007. Just as an individual investor is counseled to tailor his investment portfolio to fit his acceptable level of risk, practitioners should advise the client to choose an inflation factor that corresponds with his tolerable risk level. Following is a table that offers inflation factors, which can be used in retirement-planning calculations.

Years to Retirement	2% Inflation	3% Inflation	4% Inflation	5% Inflation
10	1.22	1.34	1.48	1.63
15	1.35	1.56	1.80	2.08
20	1.49	1.81	2.19	2.65
25	1.64	2.09	2.67	3.39
30	1.81	2.43	3.24	4.32

Example 20. Samantha plans to retire in 15 years. After several discussions with her CPA about her retirement plans, she estimates that she can live comfortably on $5,000 per month (in today's dollars) after retirement. Samantha decides to plan for 4% annual inflation. Her estimated monthly costs 15 years from now are $9,000 ($5,000 × 1.80).

STEP 3 — ESTIMATE POST-RETIREMENT INCOME

In the first part of this chapter, detailed instructions were given on how to estimate social security benefits after retirement. In addition to estimating social security benefits, practitioners can assist clients in determining how much they can expect to receive from employer pension plans. Usually, there is a table or formula in the employer benefit information made available to the employee that uses age, salary level, and years of service to compute the amount of pension benefits that will be provided at the time of retirement.

STEP 4 — CALCULATE RETIREMENT INCOME DEFICIT

Next, it is easy to calculate how much of a deficit, if any, exists between annual post-retirement living costs, as estimated in Step 2, and annual post-retirement income, as calculated in Step 3. The challenge lies in making an estimate of life expectancy in order to determine the **total** shortfall in income that the individual needs to overcome before retirement. Following is a table of life expectancy from the CDC.[22] The practitioner needs to make sure clients fully understand the implications of using such tables to plan for retirement. If just enough is set aside to fund a retirement based on **average** life expectancy, the individual runs the risk that she will run out of money if she lives longer than expected.

[22] Centers for Disease Control, *National Vital Statistics Reports, 56-16,* p. 27 (2008, June 11)

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Table 6. Expectation of life by age, race, and sex: United States, final 2005 and preliminary 2006

[Data are based on a continuous file of records from the states. Calculations of life expectancy employ populations estimated as of July 1 for 2005 and 2006; see "Technical Notes." Race categories are consistent with the 1977 Office of Management and Budget (OMB) standards. Multiple-race data were reported by 25 states and the District of Columbia in 2006 and by 21 states and the District of Columbia in 2005; see "Technical Notes." The multiple-race data for these states were bridged to the single-race categories of the 1977 OMB standards for comparability with other states; see "Technical Notes"]

Age (years) and race	Both sexes		Male		Female	
	2006	2005	2006	2005	2006	2005
All races[1]						
0	78.1	77.8	75.4	75.2	80.7	80.4
1	77.7	77.4	75.0	74.7	80.2	79.9
5	73.7	73.5	71.1	70.8	76.3	76.0
10	68.8	68.5	66.2	65.9	71.3	71.0
15	63.8	63.6	61.2	61.0	66.4	66.1
20	59.0	58.8	56.5	56.2	61.5	61.2
25	54.3	54.1	51.9	51.6	56.6	56.4
30	49.6	49.3	47.2	47.0	51.8	51.5
35	44.8	44.6	42.6	42.3	46.9	46.7
40	40.2	39.9	37.9	37.7	42.2	41.9
45	35.6	35.3	33.5	33.2	37.5	37.3
50	31.2	30.9	29.1	28.9	33.0	32.7
55	26.9	26.7	25.0	24.8	28.6	28.3
60	22.8	22.6	21.1	20.8	24.3	24.0
65	19.0	18.7	17.4	17.2	20.3	20.0
70	15.4	15.2	14.0	13.8	16.5	16.3
75	12.2	12.0	10.9	10.8	13.0	12.8
80	9.3	9.2	8.3	8.2	9.9	9.7
85	7.0	6.8	6.2	6.1	7.4	7.2
90	5.1	5.0	4.5	4.4	5.3	5.2
95	3.7	3.6	3.3	3.2	3.8	3.7
100	2.7	2.6	2.4	2.3	2.7	2.6

STEP 5 — TABULATE CURRENT SAVINGS AND INVESTMENTS

The practitioner needs to ascertain the current value of the client's savings and investment portfolio. This should be relatively simple, assuming the client keeps all pertinent investment statements. To help jog his memory, the following worksheet can be used:

Category	Current Amount
IRAs	__________
401(k), 403(b), 457 or other plan	__________
Savings	__________
Stocks, bonds, mutual funds	__________
Other assets to be used to fund retirement	__________

STEP 6 — ESTIMATE FUTURE VALUE OF INVESTMENTS

A predicted rate of return should be applied to each investment category. As always, the practitioner needs to give clients the standard cautions about the volatility of investments and then urge them to use conservatism in estimating the future value of their funds. The following table, which shows the value of $1 at various rates of return and years to retirement, is a useful tool. It assumes that all monies invested are left to grow for the stated number of years on a tax-deferred basis.

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Years to Retirement	3% Annual Return	5% Annual Return	8% Annual Return	10% Annual Return
10	1.344	1.629	2.159	2.594
15	1.558	2.079	3.172	4.177
20	1.806	2.653	4.661	6.728
25	2.094	3.386	6.848	10.835
30	2.427	4.322	10.063	17.449

Example 21. Josie wants to retire in 20 years. She currently has $100,000 in investments and believes that planning for a 5% annual return is conservative. Using those parameters, Josie estimates that her investments will be worth $265,300 at retirement ($100,000 × 2.653).

STEP 7 — CALCULATE ADDITIONAL RETIREMENT SAVINGS NEEDED

In the final step, the retirement income deficit (Step 4) is subtracted from the future value of the client's investments (Step 6) to arrive at the additional amount the client needs to save before retirement. The factors in the following table can be used to determine the annual amount of savings needed to reach the desired amount of retirement savings.

Years to Retirement	3% Annual Return	5% Annual Return	8% Annual Return	10% Annual Return
10	.0872	.0795	.0690	.0627
15	.0538	.0463	.0368	.0315
20	.0372	.0302	.0219	.0175
25	.0274	.0210	.0137	.0102
30	.0210	.0151	.0088	.0061

Example 22. Frederick plans to retire in 20 years. With the help of his financial advisor, he projects that he will need an additional $300,000 at the time of retirement in order to live the lifestyle he desires. He wants to be conservative in his planning, so he told his advisor to factor in a 3% annual return on his investment. Frederick will need to save $11,160 each year for the next 20 years in order to reach his goal of $300,000 ($300,000 × .0372 = $11,160).

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