Chapter 5: Retirement Plans for Small Businesses

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Please note. Corrections were made to this workbook through January of 2019. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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When a small business client asks for advice on choosing appropriate retirement plans, the tax practitioner may immediately think of a SEP IRA or SIMPLE IRA. However, there are several other retirement plan alternatives to consider, including the following.

- Solo 401(k) plan
- Safe harbor 401(k) plan
- SIMPLE 401(k) plan
- Traditional IRA
- Roth IRA

The tax practitioner faces a challenge in providing advice on the right plan or combination of retirement plans that best meets the client's needs. In this chapter, each of the above-mentioned retirement plans is considered in detail and compared with other plans. This chapter discusses factors that influence the decisions about the optimal plan for a business including available tax credits. Decision flowcharts are also provided that tax practitioners can use to guide their clients in making appropriate retirement plan selections.

Note. A recent article in the *Journal of Accountancy* compares four small business retirement plans (SEP, SIMPLE IRA, 401(k), and Solo 401(k)).[1] While less detailed than this chapter, this article provides useful supplementary information on this subject.

Regular 401(k) plans are not analyzed in this chapter because they are subject to greater reporting requirements and potentially onerous nondiscrimination testing. Additionally, this chapter does not include a detailed analysis of retirement plan distributions or rollovers.

SEP IRA PLAN[2]

A simplified employee pension (SEP) plan allows the employer to create SEP IRAs for the business and its eligible employees. Generally, only the employer contributes to this type of plan. Under a salary reduction simplified employee pension (SARSEP) plan, employees have the option to make voluntary contributions. However, a SARSEP plan cannot be established after 1996.

SEP IRAs do not permit loans to plan participants.[3]

1. *Help small businesses choose the right employee retirement plans*. Williams, Jimmy J. Feb. 1, 2018. Journal of Accountancy. [www.journalofaccountancy.com/issues/2018/feb/small-business-employee-retirement-plans.html] Accessed on Feb. 1, 2018.
2. IRC §408(k); IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.
3. *IRA FAQs — Loans*. Aug. 12, 2017. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-iras-loans] Accessed on Feb. 2, 2018.

ESTABLISHING A SEP IRA PLAN

Most employers, including self-employed individuals, can establish SEP plans. SEPs have low start-up and operating costs and, in most cases, can be established by adopting an IRS-model SEP using Form 5305-SEP, *Simplified Employee Pension — Individual Retirement Accounts Contribution Agreement*.

If an employer adopts an IRS-model SEP using Form 5305-SEP, no prior IRS approval or determination letter is required. The employer keeps the Form 5305-SEP and does not file it with the IRS. Using Form 5305-SEP usually provides relief to the employer from annual filing requirements for retirement plan information returns.

An employer **cannot use** Form 5305-SEP if any of the following applies.

1. The employer currently maintains another qualified retirement plan other than another SEP.
2. The employer has eligible employees for whom IRAs were not set up.
3. The employer uses the services of leased employees who are not the employer's common-law employees.
4. The employer is a member of any of the following unless all eligible employees of all the members of these groups, trades, or businesses participate under the SEP.
   - **a.** An affiliated service group as described in IRC §414(m)
   - **b.** A controlled group of corporations as described in IRC §414(b)
   - **c.** Trades or businesses under common control as described in IRC §414(c)
5. The employer does not pay the cost of the SEP contributions.

The employer must give each eligible employee a copy of Form 5305-SEP, its instructions, and the other information listed in the Form 5305-SEP instructions. An IRS-model SEP is not considered adopted until the employer provides this information to each employee.

A SEP IRA must be set up by or for each eligible employee. A SEP IRA can be established with a bank, insurance company, or other qualified financial institution. The employer sends SEP contributions to the financial institution at which the SEP IRA is maintained.

The employer can establish a SEP for any year as late as the due date (including extensions) of its income tax return for that year.

ELIGIBLE EMPLOYEES

The most significant downside to a SEP plan is that it has broad eligibility requirements. The plan **must** cover all employees who:

1. Are at least 21 years of age,
2. Were employed by the employer for three of the last five years, and
3. Received compensation of $600 or more during the year (2017 or 2018).[4]

An employer can use less restrictive participation requirements than these but **not more** restrictive requirements.

Any employee who meets these three requirements during the year **must** be covered regardless of whether they were temporary, part-time, or **not** employed at yearend.[5] This includes employees who are over age 70½.

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4. IRS News Release IR-2017-177 (Oct. 19, 2017).

5. *SEP Plan Fix-It Guide - Eligible employees were excluded from participating*. Jan. 19, 2018. IRS. [www.irs.gov/retirement-plans/sep-fix-it-guide-the-plan-excluded-eligible-employees-from-participating-in-the-sep] Accessed on Feb. 2, 2018.

The following employees **can be excluded** from coverage under a SEP.

- Employees covered by a union agreement and whose retirement benefits were bargained for in good faith by the employees' union and the employer
- Nonresident alien employees who have received no U.S. source wages, salaries, or other personal services compensation from the employer

CONTRIBUTIONS

The employer must contribute a uniform percentage of pay for each employee but the **employer is not required to make contributions to the plan every year**. Because the employer can decide how much to put into a SEP each year, this plan gives the company the flexibility to deal with fluctuating business conditions.

The employer has until the due date of the tax return, **including** extensions, to make contributions to the plan. The contributions are deductible for the designated tax year, even if the employer uses cash basis for tax reporting.

Employer contributions are not taxable to the employee until withdrawn. In addition, they are **not reported** on the employee's Form W-2, *Wage and Tax Statement;* although the "retirement plan" box (box 13 on the 2017 Form W-2) must be checked.

Elective deferrals by an employee in a SARSEP plan reduce the wages reported in box 1 of Form W-2 and are reported in box 12 using code "F."[6]

Employer contributions for 2018 to an employee's SEP IRA are limited to the **lesser** of:[7]

- 25% of the employee's compensation (up to $275,000 of compensation), or
- $55,000.

Employees are immediately vested in contributions to SEP IRA accounts.[8]

Limits for Self-Employed Individuals

Self-employed taxpayers must make a special calculation to determine the maximum amounts of their elective deferrals and nonelective contributions. When calculating such a contribution, the compensation amount used is the taxpayer's earned income, which is defined as net earnings from self-employment (SE) after deducting both of the following.

- One-half of the SE tax
- Contributions for the self-employed taxpayer

The compensation amount and the amount of the taxpayer's plan contribution depend on each other (i.e., this is a circular calculation). One way to make the calculation is to use a reduced plan contribution rate, which is calculated by dividing the plan contribution rate by the sum of 100% plus the plan contribution rate.[9] This means that a self-employed taxpayer is effectively limited to a nonelective contribution rate of 20% of compensation (25% maximum contribution rate ÷ (100% + 25% contribution rate)).

A worksheet in IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans),* can also be used to determine the maximum deductible contribution for a self-employed taxpayer.

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6. General Instructions for Forms W-2 and W-3.

7. *SEP Plan FAQs — Contributions.* Oct. 25, 2017. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-seps-contributions] Accessed on Feb. 2, 2018.

8. *Operating a SEP*. Oct. 25, 2017. IRS. [www.irs.gov/retirement-plans/operating-a-sep] Accessed on Feb. 2, 2018.

9. *Self-Employed Individuals — Calculating Your Own Retirement-Plan Contribution and Deduction*. Oct. 24, 2017. IRS. [www.irs.gov/retirement-plans/self-employed-individuals-calculating-your-own-retirement-plan-contribution-and-deduction] Accessed on Feb. 2, 2018.

Example 1. Beth is the sole proprietor of a successful consulting business. She has one employee, Randall. The company has a SEP plan.

In 2018, Randall's wages are $40,000. Beth's net income on Schedule C is $250,000 before taking into account any SEP contributions. After meeting with her tax accountant, Beth decides to make the **maximum** contributions to her and to Randall's SEP accounts.

The maximum amount that Beth can contribute to Randall's SEP IRA is $10,000 ($40,000 × 25%). Beth can deduct this contribution on her 2018 Schedule C even though she does not remit the money until after the end of the year. She has until the due date of her return, including extensions, to make the contribution.

The amount that Beth can contribute to her SEP IRA for 2018 is $45,765, which is calculated as follows.

Net profit from self employment before SEP contributions	$250,000
Less: contribution to Randall's SEP IRA	(10,000)
Net profit from self employment after SEP contribution	$240,000
Less: ½ SE tax ($128,400 [a] × 6.2% + $240,000 × 92.35% × 1.45%)	(11,175)
Net profit reduced by ½ SE tax	$228,825
Multiplied by reduced plan contribution rate ((25% plan contribution rate ÷ (100% + 25% plan contribution rate))	× 20%
Beth's SEP IRA contribution	$ 45,765

[a] *Contribution and Benefit Base.* Social Security Administration. [www.ssa.gov/oact/cola/cbb.html] Accessed on Feb. 2, 2018.

NOTIFICATION AND REPORTING REQUIREMENTS

Employee Notification Requirements

As mentioned earlier, the employer must give eligible employees certain information about the SEP when it is established. In addition, the employer must give eligible employees an annual statement showing any contributions made to their SEP IRAs.

Note. For further details about the information that must be provided to employees, see the instructions to Form 5305-SEP.

Annual Reporting

SEP IRAs are generally **not required** to file annual reports (Form 5500 series).[10]

TESTING REQUIREMENTS

SEP IRA plans are subject to the top-heavy rules of IRC §416. These rules are designed to ensure that lower-paid employees receive at least a minimum benefit in plans in which higher-paid employees (referred to as **key employees)** own most of the assets. Top-heavy plans are subject to additional requirements, such as faster vesting and minimum contributions for participants who are not key employees.

10. *SEP Plan Fix-It Guide — SEP Plan Overview*. Oct. 26, 2017. IRS. [www.irs.gov/retirement-plans/sep-fix-it-guide-sep-plan-overview] Accessed on Feb. 2, 2018.

Although a SEP IRA plan must provide for immediate vesting regardless of the top-heavy rules,[11] a SEP plan is treated as a defined contribution plan for purposes of the minimum contribution top-heavy requirements under §416.[12] A SEP IRA plan generally is top-heavy if the sum of the IRA balances of the key employees[13] is more than 60% of the sum of the IRA balances of all employees.[14] The minimum employer contribution required in a top-heavy plan year for each non-key employee eligible to participate in the SEP plan is the lesser of 3% of the employee's compensation or the percentage that is equal to the highest percentage of compensation allocated to any key employee.[15]

Note. For more information about the top-heavy requirements, see IRS Pub. 7002, *Employee Benefit Plans.*

ADVANTAGES AND DISADVANTAGES OF A SEP IRA PLAN

Some **advantages** of SEP IRA plans include the following.

- No upper limit on the number of employees covered.
- Employees immediately vest in all contributions.
- Employer contributions are not required every year.
- Contributions can be made for participants over age 70½.

