CHAPTER 11
RETIREMENT PLANS

Having adequate resources for retirement is of concern to everyone. Social Security was established so that the participants would have a minimum floor of retirement income. Other sources of retirement income will be needed in addition to Social Security.

Retirement plans can be divided into two broad categories—qualified plans and nonqualified plans. Qualified plans must conform to requirements established by the federal government and enjoy favorable tax treatment. Nonqualified plans do not meet these federal guidelines and do not receive favorable tax treatment. Nonqualified plans can limit participation to select employees. In other words, nonqualified plans can be discriminatory as to participation. Qualified plans cannot discriminate in favor of a select few employees.

In a qualified plan, contributions made on behalf of the participants are:

- Deductible as a business expense for the business. This lowers the income tax of the business.
- Not taxable to the employee. Benefits will be taxable to the employee when paid after retirement.
- Allowed to accumulate in the plan on a tax-deferred basis.
- Not included as taxable income to the employee when the employee makes contributions on his/her own behalf into a qualified retirement plan.

The Employee Retirement Income Security Act (ERISA) of 1974 was passed to protect the rights of workers covered by employer-sponsored plans. It established rules and regulations to govern private pension plans including vesting requirements, funding mechanisms, and general plan design and descriptions.

- Participation Standards—All qualified plans must comply with standards in determining employee eligibility. All employees 21 years of age and who have worked one year must be allowed to enroll. Employees working less than 1000 hours a year may be excluded. Two years of work may be required by plans that provide for 100% vesting upon participation.

- Vesting—All qualified plans must satisfy the vesting rules of the Internal Revenue Service. Vesting is the entitlement of a pension plan participant (i.e. employee) to receive benefits from a retirement plan. The vesting schedule spells out the percentage of ownership an employee has in the employer's contributions to the plan. The percentage of ownership in the plan increases as the number of years
worked increases until the employee is 100% vested. Any contributions made by the employee to the plan will vest 100% when made. There are currently two acceptable vesting schedules.

- Cliff Vesting—100% vesting after five years of service
- Graded Vesting—A seven-year graded vesting

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Other alternative schedules for vesting may be used as long as they are not less favorable to the plan participants.

- Funding Requirements—For a plan to be qualified it must be funded. This means the funds are set aside specifically to meet the financial obligation of providing retirement income. These funds will be held and invested by a third party in a funding vehicle. There are federal minimum funding standards requiring an employer's annual contributions are sufficient to cover the benefits payable during the year as well as covering administrative expenses.

- Contributions—There are standards governing the amount and type of contributions that may be made to a plan depending on whether it is a defined benefit or defined contribution plan. All plans restrict the maximum contribution amount that can be made for any one plan participant.

QUALIFIED EMPLOYER PLANS

The two major categories of qualified employer retirement plans are defined contribution and defined benefit. These plans are used by corporations, and corporate pension plans comprise a large portion of existing qualified plans.

Defined Benefit

The defined benefit plan is a retirement plan under which benefits are fixed in advance by formula and contributions vary. The amount of benefit normally is dependent upon years of service or highest salary earned or a combination of these two factors.
A defined benefit plan must meet the following criteria. (1) The plan has to provide for a definitely determinable benefit. (2) The plan has to provide for systematic payment of benefits after retirement. (3) The plan’s primary purpose must be to provide retirement benefits. Any death or disability benefits provided must be incidental to the plan. (4) The maximum benefit amount payable to an employee is limited to an amount established by tax law.

Defined benefit plans are more appropriate for large corporations. Small and medium sized companies are no longer using defined benefit plans as such plans commit the company to pay specific retirement amounts regardless of the present financial performance of the company.

Defined Contribution

Defined contribution plans are retirement plans under which contributions are fixed in advance by formula and benefits vary. The final fund available to a plan participant will depend on the total amount contributed plus interest earned in the account.

Defined contribution plans include profit sharing plans, money-purchase plans, and stock bonus plans.

In a profit sharing plan, the employer makes contributions into the plan only if profits are realized. The plan specifies the amount of contribution as a percentage of the company’s profits (e.g. 25%) up to a percentage of each employee’s salary (e.g. 10% of salary).

In a money-purchase plan, fixed contributions are made with future benefits to be determined.

A stock bonus plan is a retirement plan in which benefits are distributed in the form of stock.

Thrift Savings Plan (TSP)

Federal employees and members of the uniformed services have the opportunity to participate in the Thrift Savings Plan. The TSP is a defined contribution plan and is designed to supplement the normal retirement pay of a federal employee or service member. It is a voluntary plan and the participant may elect to contribute any dollar amount or percentage of income he/she chooses subject to annual maximum amounts ($17,000 for 2012). The advantages are before-tax contributions and tax-deferred investment earnings. The TSP is a portable retirement account that can move with the participant when retiring or leaving federal service.
The assets of the TSP are called the Thrift Savings Fund. There is a diversified choice of investment options including Government Securities Investment Fund, Fixed Income Index Investment Fund, Common Stock Index Investment Fund, Small Capitalization Stock Index Investment Fund, International Stock Index Investment Fund, and Lifecycle Funds. Contributions will be invested in the Government Securities Investment Fund until the participant informs the TSP that another plan of distribution is desired.

