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Qualified Retirement Plans

Qualified retirement plans are Congressionally-approved retirement plans which have several major tax benefits.

- The employer's contributions can be deducted for income tax purposes.
- The earnings on the plan's investments accumulate on a tax-deferred basis.
- When the funds are distributed at retirement age, they may be eligible for favorable tax treatment.[1]
- Taxpayers may be in a lower income tax bracket after retirement.

Two Principal Types of Plans

Qualified retirement plans can generally be classified as either defined benefit or defined contribution plans.[2]

Defined benefit plans: Specify the dollar amount each participant will receive at retirement age and then estimate how much must be contributed each year to accumulate the necessary future fund. Interest rates, ages of participants, etc., will have an effect on the calculation. The amount of the contribution is generally determined by an actuary. The investment risk rests on the employer.

Defined contribution plans: Generally put a percentage of current salaries into the plan each year. The amount at retirement will depend on the amount contributed, the investment return and the number of years until a participant retires. The investment risk rests on the participant.

Plan Type	Contributions	Retirement Benefits	Investment Risk
Defined benefit	Vary	Fixed	Employer
Defined contribution	Pension – Fixed Profit sharing – Vary	Vary	Employee

[1] Those born before 1936 may be able to elect 10-year averaging or capital gains treatment; these strategies are not available to those born after 1935.

[2] Note that some plans have features of both types.

What Is the Best Type of Plan?

There is no best type of plan. The choice of what type of plan to use is an individual one. The answer depends on factors such as employer goals and available cash flow.

Defined Benefit Plans

The employer contributes an actuarially-determined amount sufficient to pay each participant a fixed or defined dollar amount at his or her retirement. The benefit may be defined as a flat percentage of compensation, a percentage which increases with years of service, or a percentage which changes at certain compensation levels, etc.

This type of plan generally favors older employees, because more of the employer's contributions must go into his or her account to make certain that there will be enough to pay the promised (or defined) benefit at retirement age.