Some **disadvantages** to SEP IRA plans include the following.

- The eligibility requirements are broad.
- Plans are subject to top-heavy requirements.
- Employees cannot make voluntary contributions, except for pre-1997 SARSEP plans.
- Employer contributions to a SEP IRA do not qualify for the qualified retirement savings contributions credit.

SIMPLE IRA PLAN[16]

A savings incentive match plan for employees (SIMPLE) IRA plan is a retirement plan option for an employer with 100 or fewer employees who received at least $5,000 in compensation for the preceding year (unlike a SEP IRA for which there is no limit on the number of employees). An employer with a SIMPLE IRA plan that is not eligible in a subsequent year due to exceeding the 100-employee rule can nevertheless be treated as an eligible employer for the two years following the last year the employer was an eligible employer.[17] However, this 2-year grace period does not apply if such failure is due to any acquisition, disposition, or similar transaction involving the employer.[18]

In order for the SIMPLE IRA to be a qualified salary reduction arrangement, an employer cannot offer any other retirement plan to their employees.[19]

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11. *Retirement Topics — Vesting*. Sep. 29, 2017. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-vesting] Accessed on Feb. 2, 2018.
12. IRC §416(i)(6)(A).
13. See IRC §416(i)(1).
14. IRC §§408(k)(1)(B), 416(c)(2)(A), and 416(g)(1)(A)(ii).
15. IRS Pub. 7002, *Employee Benefit Plans.*
16. IRC §408(p); IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.
17. IRC §408(p)(2)(C)(i)(II).
18. Ibid.
19. IRC §408(p)(2)(D).

These plans allow the **employee** to contribute a percentage of their salary each pay period. They also require the **employer** to contribute a certain minimum amount.

SIMPLE IRAs do not permit loans to plan participants.[20]

ESTABLISHING A SIMPLE IRA PLAN

A SIMPLE IRA plan is easy to establish. Form **5304**-SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) — Not for Use With a Designated Financial Institution,* is used if the plan participants are allowed to select the financial institution at which the SIMPLE IRA is established. Form **5305**-SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) — for Use With a Designated Financial Institution,* is used if all the contributions under the plan are deposited initially at a designated financial institution of the employer's choosing.

The SIMPLE IRA plan is adopted when the appropriate form is completed and signed by the employer (and the designated financial institution, if any). The employer should retain a copy of the form; it is not filed with the IRS.

To make a SIMPLE IRA effective for the current tax year, the employer generally must adopt the plan by **October 1** of that tax year. However, new employers coming into existence after October 1 of the year the SIMPLE IRA is established are permitted to set up a SIMPLE IRA plan as soon as administratively feasible after the business comes into existence.

A SIMPLE IRA must be established for each eligible employee. Form 5305-S, *SIMPLE Individual Retirement Trust Account,* and Form 5305-SA, *SIMPLE Individual Retirement Custodial Account,* are model trust and custodial account documents, respectively, that the participant and the trustee or custodian can use for this purpose.

A SIMPLE IRA cannot be a Roth IRA. Contributions to a SIMPLE IRA are not counted towards the maximum amount an individual can contribute to a Roth or traditional IRA.

ELIGIBLE EMPLOYEES

The eligibility requirements for SIMPLE IRA plans are more employer friendly than those for SEP IRA plans. Any employee who received at least $5,000 in compensation during any two years preceding the current calendar year and who is reasonably expected to receive at least $5,000 during the current calendar year is eligible to participate. Here, the term **employee** includes a self-employed individual who realizes a profit from their sole proprietorship. Employees who are over 70½ years of age are also eligible to participate.[21]

The employer can use less restrictive eligibility requirements by eliminating or reducing the prior-year compensation requirements, the current-year compensation requirements, or both. However, the employer cannot impose additional employee eligibility conditions or requirements that are more restrictive.

If the plan provides for it, the employer can choose to automatically enroll employees in a SIMPLE IRA plan. However, the employees must be allowed to choose the amount of their salary reduction contributions or to contribute nothing.

The following employees **can be excluded** from coverage under a SIMPLE IRA plan.

- Employees covered by a union agreement and whose retirement benefits were bargained for in good faith by the employees' union and the employer
- Nonresident alien employees who received no U.S. source wages, salaries, or other personal services compensation from the employer

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20. *IRA FAQs — Loans*. Aug. 12, 2017. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-iras-loans] Accessed on Feb. 2, 2018.

21. *SIMPLE IRA Plan FAQs — Contributions*. Oct. 25, 2017. IRS. [www.irs.gov/retirement-plans/simple-ira-plan-faqs-contributions] Accessed on Feb. 2, 2018.

CONTRIBUTIONS

Under a SIMPLE IRA plan, an employee can contribute up to $12,500 in 2018 ($15,500 if age 50 or older) by payroll deduction.[22] Employer contributions may be made using either of the following methods.

1. **Matching Contributions.** Match employee contributions dollar for dollar **up to 3% of an employee's compensation** (not subject to annual compensation limits).
2. **Nonelective Contributions.** Make a **fixed contribution of 2% of compensation** (up to $275,000 in compensation for 2018)[23] for each eligible employee, even for an employee who chooses **not** to contribute.

If the employer chooses a matching contribution of less than 3%, the percentage **cannot** be less than 1%. In addition, employees must be notified of the lower match within a reasonable period before they must determine their elective deferrals for the calendar year. Furthermore, the employer **cannot** choose a percentage less than 3% for more than two years during the 5-year period that ends with the year for which the choice is effective. Contributions to SIMPLE IRA accounts are always immediately vested by the employee.[24]

For a **self-employed** taxpayer, **compensation** is defined as net SE earnings before subtracting any contributions made to the SIMPLE IRA plan.[25]

Plan contributions made by the employer for their **employees** are deducted on the employer's tax return. For example, sole proprietors deduct contributions on Schedule C, *Profit or Loss From Business,* or Schedule F, *Profit or Loss From Farming;* partnerships deduct them on Form 1065, *U.S. Return of Partnership Income;* and corporations deduct them on Form 1120, *U.S. Corporation Income Tax Return,* or Form 1120S, *U.S. Income Tax Return for an S Corporation*. Contributions made for partners by a partnership are reported to the partners on the Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc*. Sole proprietors and partners deduct contributions for **themselves** on Form 1040, Schedule 1.

Simple IRA contributions are not taxable to the employee for federal income tax purposes until withdrawn. Voluntary employee contributions **are** subject to social security, Medicare, and federal unemployment (FUTA) Taxes. However, employer matching and nonelective contributions are not subject to these taxes.

Voluntary employee contributions are not included in the wages reported in Box 1 of the employee's Form W-2. The employee's total contributions are reported in Box 12 using Code "S".[26] Also, the "Retirement Plan" box must be checked. Employer matching and nonelective contributions are not reported on Form W-2.

Matching and nonelective contributions for a particular tax year must be made by the due date, including extensions, of the employer's income tax return. The employer must make the salary reduction contribution to the SIMPLE IRA within 30 days after the end of the month in which the amount was withheld from the employee's pay.

The tax year of the deduction for matching and nonelective contributions is based upon the **calendar year** for which the contributions are made. For fiscal year taxpayers, the deductions for the entire calendar year are taken on the return for the fiscal year which includes December 31.

Example 2. The fiscal year for Westmorland Water Works Inc. (Westmorland) ends on August 31. Matching and nonelective contributions made under the company's SIMPLE IRA plan for calendar year 2017 are deductible by Westmorland for the tax year beginning September 1, 2017 and ending August 31, 2018.

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22. IRS News Release IR-2017-177 (Oct. 19, 2017).
23. Ibid.
24. *Operating a SIMPLE IRA Plan*. Oct. 25, 2017. IRS. [www.irs.gov/retirement-plans/operating-a-simple-ira-plan] Accessed on Feb. 2, 2018.
25. IRC §408(p)(6)(A)(ii).
26. General instructions for Forms W-2 and W-3.

Example 3. Use the same facts as **Example 1,** except Beth has a SIMPLE IRA plan instead of a SEP. In October 2017, Beth notified Randall that she would match employee contributions up to 3% of compensation in 2018. Randall chose to contribute the maximum amount allowed; he is aged 51 in 2018, so his voluntary payroll deduction is $15,500 for 2018.

Randall's 2018 wages are $40,000; therefore, Beth's 3% match into Randall's SIMPLE IRA is $1,200. Beth has 30 days after withholding Randall's voluntary contributions to deposit them into his SIMPLE IRA account. She has until the due date of her return, including extensions, to deposit the $1,200 matching contribution.

Beth is aged 46, so her maximum deferral for 2018 is $12,500. The calculation of her matching contribution of $6,893 follows.

Net profit from self employment before SIMPLE contributions	$250,000
Less: matching contribution to Randall's SIMPLE IRA	(1,200)
Net profit from self employment after SIMPLE matching contribution	$248,800
Multiplied by taxable SE percentage	× 92.35%
Net SE earnings (from Schedule SE, line 4)	$229,767
Multiplied by matching percentage	× 3%
Beths SIMPLE IRA matching contribution	$ 6,893

Observations for Example 3:

1. SE income is determined differently in **Example 1** and **Example 3.** SE income under the SEP plan is based on the qualified pension plan rules of IRC §401(c)(2), while SE income under the SIMPLE plan is based on IRC §1402(a).[27] There are two distinguishing factors in the calculations.
   a. The SEP calculation subtracts the self-employed person's IRA contribution from qualified earnings, while the SIMPLE calculation does not.
   b. The SEP calculation includes a deduction for the employer's portion of SE taxes, while the SIMPLE calculation adjusts for this factor by multiplying earnings by 92.35%.
2. In **Example 1,** Beth is permitted to contribute **$45,765** to her own retirement funds, while in **Example 3,** her maximum contribution is only **$19,393** ($12,500 elective deferral + $6,893 matching contribution). Which plan is better for Beth depends in part on how much available cash she has each year to fund the plan. Her contribution for Randall in **Example 1** is $10,000, whereas in **Example 3** the amount is only $1,200.

NOTIFICATION AND REPORTING REQUIREMENTS

Employee Notification Requirements

The employer is required to provide the following information to each employee before the beginning of the election period.

1. The employee's opportunity to make or change a salary reduction choice
2. The employer's decision to make either matching contributions or nonelective contributions
3. A summary description provided by the financial institution
4. Written notice that the employee's balance can be transferred without cost or penalty if they use a designated financial institution

27. IRC §§408(p)(6)(A)(ii) and 1402(a)(12).

The **election period** is generally the 60 days immediately preceding January 1 (November 2 to December 31 of the preceding calendar year). However, these dates are modified if the employer establishes a SIMPLE IRA plan midyear or if the 60-day period falls before the first day an employee becomes eligible to participate in the plan. (For more information, see IRS Pub. 560.)