Employee Stock Ownership Plan (ESOP)

An ESOP is a type of defined contribution plan. In an ESOP, a company sets up a trust fund into which it contributes new shares of its own stock or cash to buy existing shares. Alternatively, an ESOP can borrow money to buy new or existing shares with the company making cash contributions to the plan to enable it to repay the loan. The company contributions to the trust are tax deductible within certain limits.

Shares in the trust are allocated to individual employee accounts. Generally, all full-time employees over 21 years old participate in the plan. Allocations usually are made on the basis of the employee’s level of compensation. As employees gain seniority with the company, they acquire an increasing right to the shares in their account. Employees must be 100% vested within three to six years (depending on whether vesting is cliff vesting or gradual vesting). When employees leave the company, they receive their stock which the company must buy back from them.

401(K) Plan (Salary Reduction)

The 401(k) is an employer-sponsored retirement savings program named after a section of the Internal Revenue Code that permits it. This plan allows an employee to reduce his/her compensation by a certain percentage and place that amount into the 401(k) plan on a tax deductible and tax deferred basis. Frequently these contributions are matched in some portion by the employer, such as 50 cents for each dollar contributed by the employee.

401(k) plans have special rules applying to them. These are: (1) employee contributions are nonforfeitable; (2) nondiscrimination requirements must be met to keep highly compensated employees from deferring larger amounts of income; and (3) amounts deferred may be distributed only due to retirement, death, disability, sever hardship, separation from service, or attainment of age 59½.

Tax Sheltered Annuity—403(b)

A tax-sheltered annuity (TSA) is an employer-sponsored pension plan for employees of non-profit organizations. Employees of organizations such as
school systems, churches, and hospitals may set aside a portion of their current income by means of an elective deferral or salary reduction. The elective deferral is not taxed currently and will grow tax deferred. When the employee receives the amount at a later date, the full amount will be taxable to the employee.

In 2012 the amount of deferral for both 401(k) and 403(b) plans is $17,000. If the plan participant is 50 or older, an additional $5,500 may be deferred for a total deferral of salary of $22,500.

Code Section 457 Deferred Compensation Plans

Code Section 457 of the Internal Revenue Code allows employees of state and local governments to defer part of compensation without current taxation. Amounts deferred are not included in taxable income until received. In 2012 this amount is $17,000 (not including “catch up” amounts).

QUALIFIED PLANS FOR SMALL BUSINESS

Simplified Employee Pension Plan (SEP)

The Simplified Employee Pension Plan (SEP) was designed for the small employer as it relieves many of the administrative burdens and costs of setting up a qualified plan. Each eligible employee establishes an IRA. The employer contributes specific amounts directly into IRA accounts on behalf of eligible employees. As IRAs are qualified plans, this is an easy way of establishing a pension plan. Employer contributions are not included in the employee’s gross income. The maximum SEP contribution for 2012 is $50,000.

Savings Incentive Match Plans for Employees of Small Employers (SIMPLE Plans)

SIMPLE Plans are available to employers who have no more than 100 employees who received at least $5,000 in annual compensation and the business has no other qualified retirement plan. SIMPLE plans are structured as either IRAs or 401(k) qualified deferred plans. These plans allow employees to make contributions of up to $11,500 in 2012. In future years this limit will be indexed to inflation. If a plan participant is 50 or older, he/she may contribute an additional $2,500 in 2012. In following years this catch-up contribution will be indexed to inflation in $500 increments.

The employer will make contributions to the account of each eligible employee who has earned at least $5,000 during the year. Funds in SIMPLE plans are not taxed until distributed to the employee. Contributions made by the employer are tax deductible for the business.
Individual Retirement Plans

Individuals have a few options available to them in planning for retirement. These include individual retirement accounts, spousal retirement accounts, rollover retirement accounts, and individual annuities.

Individual Retirement Accounts (IRAs)

An IRA can be established by anyone under the age of 70½ who has earned income. The amount of contribution in 2012 is $5,000 or 100% of earned income, whichever is less. If a person is 50 or older, he/she can contribute up to $6,000 in 2012. Contributions into the IRA grow tax deferred until withdrawn. Whether or not the contribution is tax deductible is dependent upon two factors. These are: (1) Is the person covered by an employer-sponsored plan? (2) How much earned income did the person have?

If not covered by an employer-sponsored plan, a person may make up to the allowable contribution and deduct it from current income regardless of present earned income. Married couples who both work and neither is covered by an employer-sponsored plan may each contribute up to the allowable limits and deduct it from present earned income.

If covered by an employer-sponsored plan, the annual adjusted gross income must fall below a certain limit for the contribution to an IRA to be deductible. If a single person earns less than $58,000 or a married couple earns less than $92,000 in 2012, the contribution may be fully deductible. In addition, partial deductions are allowed if the limitations are exceeded, but only up to a certain dollar amount.