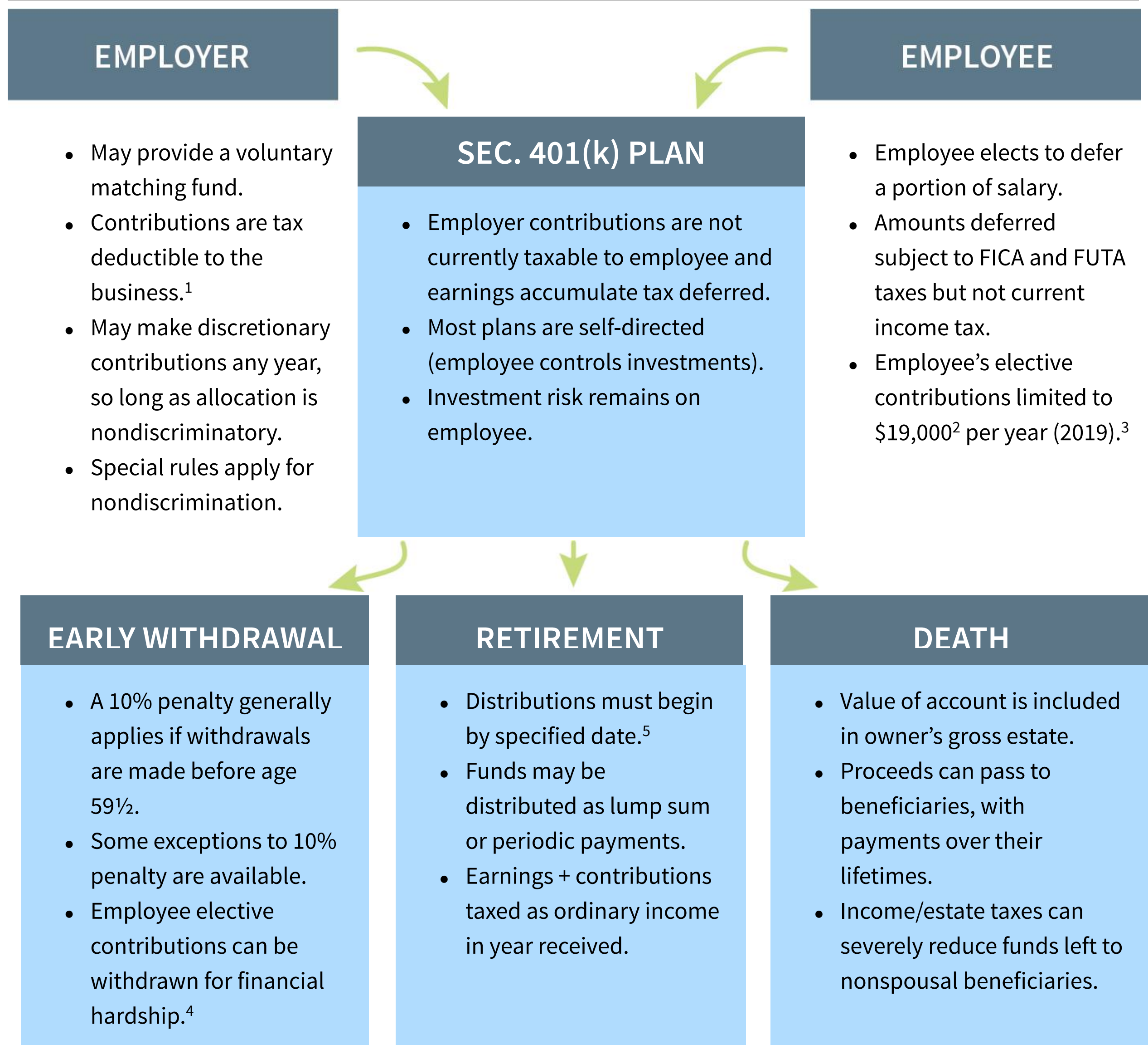
Defined Contribution Plans

There are several variations of defined contribution plans. Some of the more common ones include the following:

- **Money purchase pension:** The employer contributes a specified percentage of the participating employee's salary each year. Whatever that fund grows to is what the retiring employee receives.
- **Profit sharing plan:** Similar to the money purchase pension, except that contributions do not need to be a specific percentage and they do not need to be made every year, as long as they are substantial and recurring.
- **Stock bonus plan:** Similar to the traditional profit sharing plan. The plan may, but is not required to, invest primarily in the employer's stock.
- **ESOP - Employee stock ownership plan:** Like a stock bonus plan, to which the employer can contribute company stock instead of cash. The plan must be primarily invested in company stock.

- **IRC Sec. 401(k) plan:** Also called a cash or deferred plan, this plan is any stock bonus plan or profit sharing plan which meets certain participation requirements of IRC Sec. 401(k). An employee can agree to a salary reduction or to defer a bonus which he or she has coming.
- **SIMPLE plans:** SIMPLE stands for Savings Incentive Match Plan for Employees. SIMPLE plans can be in either an IRA format or a 401(k) format.
- **SEP:** This stands for Simplified Employee Plan. A SEP is a group of individual IRAs established for employees to which the employer and employees may contribute more than an individual employee could contribute to a traditional IRA or Roth IRA.

How a 401(k) Cash or Deferred Plan Works



[1] The total deductible employer contribution may not exceed 25% of covered payroll, including employer contributions and account forfeitures.

[2] For those age 50 and older, additional "catch-up" contributions of $6,000 may be made.

[3] For 2019, the allocation total of employer contributions and employee deferrals to a participant's account may not exceed the lesser of 100% of compensation or $56,000 per year.

[4] If provided for by the plan; specific requirements may apply.

[5] Except for more than 5% owners, distributions must begin by April 1 of the later of (a) the year following the year in which the participant reaches age 70½, or (b) the year following the year in which the participant retires. If the employee is a 5%-or-more owner, withdrawals must begin by April 1 of the year following the year he or she reaches age 70-½.

Making the Most of Your Retirement Plan

Defined Contribution Retirement Plans

Many employers offer some form of defined contribution retirement plan. Although the name may vary (401(k), 403(b), 457(b))[1], on a basic level they all function in much the same way. During your working years money is automatically deducted from your paycheck and contributed to the plan. The accumulated funds are ultimately used to help pay for your retirement.

Why Participate?

The answer to this is simple: you'll likely need the money. With people living longer, more money is needed to pay for retirement. And two of the traditional financial pillars of retirement, defined benefit pension plans (providing a known benefit) and Social Security are playing a smaller role in meeting this increased need for retirement income.