Annual Reporting

An employer is **not required** to file an annual Form 5500 for a SIMPLE IRA plan.[28]

TESTING REQUIREMENTS

Nondiscrimination testing is **not required** for a SIMPLE IRA plan.

ADVANTAGES AND DISADVANTAGES OF A SIMPLE IRA PLAN

The **advantages** of a SIMPLE IRA plan include the following.

- Employees may make salary reduction contributions.
- Employee eligibility requirements are more employer-friendly than the requirements for the SEP IRA.
- Employees are immediately vested in all contributions.
- Nondiscrimination testing is not required.
- There is no annual reporting requirement.

The **disadvantages** of a SIMPLE IRA plan include the following.

- They are only for employers with 100 or fewer employees.
- Either employer matching or nonelective contributions are required.
- The employer cannot offer any other retirement plan.

SOLO 401(k) PLAN

Solo 401(k) plans are available to sole proprietors, partnerships, C corporations, and S corporations. Other names for solo 401(k) plans include the following.

- One-participant 401(k) plan
- Solo-k
- Uni-k
- One-participant k

A solo 401(k) plan has the same rules and requirements as any other 401(k) plan. It is a traditional 401(k) plan that may be suitable for a business that has no employees. Such a plan covers only:[29]

- The owner,
- The owner of a wholly owned trade or business (whether or not incorporated) and their spouse, or
- Partners (or partners and their spouses) of a business partnership.

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28. *Operating a SIMPLE IRA Plan*. Oct. 25, 2017. IRS. [www.irs.gov/retirement-plans/operating-a-simple-ira-plan] Accessed on Feb. 2, 2018.

29. *Form 5500 Corner*. Nov. 24, 2017. IRS. [www.irs.gov/Retirement-Plans/Form-5500-Corner] Accessed on Feb. 2, 2018.

Loans to participants are permitted, subject to the rules of the 401(k) plan.[30] Generally, 401(k) plan loans must be repaid within five years but a loan used to purchase the employee's principal residence may be paid back over a period of more than five years.[31]

ESTABLISHING A SOLO 401(k) PLAN[32]

As mentioned earlier, a solo 401(k) plan has the same rules and requirements as any other traditional 401(k) plan. Therefore, the same basic actions are necessary to set up a solo 401(k) as are required for a multi-participant 401(k) plans.

One of the first decisions that must be made is whether the owner wants to establish the plan or to use a professional or financial institution (e.g., a bank, mutual fund provider, or insurance company) to establish and maintain the plan. After the owner makes that decision, the following actions are necessary for a tax-advantaged 401(k) plan.

1. Adopt a written plan
2. Arrange a trust fund for the plan's assets
3. Develop a recordkeeping system
4. Provide plan information to the participant

> **Note.** For detailed information about each of these steps, go to **uofi.tax/16a1x5** [www.irs.gov/retirement-plans/irc-401-k-plans-establishing-a-401-k-plan].

CONTRIBUTIONS[33]

The business owner has two roles in a 401(k) plan: employer and employee. Plan contributions can be made in both capacities. The **owner** can contribute both of the following.

- **Elective deferrals** up to 100% of compensation, not to exceed the annual contribution limit (In 2018, the limit is $18,500 or $24,500 if the employee is age 50 or over and the plan allows catch-up contributions.)[34]
- **Employer nonelective contributions** up to 25% of compensation as defined by the plan (The limits for self-employed individuals are discussed later.)

The limits on elective deferrals are by person, not by plan. Therefore, a business owner who is also employed by another company and participates in its qualified retirement plan must consider the limit for **all** the elective deferrals they make during a year.

Example 4. Dylan, age 36, is employed by Albion LLC, which has a 401(k) plan. He contributed $18,500 to his employer's 401(k) plan for 2018. He also has a side business, Kart Racing, LLC, that is organized as an S corporation, from which he received compensation of $250,000 in 2018. Dylan set up a solo 401(k) plan for his S corporation. He would like to contribute the maximum amount to this plan. However, he cannot make elective deferrals to his solo 401(k) plan because he already contributed the maximum deferral amount to his employer's plan.

30. IRS Pub. 4222, *401(k) Plans for Small Businesses*.

31. *Retirement Plans FAQs regarding Loans*. Feb. 15, 2018. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-loans] Accessed on Feb. 20, 2018.

32. *IRC 401(k) Plans — Establishing a 401(k) Plan*. Sep. 30, 2017. IRS. [www.irs.gov/retirement-plans/irc-401k-plans-establishing-a-401k-plan] Accessed on Feb. 2, 2018.

33. *One-Participant 401(k) Plans*. Oct. 25, 2017. IRS. [www.irs.gov/retirement-plans/one-participant-401k-plans] Accessed on Feb. 2, 2018.

34. IRS News Release IR-2017-177 (Oct. 19, 2017).

The **overall limit on contributions** (annual additions) to a participant's account (elective deferrals and nonelective contributions) **cannot exceed the lesser** of:[35]

- $55,000 for 2018 or $61,000 including a $6,000 catch-up contribution (for contributors over age 50), or
- 100% of the participant's compensation.

Note. Elective deferrals are not treated as catch-up contributions until they exceed the 2018 annual limit of $18,500, the actual deferral percentage (ADP) test limit of IRC §401(k)(3), or the plan limit (if any).[36] For more information about the ADP test, see the 2013 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Small Business Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Unlike the limit on elective deferrals, which is by **person**, the annual overall limit on total contributions applies to each **plan.**[37]

Example 5. Use the same facts as **Example 4.** While Kart Racing, LLC can make a nonelective contribution of up to 25% of Dylan's 2018 compensation (which would be $62,500, or $250,000 × 25%), the contribution cannot exceed the overall limit on contributions for 2018, which is $55,000. Therefore, Kart Racing's nonelective contribution is limited to $55,000. This limit is not affected by the elective deferrals Dylan made under the Albion LLC plan nor by the employer contributions made by Albion LLC because the overall limit on contributions applies to each plan separately.

Example 6. Use the same facts as **Example 5,** except Dylan is 57 years old and eligible to make catch-up contributions. He can contribute an additional $6,000 of elective deferrals for 2018. His catch-up contributions can be split between the plans in any proportion he chooses. If Dylan elects to make catch-up contributions to his solo 401(k) plan, then his overall limit on total contributions to that plan is increased by the catch-up contributions (from $55,000 to a maximum of $61,000 for 2018).[38]

Plan contributions are generally applied to the year in which they are made. However, they can be applied to the previous year if all the following requirements are met.[39]

1. They are made by the due date of the tax return for the previous year (plus extensions).
2. The plan was established by the end of the previous year.
3. The plan treats the contributions as though it had received them on the last day of the previous year.
4. The contributor accomplishes **both** of the following.
   a. Specifies in writing to the plan administrator or trustee that the contributions apply to the previous year.
   b. The contributions are deducted on the previous year's tax return. (A partnership shows contributions for partners on Form 1065.)

35. IRC §415(c); *Retirement Topics — 401(k) and Profit-Sharing Plan Contribution Limits*. Oct. 24, 2017. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-401k-and-profit-sharing-plan-contribution-limits] Accessed on Feb. 2, 2018.

36. *Retirement Topics — Catch-Up Contributions*. Oct. 24, 2017. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-catch-up-contributions] Accessed on Feb. 2, 2018.

37. *Retirement Topics — 401(k) and Profit-Sharing Plan Contribution Limits*. Oct. 24, 2017. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-401k-and-profit-sharing-plan-contribution-limits] Accessed on Feb. 2, 2018.

38. Adapted from Example 2 in *Retirement Topics — 401(k) and Profit-Sharing Plan Contribution Limits*. Oct. 24, 2017. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-401k-and-profit-sharing-plan-contribution-limits] Accessed on Feb. 2, 2018.

39. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

Contribution Limits for Self-Employed Individuals

The contribution limits for elective deferrals and nonelective contributions of self-employed individuals are calculated in the same way as for SEP IRAs (discussed previously).

ANNUAL REPORTING

An annual report must generally be filed for a solo 401(k) if it has $250,000 or more in assets at the end of the year. The annual report can be filed using either of the following methods.

- Electronically using Form 5500-SF, *Short Form Annual Return/Report of Small Employee Benefit Plan*[40]
- Using a paper Form 5500-EZ, *Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan*[41]

A solo 401(k) plan that has less than $250,000 in assets at the end of the year is generally exempt from the annual filing requirement. However, for **every** solo 401(k) plan, a 5500-series return must be filed for the **final plan year** to indicate that all assets were distributed.[42]

TESTING REQUIREMENTS

If the business hires employees who meet the plan eligibility requirements, then they must be included in the plan. At that time, the solo 401(k) must be converted to a regular 401(k). When this occurs, the employees' elective deferrals are subject to nondiscrimination testing unless the 401(k) plan is a safe harbor plan or other plan exempt from testing.[43] Nondiscrimination testing is required only if the business has employees who could have received disparate benefits.[44] An employee may be lawfully excluded from a 401(k) plan if they meet **any** of the following conditions.[45]

- Has not attained age 21
- Has not completed a year of service during which they worked at least 1,000 hours
- Is covered by a collective bargaining agreement that does not provide for participation in the plan, if retirement benefits were the subject of good-faith bargaining

ADVANTAGES AND DISADVANTAGES OF A SOLO 401(k) PLAN

Following are **advantages** of a solo 401(k) plan.

- It is suitable for business owners and their spouses.
- An employer can make nonelective contributions and/or elective deferrals.
- Nondiscrimination testing is not required if there are no employees (other than the owners).

Following are **disadvantages** of a solo 401(k) plan.

- An annual report is required if there is more than $250,000 in plan assets.
- It becomes a regular 401(k) plan if the business hires other eligible employees.

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40. *One-Participant 401(k) Plans*. Oct. 25, 2017. IRS. [www.irs.gov/retirement-plans/one-participant-401k-plans] Accessed on Feb. 2, 2018.
41. Instructions for Form 5500-EZ.
42. Ibid.
43. *One-Participant 401(k) Plans*. Oct. 25, 2017. IRS. [www.irs.gov/retirement-plans/one-participant-401k-plans] Accessed on Feb. 2, 2018.
44. Ibid.
45. IRC §410.

SAFE HARBOR 401(k) PLAN

A major drawback of traditional 401(k) plans for small business employers with employees is the annual nondiscrimination testing requirements, which are complex and therefore time consuming.[46] The Small Business Job Protection Act of 1996[47] addressed this problem by introducing the safe harbor 401(k) plan.

Like solo 401(k) plans, safe harbor 401(k) plans are available to sole proprietors, partnerships, C corporations, and S corporations. A safe harbor 401(k) plan has the same rules and requirements as any other 401(k) plan. However, unlike a solo 401(k) plan, it is geared towards businesses with employees.

Generally, 401(k) plans cover both owners and managers (generally highly compensated employees (HCEs)) and rank-and-file employees (generally, non-highly compensated employees (NHCEs)).[48] However, some employees may be **excluded** from a 401(k) plan if they meet any of the following conditions.[49]

- Have not attained age 21
- Have not completed a year of service during which they worked at least 1,000 hours
- Are covered by a collective bargaining agreement that does not provide for participation in the plan, if retirement benefits were the subject of good-faith bargaining

ESTABLISHING A SAFE HARBOR 401(k) PLAN

Establishing a safe harbor 401(k) plan entails following the same rules and requirements as any other traditional 401(k) plan (see the solo 401(k) section).

CONTRIBUTIONS[50]

Like other 401(k) plans, safe-harbor plans accept both employee and employer contributions.

Employees can make **elective deferrals** up to 100% of compensation, not to exceed the annual contribution limit. In 2018, the limit is $18,500 or $24,500 if the employee is age 50 or over and the plan allows catch-up contributions.[51]

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46. *The Safe-Harbor Solution*. Sherman Jr., Charles W. and Collins, Michael J. Jul. 1, 1999. Journal of Accountancy. [www.journalofaccountancy.com/issues/1999/jul/sherman.html] Accessed on Feb. 2, 2018.

47. PL 104-188 (Aug. 20, 1996).

48. *Operating a 401(k) Plan*. Nov. 3, 2017. IRS. [www.irs.gov/retirement-plans/operating-a-401k-plan] Accessed on Feb. 2, 2018.

49. IRC §410.

50. *Operating a 401(k) Plan*. Nov. 3, 2017. IRS. [www.irs.gov/retirement-plans/operating-a-401k-plan] Accessed on Feb. 2, 2018; *The Safe-Harbor Solution*. Sherman Jr., Charles W. and Collins, Michael J. Jul. 1, 1999. Journal of Accountancy. [www.journalofaccountancy.com/issues/1999/jul/sherman.html] Accessed on Feb. 2, 2018.

51. IRS News Release IR-2017-177 (Oct. 19, 2017).

The employer contribution requirements for safe harbor 401(k) plans are more stringent than for traditional 401(k) plans. Employer contributions can be either **matching** or **nonelective** according to **one** of the following formulas.[52]

1. **Matching contributions.** The employer makes matching contributions in accordance with the following rules.
   a. The employer contributes an amount equal to 100% of each NHCE's elective deferrals, **up to** 3% of any compensation.
   b. The employer contributes an amount equal to 50% of each NHCE's elective deferrals that **exceed** 3% but do not exceed 5% of compensation.
   c. The rate of matching contributions for HCEs, including a self-employed owner, does **not** exceed the rates for NHCEs.
2. **Nonelective contributions.** The employer makes nonelective contributions, without regard to whether the employee made elective deferrals, on behalf of all NHCEs eligible to participate in the plan, equal to at least 3% of the employee's compensation.[53]

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Plan contributions are generally applied to the year in which they are made. However, they can be applied to the previous year if all the following requirements are met.[54]

1. They are made by the due date of the tax return for the previous year (plus extensions).
2. The plan was established by the end of the previous year.
3. The plan treats the contributions as though it had received them on the last day of the previous year.
4. The contributor accomplishes **both** of the following.
   a. Specifies in writing to the plan administrator or trustee that the contributions apply to the previous year.
   b. The contributions are deducted on the previous year's tax return.

AUTOMATIC ENROLLMENT 401(k)[55]

A safe harbor 401(k) plan may have an eligible automatic contribution arrangement (EACA).[56] With this feature, the employer can automatically reduce an employee's pay by a fixed percentage and contribute that amount to the 401(k) plan on the employee's behalf. The employer must give employees notice before any deferrals are withheld. An employee must have the option of not having any deferrals withheld or to have a different amount withheld. This automatic election continues until the participant specifically elects not to have such deferral percentage made or elects a different percentage. These automatic contributions are still considered elective deferrals. The automatic enrollment feature encourages employees' saving for retirement and helps the plan pass nondiscrimination testing, if applicable.[57]

Note. For more information, see IRS Pub. 4674, *Automatic Enrollment 401(k) Plans for Small Businesses*.

52. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans);* Treas. Reg. §§1.401(k)-3(b) and (c).
53. IRS Notice 98-52, 1998-2 CB 634; Treas. Reg. §1.401(k)-3(b)(1).
54. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.
55. *Retirement Topics — Automatic Enrollment*. Sep. 29, 2017. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-automatic-enrollment] Accessed on Feb. 2, 2018.
56. Treas. Reg. §1.401(k)-1(a)(3)(ii).
57. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

Under an EACA, the plan may allow participants to withdraw their automatic contributions to the plan if **both** of the following conditions are met.[58]

1. The participant elects to withdraw no later than 90 days after the date of the first elective contributions under the EACA.
2. The participant withdraws the entire amount of EACA default contributions, including any earnings thereon.

If the plan allows withdrawals under the EACA, the amount of the withdrawal, other than the amount of any designated Roth contributions, must be included in the employee's gross income for the tax year in which the distribution is made. The additional 10% tax on early distributions does not apply to the distribution.[59]

QUALIFIED AUTOMATIC CONTRIBUTION ARRANGEMENT[60]

A qualified automatic contribution arrangement (QACA) is another type of safe-harbor plan that uses an automatic enrollment feature. In addition, mandatory employer contributions are required. If a plan includes a QACA, it is not subject to annual ADP testing and may not be subject to actual contribution percentage nondiscrimination testing requirements.

Under a QACA, each employee who is eligible to participate in the plan is treated as having elected to make elective deferral contributions equal to a certain default percentage of compensation. In order to not have default elective deferrals made, an employee must make an affirmative election specifying a deferral percentage (which can be zero, if desired). If an employee does not make an affirmative election, the default deferral percentage must meet the following conditions.

- It must be applied uniformly.
- It must not exceed 10%.
- It must be at least 3% in the first plan year that it applies to an employee and through the end of the following year.
- It must increase to at least 4% in the following plan year.
- It must increase to at least 5% in the following plan year.
- It must increase to at least 6% in subsequent plan years.

Under the terms of the QACA, the employer must make **either** matching or nonelective contributions according to the following terms.

1. **Matching contributions.** The employer must make matching contributions on behalf of each NHCE in the following amounts.
    a. 100% of elective deferrals, **up to** 1% of the NHCE's compensation
    b. 50% of elective deferrals that **exceed** 1% but do not exceed 6% of the NHCE's compensation
    c. The rate of matching contributions for HCEs, including a self-employed owner, must not exceed the rates for NHCEs.

    Other formulas may be used as long as they are at least as favorable to NHCEs.
2. **Nonelective contributions.** The employer must make nonelective contributions on behalf of every NHCE eligible to participate in the plan, regardless of whether they elected to participate, in an amount equal to at least 3% of their compensation.

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58. Ibid.

59. Ibid.

60. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans).*

All accrued benefits attributed to matching or nonelective contributions under the QACA must be 100% vested for all employees who complete two years of service. These contributions are subject to special withdrawal restrictions (not covered in this text).

NOTIFICATION AND REPORTING REQUIREMENTS[61]

Employee Notification Requirements

Every plan year, the employer **must** provide each eligible employee with an information notice regarding the plan that satisfies both content and timing requirements. The notice must be accurate and comprehensive enough to inform the employee of their rights and obligations under the plan and be written in a manner that should be understood by the average employee eligible to participate in the plan. Generally, the company must distribute the notice between 30 and 90 days before the beginning of the plan year.[62]

When automatic enrollment is being used (EACA or QACA), the employer must inform the employee of the level of elective contributions that will be made on the employee's behalf if the employee does not make an affirmative election. Additionally, employees must be informed of their rights to not have elective contributions made on their behalf or to elect a different percentage. If the employee does not provide an investment election, the notice must explain how contributions will be invested. Finally, the notice should be provided to employees in sufficient time for them to exercise their rights under an EACA plan or to make contribution and investment elections under the QACA.[63]

> **Note.** For further information on employee notification requirements, see **uofi.tax/18b5x1** [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-notices].

Annual Reporting

Safe harbor 401(k) plans (that are not also solo 401(k) plans) **must** file an annual report regardless of the value of the assets in the plan.[64] The annual report must be filed electronically using one of the following.

- Form 5500, *Annual Return/Report of Employee Benefit Plan*
- Form 5500-SF, *Short Form Annual Return/Report of Small Employee Benefit Plan*

Form 5500-SF is a simplified reporting form. It can only be filed when the plan meets **all** of the following conditions.

1. There are fewer than 100 plan participants at the beginning of the plan year.
2. The plan is exempt from the requirement that its books and records be audited by an independent public accountant.
3. All the plan assets are invested in certain secure investments with a readily determinable fair value.
4. The plan does not invest in employer securities.
5. The plan is not a multi-employer plan.

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61. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans).*
62. Treas. Reg. §1.401(k)-3(d).
63. Treas. Reg. §1.401(k)-3(k)(4).
64. Instructions for Form 5500.

TESTING REQUIREMENTS[65]

Unlike traditional 401(k) plans, safe harbor 401(k) plans are **not** subject to complex annual nondiscrimination tests.

ADVANTAGES AND DISADVANTAGES OF A SAFE HARBOR 401(k) PLAN

The **advantages** of safe harbor 401(k) plans include the following.

- Suitable for businesses with employees
- Not subject to nondiscrimination testing
- Employees may make elective deferrals
- Can include an automatic contribution arrangement for eligible employees

The **disadvantages** of safe harbor 401(k) plans include the following.

- Annual report always required
- Potentially onerous employee notification requirements

SIMPLE 401(k) PLAN[66]

Similar to the SIMPLE IRA plan, a SIMPLE 401(k) plan is a retirement plan option for an employer with 100 or fewer employees. Like the SIMPLE IRA, the SIMPLE 401(k) plan **allows the employee to elect** to contribute a percentage of their salary each pay period. **Employer contributions** are also **required.** Unlike a SIMPLE IRA, a SIMPLE 401(k) plan may allow participants to borrow funds from their accounts. Another difference is that annual reporting is required for SIMPLE 401(k) plans.

An exclusive plan requirement applies, whereby SIMPLE 401(k) plan participants cannot also participate in another qualified plan maintained by the same employer.[67] An employer with a SIMPLE 401(k) plan that fails to be eligible in a subsequent year because they exceeded the 100-employee rule can nevertheless be treated as an eligible employer for the two years following the last year the employer was an eligible employer.[68] However, this 2-year grace period may not apply if such failure is due to any acquisition, disposition, or similar transaction involving the employer.[69]

ESTABLISHING A SIMPLE 401(k) PLAN

Establishing a SIMPLE 401(k) plan involves following the same rules and requirements as any other traditional 401(k) plan (see the solo 401(k) section).

65. *401(k) Plan Overview*. Nov. 27, 2017. IRS. [www.irs.gov/retirement-plans/plan-sponsor/401k-plan-overview] Accessed on Feb. 2, 2018.