A person eligible for an IRA may set up a separate spousal IRA for a non-working spouse. The maximum deductible contribution is the same as for the working spouse.

If a person under the age of 59½ makes a withdrawal from an IRA, the amount will be included in gross income and subject to a penalty of 10%. There are some exceptions to the penalty rule. The exceptions are death, disability, payments for qualified medical expenses in excess of a certain percent of the individual’s adjusted gross income, health insurance premiums (if unemployed more than 12 weeks), and when taken in equal payments over life.

An IRA owner needs to start receiving distributions no later than April 15 following the year in which the age of 70½ is attained. Otherwise, a 50% penalty will be assessed on the distribution not taken.

Any time after age 59½, the IRA owner can elect to take either a lump sum payment or periodic installment payments from the fund. The payment...
received from a deductible contribution and interest earnings is taxable. Any portion of payment attributable to non-deductible contributions is received tax free. If an IRA owner dies before receiving full payment, any remaining funds in the account will be paid to a named beneficiary. The payment to the beneficiary is subject to taxation.

An IRA can be funded by individual retirement annuities, mutual funds, trust accounts, or other financial institution accounts.

Roth IRAs

Contributions to a Roth IRA are not tax deductible. The yearly contribution limits are the same as the traditional IRA. These limits apply to the combined contribution to both a person’s Roth and traditional IRA. However, the amount of contribution to a Roth IRA is based on the person’s modified adjusted gross income (AGI). The higher the AGI, the less that can be contributed. The earnings in the Roth IRA accumulate tax free. Generally the earnings in Roth IRAs can be withdrawn on a tax-free basis. To be received tax free, the account owner must be at least 59½ and the funds had to be held in the account for five years. Roth IRAs do not have distribution requirements as do traditional IRAs.

Rollover IRAs

A rollover occurs when money in an IRA is transferred to a different IRA or when funds are transferred from a qualified retirement plan to an IRA or another qualified plan. Rollovers between IRAs can be made only once in a 12-month period. Transfers between funds within the same family of mutual funds are not considered rollovers.

A person may have received a distribution from a qualified plan and wishes to reinvest the funds in another tax-deferred account to keep from having to pay taxes on the distribution. A distribution from a qualified employer-sponsored plan or an IRA can be reinvested in an IRA within 60 days following distribution and be eligible for a tax-free rollover as long as the participant does not take physical receipt of the distribution. By rolling funds into an individual retirement account, the person has greater investment flexibility. A company plan has a limited investment menu whereas an IRA gives the freedom to select mutual funds and other securities.

A distribution from a qualified plan also may be rolled over into another qualified plan with the consent of the participant’s new employer and provided that the new plan allows for acceptance of such funds.
EDUCATION IRA

An educational IRA (Coverdell Education Savings Account or ESA) offers a simple savings mechanism for future educational expenses. Anyone can establish an ESA for a child/beneficiary and there can be multiple savings accounts established for the same child as long as the $2,000 annual limit is maintained (the total of all accounts). Unless the beneficiary is a special needs student, contributions cannot be made into the account after the beneficiary reaches age 18. The balance of the account must be distributed within 30 days after the beneficiary reaches the age of 30 (unless a special needs student). Distributed amounts are not subject to federal income taxes if they are rolled-over to another ESA for the benefit of another family member under the age of 30.

Contributions to an ESA are not tax deductible, but the money deposited grows tax free. Distributions that are taken for the purpose of paying qualified educational expenses (tuition and fees, required books, supplies and equipment and qualified expenses for room and board) are not subject to tax which saves the beneficiary from paying tax on the fund’s growth. Money withdrawn used for other than educational expenses is subject to taxation and a 10% penalty. Eligible educational institutions can be either post-secondary schools or an eligible elementary or secondary school.

REVIEW QUESTIONS

1. Tax Sheltered Annuities are employer-sponsored pension plans for employees of non-profit organizations.

   A. True
   B. False

2. The entitlement of a pension plan participant to receive benefits from a retirement plan is called the:

   A. Participation schedule
   B. Contribution schedule
   C. Vesting schedule
   D. ERISA
3. Which of the following is/are true about qualified plans?

1. The amount of contribution made on behalf of the employees by the employer is not a taxable expense to the employees in that year.
2. Amounts placed in a qualified plan grow on a tax-deferred basis.
3. Qualified plans may be offered to a select few employees.
4. Employer contributions to a qualified plan are a deductible business expense for the employer.

A. 2 & 4  
B. 1, 2, & 3  
C. 1, 2, & 4  
D. All the above

5. IRAs:

A. Do not grow tax deferred.  
B. Allow for distributions at any age.  
C. Require forfeiture of any remaining funds in the account upon death of the owner.  
D. None of the above.

6. A person who receives a distribution from a qualified plan and wants to reinvest the funds in another tax-deferred account can reinvest those funds in an IRA.

A. True  
B. False