- Over the past several decades many employers have changed from defined benefit to defined contribution plans. From 1985 to 2000, for example, the rate of participation in defined benefit plans by full-time employees of medium and large private firms dropped from 80% to 36%.[2] A survey by the Bureau of Labor Statistics, published in 2018, found that only 22% of civilian workers in the U.S. participated in defined benefit pension plans.[3]

  Social Security also faces problems. As the baby boom generation enters retirement (the so-called "silver tsunami"), the number of individuals remaining in the workforce to support these retirees grows smaller. Although politically unpleasant, harsh fiscal realities may force increased payroll taxes, reductions in benefits, or both.

What to Do?

Today, more than ever before, you're on your own. One starting point is to take a more active role in your employer's defined contribution plan:

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[1] These refer to the sections of the Internal Revenue Code which authorize the different types of retirement plans.

[2] See, "Employee Participation in Defined Benefit and Defined Contribution Plans, 1985-2000." U.S. Bureau of Labor Statistics, updated June 16, 2004.

[3] National Compensation Survey: Employee Benefits in the United States, March 2018, Table 2.

- **Investment options:** Or, where do I invest my money? This will depend on a number of factors, including the plan's available options, the amount of your retirement income goal, the number of years until retirement begins, and your tolerance for risk.

- **Contribution rate:** A 3% rate may be the default, but is that enough to meet your needs? Another factor to consider is whether there is an employer match for part of your contributions. At the least you should contribute to the level which will maximize the employer match. Otherwise, you're walking away from "free money."

- **Annual checkup:** Everyone's situation changes over time. Make sure you thoroughly review your retirement plan at least once a year. Are you saving enough? Are your investments still appropriate?

Seek Professional Guidance

Successful long-term investing requires discipline and patience. The guidance of a financial professional is highly recommended.

Retirement Plan Distributions Before Age 59½

Federal law[1] provides significant income tax benefits to the various types of employer-sponsored and individual retirement plans. Contributions may be tax-deductible and growth inside an account is tax-deferred. The purpose of these tax breaks is to encourage and reward saving for retirement.

If funds are taken out of an account before an owner reaches age 59½, however, the distribution is viewed as being "early" and a 10% penalty[2] is applied to that portion of the distribution which is includable in gross income. The extra 10% penalty, plus the ordinary income tax, can make the total tax burden on such distributions painfully high.

How Bad Is The Tax "Bite"?

Assume that an individual who is in the 24% federal income tax bracket takes a withdrawal of $10,000 from his 401(k) plan. How much will he pay in taxes on that distribution?

Initial amount withdrawn:	$10,000
Less: federal income tax @24%	- 2,400
Less: 10% penalty tax:	- 1,000
= **Net after taxes:**	**$6,600**

Our hypothetical taxpayer must surrender 34% of the amount initially withdrawn just to pay federal income taxes. If state or local law also taxes such distributions, the total cost would be even higher.

What Types Of Retirement Plans Are Subject To The 10% Penalty?

Two types of retirement plans[3] are subject to the 10% penalty for early withdrawal:

- **Qualified plans:** Include "qualified" defined contribution retirement plans such as IRC Sec. 401(k) plans, IRC Sec. 403(b) plans and IRC Sec. 403(b) annuity contracts, IRC Sec.

[1] The discussion here concerns federal income tax law. State or local law may differ.

[2] Distributions before age 59½ from SIMPLE IRA plans made within the first two years of participation are subject to a 25% penalty, rather than a 10% penalty, subject to the exceptions discussed here. If a premature distribution from a SIMPLE IRA is made after two years of participation, the 10% penalty applies, subject to the exceptions.

[3] Life insurance policies considered to be "modified endowment contracts" and commercially purchased individual annuities are also subject to a 10% penalty, in certain situations.

403(a) annuity plans, SIMPLE 401(k) plans, and Profit Sharing and Money Purchase plans. Distributions from IRC Sec. 457 plans are generally not subject to the 10% penalty.

- **Individual retirement plans:** Include traditional IRAs, Roth IRAs, individual retirement annuities, Simplified Employee Pension (SEP) IRAs, and SIMPLE IRA plans.