66. *Choosing a Retirement Plan: SIMPLE 401(k) Plan*. Jan. 6, 2018. IRS. [www.irs.gov/retirement-plans/choosing-a-retirement-plan-simple-401k-plan] Accessed on Feb. 2, 2018; IRS Pub. 560, *Retirement Plans for Small Business.*

67. Treas. Reg. §1.401(k)-4(c).

68. Treas. Reg. §1.401(k)-4(b)(2).

69. Ibid.

CONTRIBUTIONS

Like other 401(k) plans, SIMPLE 401(k) plans accept both employee and employer contributions. Importantly, a SIMPLE 401(k) plan is not subject to the nondiscrimination and top-heavy rules if the following conditions are met.[70]

1. Employees can make **elective deferrals** up to 100% of compensation, not to exceed the annual contribution limit. (In 2018, the limit is $12,500, or $15,500 if the employee is age 50 or over and the plan allows catch-up contributions.[71])
2. In 2018, no more than $275,000[72] of the employee's compensation can be taken into account in calculating matching contributions and nonelective contributions.
3. The employer must either make:
   a. **Matching contributions** up to 3% of compensation for the year, or
   b. **Nonelective contributions** of 2% of compensation on behalf of each eligible employee who has at least $5,000 of compensation for the year.
4. No other contributions can be made to the plan.
5. No contributions are made, and no benefits accrue, under any **other** qualified retirement plan sponsored by the employer on behalf of any employee eligible to participate in the SIMPLE 401(k) plan.
6. Employees vest in all contributions immediately.

Plan contributions are generally applied to the year in which they are made. However, they can be applied to the previous year if **all** the following requirements are met.[73]

1. They are made by the due date of the tax return for the previous year (plus extensions).
2. The plan was established by the end of the previous year.
3. The plan treats the contributions as though it had received them on the last day of the previous year.
4. The contributor accomplishes **both** of the following.
   a. Specifies in writing to the plan administrator or trustee that the contributions apply to the previous year.
   b. The contributions are deducted on the previous year's tax return. (A partnership shows contributions for partners on Form 1065.)

70. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

71. IRS News Release IR-2017-177 (Oct. 19, 2017).

72. Ibid.

73. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

NOTIFICATION AND REPORTING REQUIREMENTS

Employee Notification Requirements

Similar to the SIMPLE IRA, the employer with a SIMPLE 401(k) plan is required to provide the following information to each employee before the beginning of the election period.[74]

- The employee's opportunity to make or change a salary reduction choice
- The employer's decision to make either matching contributions or nonelective contributions
- A summary description provided by the financial institution
- Written notice that the employee's balance can be transferred without cost or penalty if they use a designated financial institution

The **election period** is generally the 60 days immediately preceding January 1 (November 2 to December 31 of the preceding calendar year). However, these dates are modified if the employer establishes the SIMPLE 401(k) plan midyear or if the 60-day period falls before the first day an employee becomes eligible to participate in the plan.

Annual Reporting

SIMPLE 401(k) plans (that are not also solo 401(k) plans) must file an annual report regardless of the value of the assets in the plan. Generally, the annual report can be filed electronically using Form 5500-SF if the plan meets **all** the following conditions.

- There are fewer than 100 participants at the beginning of the plan year.
- The plan's books and records are not subject to independent audit requirements.
- All the plan assets are invested in certain secure investments with a readily determinable fair value.
- The plan does not invest in employer securities.
- The plan is not a multi-employer plan.

TESTING REQUIREMENTS[75]

Like safe harbor 401(k) plans, SIMPLE 401(k) plans are not subject to the complex annual nondiscrimination tests that apply to traditional 401(k) plans.

ADVANTAGES AND DISADVANTAGES OF A SIMPLE 401(k) PLAN

The **advantages** of a SIMPLE 401(k) plan include the following.

- Employees may make salary reduction contributions.
- Nondiscrimination testing is not required.
- Employees are immediately vested in all contributions.
- An employer can make nonelective contributions or matching contributions.

The **disadvantages** of a SIMPLE 401(k) plan include the following.

- It is only for employers with 100 or fewer employees.
- An annual report is always required.
- Participating employees cannot also participate in other pension plans from the same employer.

74. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

75. *401(k) Plan Overview*. Nov. 27, 2017. IRS. [www.irs.gov/retirement-plans/plan-sponsor/401k-plan-overview] Accessed on Feb. 2, 2018.

TAX CREDITS

SMALL EMPLOYER PENSION PLAN STARTUP COSTS CREDIT

Under IRC §45E, an **eligible employer** can claim a tax credit equal to 50% of up to $1,000 of **qualified pension plan start-up costs** paid or incurred by the employer during the year. The $500 maximum credit can be claimed in the first credit year and in each of the two subsequent years. The first credit year cannot be earlier than the year immediately preceding the tax year when the plan became effective.

For this purpose, eligible employer pension plans include §401(a) qualified pension plans and SEP and SIMPLE IRAs.[76]

An **eligible employer** is one with no more than 100 employees who were each paid at least $5,000 by the employer during the preceding year.[77] At least one of those employees must be non-highly compensated.[78] An employer is ineligible if they had a plan in which substantially the same employees participated during the three tax years immediately preceding the first credit year. For this purpose, the definition of an employer includes a member of any controlled group including the employer (or any predecessor of either).[79]

Qualified start-up costs include those incurred in establishing and administering the plan and educating employees regarding the plan.

The credit is claimed on Form 8881, *Credit for Small Employer Pension Plan Startup Costs*, and is part of the general business credit. If the credit cannot be currently used, there are carryback and carryforward provisions but in no case can the credit be carried back to a tax year beginning before January 1, 2002.[80]

For any tax year, an employer may choose to **either** claim a credit or deduction for these start-up expenses.[81]

CREDIT FOR QUALIFIED RETIREMENT SAVINGS CONTRIBUTIONS[82]

Employee and self-employed **elective** deferrals qualify for the qualified retirement savings contributions credit (also called the saver's credit).[83] The credit's 2018 income limit is $63,000 for married couples filing jointly (MFJ); $47,250 for heads of household; and $31,500 for single taxpayers and married individuals filing separately. The maximum saver's credit is $1,000 ($2,000 for MFJ taxpayers) and must be claimed on Form 8880, *Credit for Qualified Retirement Savings Contributions*. **Employer** contributions to retirement plans do not qualify for this credit.

> **Note.** For more information about who is eligible for the credit, eligible retirement plans, and calculating the credit, see the instructions to Form 8880.

KEY FEATURES DISTINGUISHING SMALL BUSINESS RETIREMENT PLANS

The following table provides a list of key features that distinguish the retirement plans discussed thus far in this chapter. The limits shown apply to 2018 deferrals and contributions.

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76. IRC §§45E(d)(2) and 4972(d)(1)(A).

77. IRC §§45E(c)(1) and 408(p)(2)(C)(i).

78. IRC §45E(d)(1)(B); Highly compensated employees are defined in IRS Pub. 560, *Retirement Plans for Small Business.*

79. IRC §45E(c)(2).

80. *Retirement Plans Startup Costs Tax Credit*. Aug. 27, 2017. IRS. [www.irs.gov/retirement-plans/retirement-plans-startup-costs-tax-credit] Accessed on Feb. 12, 2018.

81. Ibid.

82. IRC §25B; *Retirement Savings Contributions Credit (Saver's Credit)*. Oct. 26, 2017. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-savings-contributions-savers-credit] Accessed on Feb. 2, 2018.

83. *Retirement Savings Contributions Credit (Saver's Credit)*. Oct. 26, 2017. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-savings-contributions-savers-credit] Accessed on Feb. 2, 2018.

	SEP IRA	SIMPLE IRA	Solo 401(k)	Safe Harbor 401(k)	SIMPLE 401(k)
Number of employees	No upper limit	100 or less	Business owners and spouses only	No upper limit	100 or less
Employee eligibility requirements	Broad	Employer friendly	N/A	Broad	Broad
Employee elective deferrals maximum	N/A (except for pre-1997 SARSEPs)	$12,500	$18,500	$18,500	$12,500
Catch-up contributions (if age 50 or older)	N/A	$3,000	$6,000	$6,000	$3,000
Employer contributions	From zero to a maximum of the lesser of: • $55,000, or • 25% of employee's compensation (up to $275,000)	• **Matching** up to 3% of each participant's pay, **or** • **Nonelective** of 2% of employee's pay (up to $275,000)	From zero to a maximum of the lesser of: • $55,000, or • 25% of employee's compensation	• **Matching** up to 3% of each participant's pay and 50% of each NHCE's elective deferrals that exceed 3% but do not exceed 5%, **or** • **Nonelective** of 3% of employee's pay	• **Matching** up to 3% of each participant's pay (up to $275,000), **or** • **Nonelective** of 2% of participant's pay (up to $275,000)
Loans from plan allowed	No	No	Yes, subject to plan rules	Yes, subject to plan rules	Yes, subject to plan rules
Annual reporting requirements	Generally not required	None	Yes, if $250,000 or more in plan assets	Yes	Yes
Testing requirements	Subject to top-heavy plan requirements	None	None (if no other employees)	None	None

TRADITIONAL IRA[84]

An individual retirement arrangement (IRA) is a trust or custodial account established in the United States for the exclusive benefit of the taxpayer or their beneficiaries. The trustee or custodian of the IRA must be a bank, a federally insured credit union, a savings and loan association, or an entity approved by the IRS.

Traditional IRAs were introduced by the Employee Retirement Income Security Act of 1974 (ERISA)[85] so that taxpayers could annually contribute to a pension plan under their direct control. Contributions to these plans may be tax deductible, and taxes on accumulating income are deferred until plan distributions take place. Annual required minimum distributions (RMDs) must be made starting in the year when the traditional IRA account holder reaches age 70½; however, the first RMD can be delayed until April 1 of the year following the year the taxpayer attains age 70½.[86] Subsequent annual RMDs must be made by December 31 of each year. If the first distribution is made in the following year before April, this will result in two RMDs in the same tax year. The amount of the RMD is calculated based on the balance on December 31 of the prior year divided by a life expectancy factor.[87]

Taxpayers can make IRA and other pension plan contributions concurrently. Provided that neither the taxpayer nor the spouse are covered by an employer's retirement plan, a deductible traditional IRA contribution can be made up to the **general contribution limit,** regardless of the taxpayer's modified adjusted gross income (MAGI). However, taxpayers or their spouses who are covered by an employer's retirement plan may have a limited tax deduction, as explained later. All taxpayers, regardless of income, may make nondeductible contributions to a traditional IRA.

ELIGIBLE TAXPAYERS

To contribute to a traditional IRA, the taxpayer must be under the age of 70½ at the end of the tax year and must have taxable compensation, which includes the following types of income.

- Wages, salaries, tips, professional fees, bonuses, and other amounts received for providing personal services
- Commissions
- SE income
- Nontaxable combat pay
- Taxable alimony and separate maintenance payments

Note. For divorce decrees and separate maintenance agreements entered into or modified after December 31, 2018, the Tax Cuts and Jobs Act repeals the deduction for alimony and separate maintenance payments by the payor spouse and the inclusion in income by the recipient spouse. For divorces after 2018, alimony is not included in the definition of compensation under IRC §219 as amended by the TCJA. For more information, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 5: Divorce.

84. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*.

85. PL 93-406 (Sep. 2, 1974).

86. *Retirement Plan and IRA Required Minimum Distributions FAQs*. Nov. 16, 2017. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-required-minimum-distributions#3] Accessed on Feb. 20, 2018.

87. Ibid.

CONTRIBUTIONS

For 2018, the **general contribution limit** applicable to **all** of a taxpayer's **traditional and Roth** IRA contributions is the lesser of:

- $5,500 ($6,500 for taxpayers 50 or older before the end of the year),[88] or
- The taxpayer's taxable compensation for the year.

The IRA deduction is an adjustment to gross income[89] and is entered on Form 1040, Schedule 1.

SCHEDULE 1 (Form 1040)

Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

▶ Attach to Form 1040.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2018
Attachment Sequence No. 01

Name(s) shown on Form 1040 | **Your social security number**

Additional Income	1–9b	Reserved			1–9b
	10	Taxable refunds, credits, or offsets of state and local income taxes			10
	11	Alimony received			11
	12	Business income or (loss). Attach Schedule C or C-EZ			12
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			13
	14	Other gains or (losses). Attach Form 4797			14
	15a	Reserved			15b
	16a	Reserved			16b
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			17
	18	Farm income or (loss). Attach Schedule F			18
	19	Unemployment compensation			19
	20a	Reserved			20b
	21	Other income. List type and amount ▶			21
	22	Combine the amounts in the far right column. If you don't have any adjustments to income, enter here and include on Form 1040, line 6. Otherwise, go to line 23			22
Adjustments to Income	23	Educator expenses	23		
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	24		
	25	Health savings account deduction. Attach Form 8889	25		
	26	Moving expenses for members of the Armed Forces. Attach Form 3903	26		
	27	Deductible part of self-employment tax. Attach Schedule SE	27		
	28	Self-employed SEP, SIMPLE, and qualified plans	28		
	29	Self-employed health insurance deduction	29		
	30	Penalty on early withdrawal of savings	30		
	31a	Alimony paid **b** Recipient's SSN ▶	31a		
	32	IRA deduction	32		
	33	Student loan interest deduction	33		
	34	Reserved	34		
	35	Reserved	35		
	36	Add lines 23 through 35			36

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2018**

88. IRS News Release IR-2017-177 (Oct. 19, 2017).

89. IRC §62(a)(7).

Spousal IRA

Married couples filing jointly may use the Kay Bailey Hutchison Spousal IRA rules[90] to facilitate a spouse's IRA contribution by using the working spouse's compensation. The general contribution limit for a spousal IRA is the lesser of:

- $5,500 ($6,500 for spouses 50 or older before the end of the year),[91] **or**
- The combined compensation of both spouses includable in gross income for the year, reduced by any IRA contributions (traditional or Roth) made by the other spouse for the year.

Example 7. On December 31, 2018, Tom and Betty Flynn are married taxpayers aged 73 and 69, respectively. During 2018, Tom receives only retirement income. Betty has $5,000 of taxable compensation. Tom makes a timely 2018 contribution to Betty's IRA. Although Tom is over age 70½, the IRA contribution is tax deductible because the beneficiary (Betty) is under age 70½. However, the maximum contribution cannot exceed $5,000 (Betty's taxable compensation).

Example 8. On December 31, 2018, Elena and Kevin Simpson are married taxpayers aged 46 and 50, respectively. Elena and Kevin have $10,000 and $5,000 of 2018 taxable compensation, respectively. Elena makes a $5,500 timely 2018 contribution to her IRA. Kevin would like to make the maximum allowable 2018 contribution to his IRA. Although the general contribution limit for Kevin is $6,500, he only has $5,000 of taxable 2018 compensation. Fortunately, Elena has $4,500 ($10,000 − $5,500) of available taxable compensation that Kevin can use to facilitate the remaining $1,500 of his $6,500 IRA contribution for 2018.

5

Workplace Retirement Plan Participation

When the taxpayer or spouse are covered by an employer's retirement plan, the tax deduction for an IRA contribution may be less than the general contribution limit.[92] In such case, the following factors determine the tax deductibility.

1. The taxpayer's filing status
2. The taxpayer's MAGI[93]

The following table provides the MAGI phaseout ranges for 2018.[94]

Filing Status	Covered by Employer Retirement Plan: Taxpayer	Covered by Employer Retirement Plan: Spouse	2018 MAGI Phaseout Range
Single	X	N/A	$ 63,000– 73,000
MFJ	X	X	101,000–121,000
MFJ	X		101,000–121,000
MFJ		X	189,000–199,000
HoH	X	N/A	63,000– 73,000
MFS	X	N/A	0– 10,000

90. IRC §219(c).

91. IRS News Release IR-2017-177 (Oct. 19, 2017).

92. IRC §219(g).

93. See IRC §219(g)(3)(A) and IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs).*

94. IRS News Release IR-2017-177 (Oct. 19, 2017).

The mechanism for calculating the tax-deductible amount of IRA contributions made by taxpayers falling in the MAGI phaseout ranges is detailed in IRS Pub. 590-A, along with some examples. Generally, the maximum 2018 tax deduction is calculated by determining the difference between the taxpayer's MAGI and the MAGI phaseout range ceiling multiplied by a fraction, the numerator of which is the maximum possible IRA deduction and the denominator of which is the income phaseout range. The following example illustrates this calculation.

Example 9. Jack and Jill Summers are joint filers, who are both age 46. They are both employed but only Jack is covered by an employer's retirement plan. Jack's 2018 salary is $40,000 and Jill's is $70,000. They each have a traditional IRA and their combined modified 2018 AGI is $115,000 ($40,000 + $70,000 + $5,000 of investment income). Jack and Jill each make a $5,500 contribution to their respective IRAs for 2018.

As shown in the preceding table, the applicable MAGI phaseout range for calculating Jack's maximum IRA tax deduction is $101,000–$121,000.

Jack's 2018 IRA tax deduction is calculated as follows (see IRS Pub. 590-A, worksheet 1-2).

MAGI phaseout range ceiling	$121,000
Less: MAGI	(115,000)
Difference	$ 6,000
Maximum tax deduction: $6,000 × ($5,500 ÷ $20,000)	$ 1,650

Consequently, Jack can choose to take a tax deduction of no more than $1,650 of his $5,500 IRA contribution.

The applicable MAGI phaseout range for calculation of Jill's maximum IRA tax deduction is $189,000 − $199,000. Because the bottom end of this range is higher than the couple's MAGI, Jill may choose to deduct her entire $5,500 IRA contribution.

Note. For taxpayers with a MAGI less than the applicable ranges in the preceding table, the maximum tax-deductible amount is equal to the IRA general contribution limit. A taxpayer or their spouse covered by an employer's retirement plan with a MAGI exceeding the top of the applicable range cannot make tax-deductible IRA contributions.

Nondeductible Contributions

Taxpayers whose MAGI exceeds the applicable phaseout range may make nondeductible IRA contributions if they do not exceed the nondeductible limit for that year. The nondeductible limit is the excess of the general contribution limit less any IRA contribution correctly treated as tax deductible.[95] Additionally, taxpayers may elect to designate as nondeductible some or all of an otherwise deductible IRA contribution.

Example 10. Stella Grundy, a 55-year-old single filer with $35,000 of 2018 taxable compensation, would like to make the maximum possible 2018 IRA contribution but she only wants to deduct $2,000. The maximum 2018 IRA contribution of $6,500 is defined by the general contribution limit. The entire $6,500 could be treated as tax deductible because Stella's income falls below the MAGI phaseout threshold. However, Stella chooses to deduct only $2,000, so her nondeductible limit is $4,500 ($6,500 − $2,000).

95. IRC §408(o)(2).

Because nondeductible IRA contributions are made from after-tax funds, they represent cost basis to the taxpayer. However, to establish this cost basis, the taxpayer must complete and file Form 8606, *Nondeductible IRAs*, with their tax return.[96] IRA distributions that represent cost basis are not taxed.[97] Furthermore, the cost basis in an inherited IRA remains with the IRA even after the death of the account owner.[98]

Excess Contributions

Contributions made in excess of the general IRA contribution limit are considered excess contributions and are subject to a 6% penalty,[99] which is reported on Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*. This penalty cannot exceed 6% of the combined yearend value of all the taxpayer's IRAs. This penalty continues to apply each year to these excess contributions until the year they are withdrawn.[100]

The excess contribution to traditional IRAs is the difference between the amount contributed to those IRAs and the taxpayer's general contribution limit.[101]

TAX CREDITS

Contributions made to a traditional IRA qualify for the qualified retirement savings contributions credit (saver's credit).[102]

ADVANTAGES AND DISADVANTAGES OF A TRADITIONAL IRA

The **advantages** of a traditional IRA include the following.

- Choice of deductible and/or nondeductible contributions
- Nondeductible contributions not subject to the MAGI phaseout
- Deductible contributions not subject to the MAGI phaseout if neither the taxpayer nor spouse are covered by an employer's retirement plan

The **disadvantages** of a traditional IRA include the following.

- Contributors must be under the age of 70½ at the end of the tax year
- Contributions limited to taxable compensation
- RMDs are required when the traditional IRA owner reaches age 70½

96. IRC §408(o)(4).
97. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs).*
98. Ibid.
99. IRC §4973(a).
100. IRC §4973(b).
101. IRC §4973(b)(1).
102. IRS Pub. 4703, *Retirement Savings Contributions Credit*.

ROTH IRA[103]

Roth IRAs differ from traditional IRAs in five fundamental ways.[104]

1. Contributions are not tax deductible.[105]
2. There is no upper age limit on contributing taxpayers.[106]
3. Qualifying distributions are excluded from gross income.[107]
4. Contributions are not reported on the contributor's tax return unless the saver's credit is being claimed.
5. No withdrawals are required until after the owner's death.[108]

Note. A taxpayer must designate the account as a Roth IRA when it is opened.

A taxpayer must have taxable compensation (as defined in the "Traditional IRA" section of this chapter) to fund Roth IRA contributions.

CONTRIBUTIONS

The general contribution limit applies to all IRAs (traditional or Roth).[109] However, the Roth IRA contribution limit requires that the taxpayer first reduce the general contribution limit by any traditional IRA contributions made.[110]

Example 11. Sally Scrimpy, a 60-year-old single filer with $5,500 of 2018 taxable compensation, would like to make a $4,000 traditional IRA contribution and a $2,000 Roth IRA contribution for 2018. Sally's general contribution limit is $5,500 (lesser of compensation and $6,500). If Sally makes a $4,000 traditional IRA contribution, her Roth IRA contribution limit is $1,500 ($5,500 general contribution limit − $4,000 traditional IRA contribution). Therefore, Sally can only make a $1,500 Roth IRA contribution for 2018.

The Roth IRA contribution limit is reduced for **all** taxpayers whose MAGI falls within the ranges shown in the following table. [111]

Filing Status	2018 MAGI Phaseout Ranges
Single or HoH	$120,000–135,000
MFJ	189,000–199,000
MFS (lived with spouse)	0– 10,000
MFS (lived apart from spouse)	120,000–135,000

103. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*.

104. IRC §408A.

105. IRC §408A(c)(1).

106. IRC §408A(c)(4).

107. IRC §408A(d).

108. *Retirement Plan and IRA Required Minimum Distributions FAQs*. Nov. 16, 2017. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-required-minimum-distributions#3] Accessed on Feb. 20, 2018.

109. IRC §408A(c)(2).

110. Ibid.

111. *Amount of Roth IRA Contributions That You Can Make for 2018.* Oct. 20, 2017. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/amount-of-roth-ira-contributions-that-you-can-make-for-2018] Accessed on Feb. 8, 2018.

For purposes of a Roth IRA, MAGI is defined as follows.[112]

	AGI
–	Income resulting from the conversion of a traditional IRA to a Roth IRA
–	Income resulting from the rollover of a qualified retirement plan to a Roth IRA
+	Traditional IRA deduction
+	Student loan interest deduction
+	Tuition and fees deduction
+	Domestic production activities deduction [a]
+	Foreign-earned income exclusion and/or housing exclusion
+	Foreign housing deduction
+	Excludable qualified savings bond interest
+	Excluded employer-provided adoption benefits
	MAGI

[a] This deduction is not available for tax years beginning after December 31, 2017.

Worksheets 2-1 and 2-2 from IRS Pub. 590-A can be used to determine MAGI for Roth IRA purposes and to calculate the reduced Roth IRA contribution limit, if applicable.

Taxpayers with a MAGI exceeding the phaseout ranges cannot make Roth IRA contributions.

Note. Under certain circumstances, a traditional IRA can be converted into a Roth IRA.[113] Such conversions are considered rollovers and are beyond the scope of this chapter. For more information, see IRS Pub. 590-A.

Spousal Roth IRA

The spousal IRA rules described in the "Traditional IRA" section also apply to Roth IRAs.

Excess Contributions

Contributions made in excess of the general or Roth IRA contribution limits are considered excess contributions and are subject to a 6% penalty,[114] which is reported on Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*. This penalty cannot exceed 6% of the combined yearend value of all the taxpayer's IRAs. This penalty continues to apply each year to these excess contributions until the year they are withdrawn.[115]

The excess contribution to Roth IRAs is calculated as follows.

1. Current year contributions to Roth IRAs that are more than the Roth contribution limit for the year, plus
2. Any excess contributions for the preceding year, reduced by the total of:
    a. Any Roth IRA distributions for the year, plus
    b. The general contribution limit for the year less all IRA contributions for the year.

112. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*.

113. IRC §408A(d)(3).

114. IRC §4973(a).

115. IRC §4973(b).

IRA contributions withdrawn by the due date of the tax return (including extensions) are not considered distributions provided that no deduction is claimed and the amount withdrawn includes the net income attributable to those contributions.[116] Such net income is reported on the tax return for the year **to which the contribution relates** and may be subject to the 10% early distribution penalty.[117]

> **Caution.** Including the income earned on excess contributions increases MAGI, and accordingly, reduces the deductible contributions. The circular nature of this calculation must be taken into account when determining the amount of excess contributions to withdraw.

When a tax return with an IRA contribution is timely filed (excluding extensions), the IRA contribution can still be returned penalty-free within six months of the original due date.[118] In this case, the taxpayer should file an amended return with "Filed pursuant to section 301.9100-2" written at the top. Any related earnings should be reported on the amended return and an explanation of the withdrawal should be included.[119]

Excess traditional or Roth IRA contributions cannot be applied to an earlier year but may be applied to a later year if the taxpayer contributed less than the contribution limit for that year.[120]

Example 12. On April 20, 2017, when her Roth IRA was worth \$8,000, Anne made a \$7,000 contribution to her IRA for 2017. Because Anne is 40 years old, her maximum contribution is \$5,500. In February 2018, Anne requested that \$1,500 (\$7,000 – \$5,500) excess contribution be returned to her. On February 15, 2018, when the Roth IRA was worth \$15,150, the IRA trustee complied with Anne's request and returned the \$1,500 plus the earnings accumulated on the amount. Anne made no other contributions to the Roth IRA for 2017 and received no other distributions.

The balance of Anne's IRA on April 20, 2017, was \$15,000 (\$8,000 + \$7,000) and the balance on February 15, 2018, was \$15,150. The net income due to the portion of the April 20, 2017 contribution that was returned is \$15 (\$1,500 × (\$15,150 – \$15,000) ÷ \$15,000). Therefore, the total distributed on February 15, 2018, is \$1,515. The \$15 earnings are taxable in 2017 but there is no 6% excess contribution penalty because the \$1,500 (\$7,000 – \$5,500) excess contribution was withdrawn before the tax return due date. There is a 10% penalty on the \$15 of earnings.

Example 13. Tom aged 60, made contributions of \$8,000 to his Roth IRA for both 2017 and 2018. In 2017, Tom received a \$1,000 distribution from his Roth IRA (which was not a return of his 2017 contribution). No further Roth IRA distributions were made after that.

For 2017, Tom had an excess contribution of \$1,500 (\$8,000 – \$6,500 general contribution limit). For 2018, Tom had an excess contribution of \$2,000. This is calculated as follows.

2018 excess contribution (\$8,000 − \$6,500 general contribution limit)	\$1,500
2017 excess contribution (\$8,000 − \$6,500 general contribution limit − \$1,000 distribution)	500
Total excess contribution for 2018	\$2,000

Tom is subject to an excise tax on these excess contributions of \$90 (\$1,500 × 6%) for 2017 and \$120 (\$2,000 × 6%) for 2018.

116. IRC §408(d)(4).

117. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*; IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*.

118. Treas. Reg. §301.9100-2.

119. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*.

120. Ibid.

TAX CREDITS

Contributions made to a Roth IRA qualify for the saver's credit (discussed earlier).[121]

ADVANTAGES AND DISADVANTAGES OF A ROTH IRA

The **advantages** of a Roth IRA include the following.

- No upper age limit on contributing taxpayers
- Qualifying distributions are entirely excluded from gross income
- Contributions not reported on tax return

The **disadvantages** of a Roth IRA include the following.

- No tax deduction available for contributions
- Contributions subject to an income limit

KEY FEATURES DISTINGUISHING TRADITIONAL AND ROTH IRAs

The following table provides a list of key features that distinguish traditional and Roth IRAs.

	Traditional IRA	Roth IRA
Tax deductible contributions	Yes	No
Income ceiling for nondeductible contributions	No	Yes
Tax reporting of contributions required	Yes	No
Upper age limit for making contributions	Under age 70½ at end of year	None
Distributions taxable	Yes (except for return of nondeductible contributions)	No (to the extent of qualifying distributions)

RETIREMENT PLAN DECISION FLOWCHARTS

The following flowcharts were developed from the material in this chapter, particularly the two tables listing key features distinguishing small business retirement plans and traditional/Roth IRAs. These flowcharts are intended to aid small business taxpayers in choosing appropriate retirement savings plans.

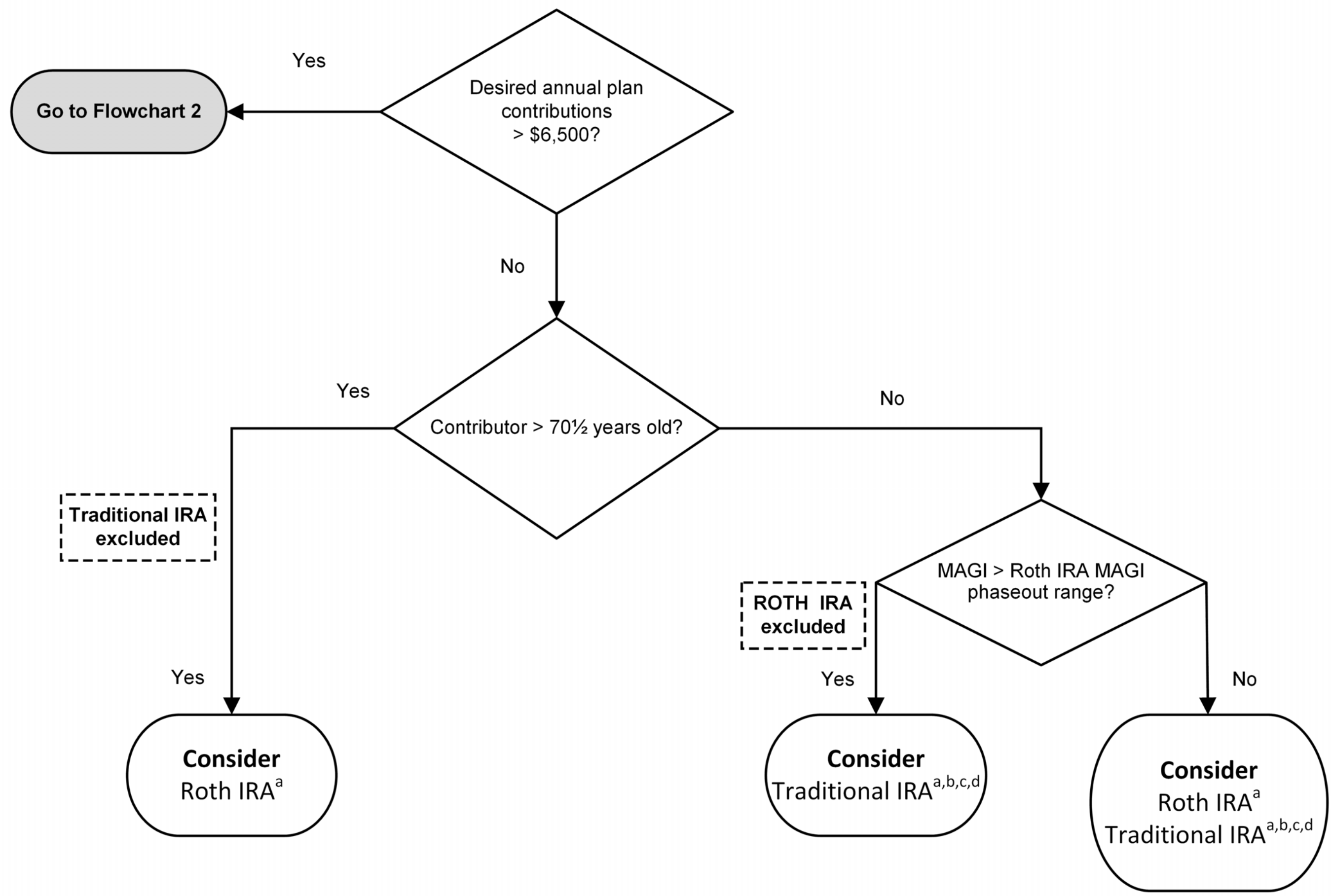
Flowchart 1 is appropriate for small business owners without employees who want to make annual retirement plan contributions that do not exceed $6,500 for themselves.

Flowchart 2 is aimed at small business owners without employees who want to make annual retirement plan contributions exceeding $6,500 for themselves.

Flowchart 3 is suitable for small business owners with employees.

121. Ibid.

2018 Retirement Plan Decision Flowcharts for Small Business Owners
Flowchart 1 – Annual contributions less than $6,500

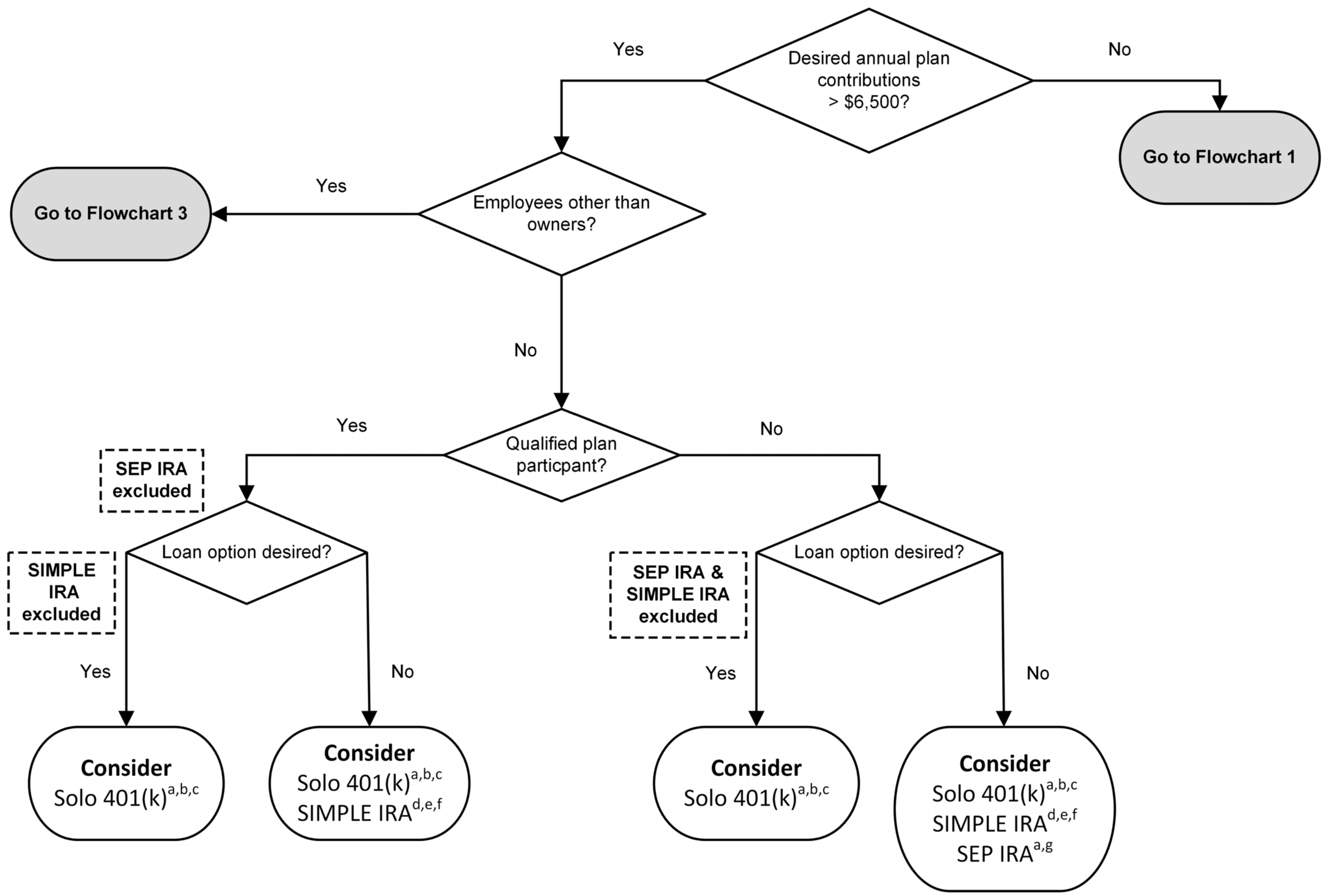


Notes

a. $6,500 annual general contribution limit on aggregate contributions to traditional and Roth IRAs for contributors aged 50 or older; $5,500 annual general contribution limit for other contributors.
b. Unlike Roth IRA contributions, nondeductible contributions to traditional IRAs are not subject to income limitations.
c. No income limit for deductible contributions if neither the taxpayer nor spouse are covered by a workplace retirement plan.
d. Lower MAGI limits may apply to tax-deductible contributions for contributors participating in a qualified plan.

2018 Retirement Plan Decision Flowcharts for Small Business Owners

Flowchart 2 – Annual contributions over $6,500



Notes

a. Employer contributions up to 25% of employee pay subject to the $55,000 overall limit on contributions.
b. No annual reporting requirements if plan assets < $250,000 and generally no testing requirements.
c. Annual employee elective deferral ≤ $18,500 ($24,500 if 50 or over) aggregate for **all** qualified plans.
d. Annual employee elective deferral ≤ $12,500 ($15,500 if 50 or over).
e. Annual employer contributions either matching (up to 3% of each participant's pay), **or** nonelective (2% of up to $275,000 of employee's pay).
f. No annual reporting or testing requirements.
g. Annual reporting generally not required but subject to top-heavy plan testing requirements.

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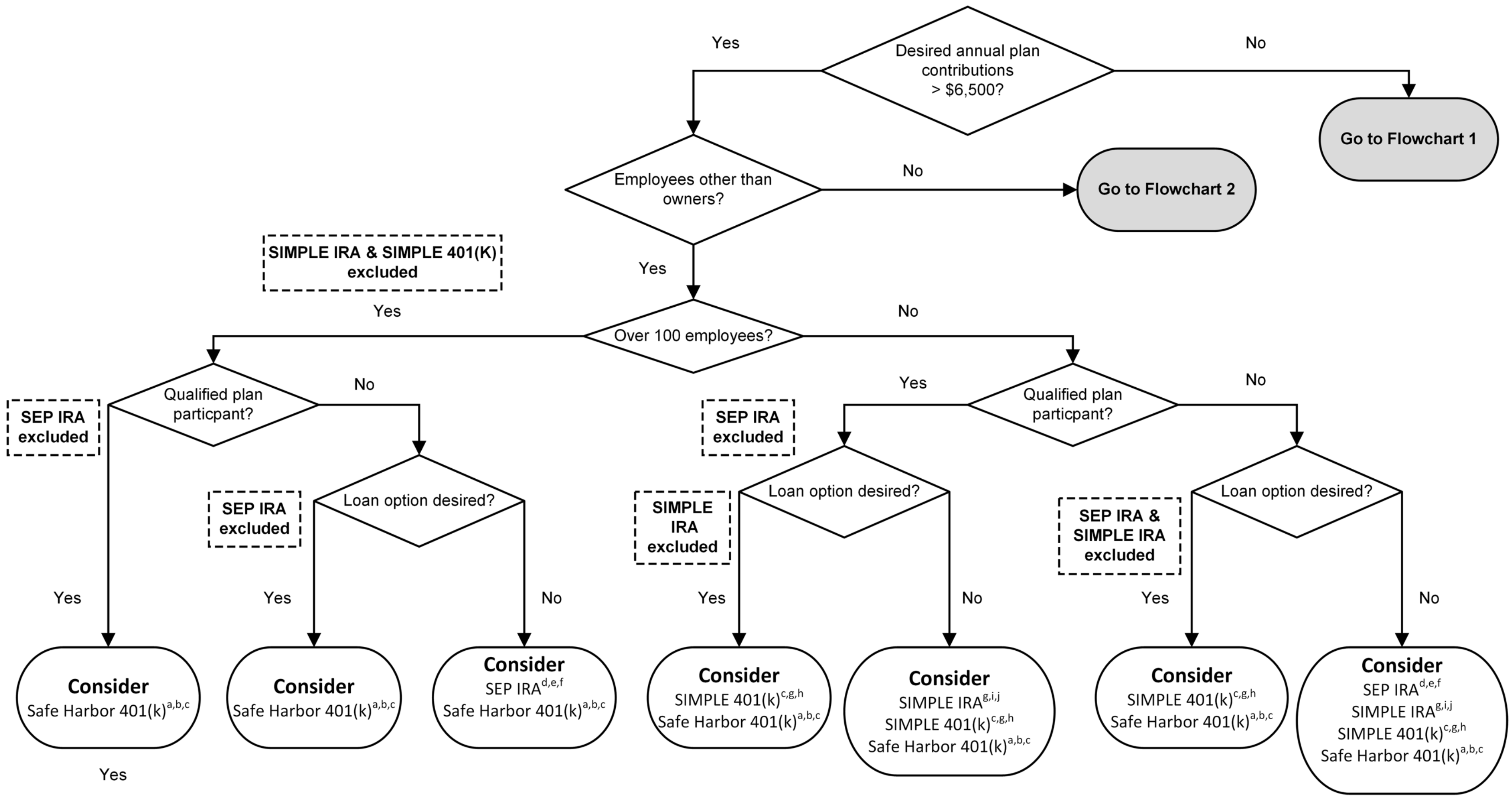
2018 Retirement Plan Decision Flowcharts for Small Business Owners

Flowchart 3 – Owners with employees



Notes

a. Annual employee elective deferral ≤ $18,500 ($24,500 if 50 or over) aggregate for **all** qualified plans.
b. Annual employer contributions either matching (up to 3% of employee's pay + 50% of NHCE elective deferrals between 3% to 5%), **or** nonelective (3% of employee's pay).
c. Subject to annual reporting requirements but not to testing requirements.
d. Employer contributions up to 25% of employee pay subject to the $55,000 annual overall limit on contributions.
e. Funded only by employer contributions (except for pre-1997 SARSEPs).
f. Annual reporting generally not required but subject to top-heavy plan testing requirements.
g. Annual employee elective deferral ≤ $12,500 ($15,500 if 50 or over).
h. Annual employer contributions either matching (up to 3% of each participant's pay), **or** nonelective (2% of each employee's pay who has at least $5,000 of compensation).
i. Annual employer contributions either matching (up to 3% of each participant's pay), **or** nonelective (2% of up to $275,000 of employee's pay).
j. No annual reporting or testing requirements.