Possible Exceptions to the 10% Penalty Tax

The table below lists the major exceptions to the 10% penalty tax:

General Description	Applicable To Qualified Plans?	Applicable To IRAs?
Separation from service after age 55. Distributions made to an employee after separating from service after reaching age 55.[1]	Yes	No
Qualified Domestic Relations Order (QDRO). Distributions made to an alternate payee, such as in a divorce.	Yes	No
Death or disability. Distributions made due to the death or disability of the account owner.	Yes	Yes
Substantially equal periodic payments. Distributions that are part of a series of substantially equal periodic payments made over the life (or life expectancy) of the taxpayer or made over the joint life (or joint life expectancies) of the taxpayer and a beneficiary.	Yes	Yes
Medical expenses. Distributions made to pay for deductible medical expenses. Only the portion that exceeds 7.50% of AGI is exempt from the 10% penalty.[2]	Yes	Yes

[1] In the case of certain public safety officials, an exception applies to distributions made after separating from service after age 50.

[2] Under current federal law, the 7.50 % threshold applies to 2017 and 2018. This threshold is scheduled to increase to 10.0% for 2019 and later years. State or local law may vary.

Retirement Plan Distributions Before Age 59½

General Description	Applicable To Qualified Plans?	Applicable To IRAs?
Higher education expenses. Distributions made to pay for "qualified higher education expenses" for the taxpayer, spouse, child, or grandchild. The expenses must be incurred in the year of distribution and generally include tuition, fees, books, supplies and equipment required for attendance at an eligible educational institution.	No	Yes
First-time homebuyer. Distributions of up to $10,000 to buy, build, or rebuild a first home. A "first-time homebuyer" is someone who had no ownership in a principal residence in the two years prior to buying the new home. The funds must be used within 120 days of receipt.	No	Yes
Unemployed health insurance premiums. Distributions made to certain unemployed individuals to pay for health insurance premiums. The individual must have lost a job and generally must have received unemployment compensation for at least 12 weeks because of the job loss.	No	Yes
Qualified reservist. Distributions made to a military reservist called to active duty for more than 179 days (or indefinitely) after September 11, 2001. Such distributions may be repaid within two years after the end of active duty.	Yes	Yes
Transfer to a Health Savings Account (HSA). A once-in-a-lifetime distribution of amounts in a traditional or Roth IRA, in a direct, trustee-to-trustee transfer. The distribution is limited to the maximum amount for the year that could otherwise be contributed to the HSA and deducted.	No	Yes
IRS levy on the account. Distributions made to satisfy an IRS levy on the account.	Yes	Yes
Qualified rollover. Generally, a transfer of funds from one IRA or qualified plan to an eligible recipient IRA or qualified plan are exempt.	Yes	Yes
Correct excess contributions. Generally, distributions made to correct excess contributions, either by the account owner, the employer, or both are exempt.	Yes	Yes

Retirement Plan Distributions Before Age 59½

General Description	Applicable To Qualified Plans?	Applicable To IRAs?
Phased retirement for certain federal employees. An exception applies to pension annuity payments and composite retirement annuity payments paid to certain federal employees participating in a phased retirement program.	Certain federal employees only.	No
2017 Hurricane Victims – Harvey, Irma, and Maria. Individuals affected by the three hurricanes, and who suffered an economic loss, may withdraw up to $100,000 in "qualified hurricane distributions" from an IRA or other qualified retirement plan. Such distributions are not subject to the 10% early withdrawal penalty. Qualifying distributions must be made before January 1, 2019, and on or after August 23, 2017 for victims of Hurricane Harvey, on or after September 4, 2017 for Hurricane Irma victims, and on or after September 16, 2017 for victims of Hurricane Maria.	Yes	Yes
2017 California Wildfire Victims. Individuals affected by the California wildfires, and who suffered an economic loss, may withdraw up to $100,000 in "qualified wildfire distributions" from an IRA or other qualified retirement plan. Such distributions are not subject to the 10% early withdrawal penalty. Qualifying distributions must be made before January 1, 2019, and on or after October 8, 2017.	Yes	Yes

Seek Professional Guidance

The income tax treatment of distributions from employer-sponsored and individual retirement plans is complex and often confusing. Given the potentially heavy cost of such withdrawals, individuals considering taking funds from a retirement plan before reaching age 59½ are strongly advised to first seek the guidance of a Certified Public Accountant (CPA), IRS enrolled agent (EA), or other competent professional.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

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For further information on the possible IRS exceptions can be found at https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions