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2023

Retirement Savings and Income Planning

COLLEGE FOR FINANCIAL PLANNING®
A KAPLAN COMPANY

Retirement Savings and Income Planning

FP515

COLLEGE FOR
FINANCIAL PLANNING®
A KAPLAN COMPANY

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CONTENTS

Learning Objectives (LOs) vi
Introduction ix

MODULE 1

Qualified Plan Requirements and Regulatory Plan Considerations 1
Introduction 1
Topics, Learning Objectives, and Readings 1
Key Terms 2
Topic 1.1: Qualified Plan Regulatory Bodies and Key Legislation 3
Topic 1.2: Qualified vs. Nonqualified Plans 7
Topic 1.3: Qualified Plan Requirements 10
Topic 1.4: Other Qualified Plan Considerations 24
Module 1 Answer Key for Practice Questions 29

MODULE 2

Defined Benefit and Other Pension Plans 31
Introduction 31
Topics, Learning Objectives, and Readings 31
Key Terms 32
Topic 2.1: Traditional Defined Benefit Pension Plans 32
Topic 2.2: Other Types of Defined Benefit Pension Plans 39
Topic 2.3: Defined Contribution Pension Plans 42
Module 2 Answer Key for Practice Questions 46

MODULE 3

Profit-Sharing and Other Defined Contribution Plans 47
Introduction 47
Topics, Learning Objectives, and Readings 47
Key Terms 49
Topic 3.1: Traditional Profit-Sharing Plans 49
Topic 3.2: Other Types of Profit-Sharing Plans and Employee Stock Ownership Plans (ESOPs) 53
Topic 3.3: Section 401(k) Plans 60
Module 3 Answer Key for Practice Questions 74

MODULE 4

Tax-Advantaged Plans and Nonqualified Plans 77
Introduction 77
Topics, Learning Objectives, and Readings 77
Key Terms 78
Topic 4.1: Tax-Advantaged Plans 78
Topic 4.2: Savings Incentive Match Plans for Employees (SIMPLEs) and Simplified Employee Pensions (SEPs) 79
Topic 4.3: Tax-Sheltered Annuities (TSAs)/Section 403(b) Plans and Section 457 Plans 86
Topic 4.4: Multiple Plan Limits 92
Module 4 Answer Key for Practice Questions 94

MODULE 5

Traditional and Roth IRAs 95

Introduction....95
Topics, Learning Objectives, and Readings 95
Key Terms 96
Topic 5.1: Traditional IRAs....97
Topic 5.2: Rollover, Inherited, and Stretch IRAs 103
Topic 5.3: Tax Implications of Traditional IRA Distributions 106
Topic 5.4: Roth IRAs.... 108
Module 5 Answer Key for Practice Questions 121

MODULE 6

Plan Distributions 125

Introduction.... 125
Topics, Learning Objectives, and Readings 125
Key Terms 127
Topic 6.1: Lifetime Distribution Options 127
Topic 6.2: Required Minimum Distributions 138
Topic 6.3: Early Distributions and Loans.... 144
Topic 6.4: Beneficiary Designations and Survivor Benefits.... 148
Topic 6.5: Other Distribution Considerations.... 162
Module 6 Answer Key for Practice Questions 164

MODULE 7

Social Security 167

Introduction.... 167
Topics, Learning Objectives, and Readings 167
Key Terms 168
Topic 7.1: Social Security Funding, Coverage, and Benefits 168
Topic 7.2: Types and Amounts of Social Security Benefits Available.... 171
Module 7 Answer Key for Practice Questions 184

MODULE 8

Retirement Plan Selection for Employer-Sponsors and Needs Analysis 187

Introduction.... 187
Topics, Learning Objectives, and Readings 187
Key Terms 188
Topic 8.1: Retirement Plan Selection 189
Topic 8.2: Investment Asset Considerations for Retirement Plans 200
Topic 8.3: Retirement Needs Analysis and Saving for Retirement 205
Module 8 Answer Key for Practice Questions 218

MODULE 9

Deferred Compensation and Stock Plans....221
Introduction.... 221
Topics, Learning Objectives, and Readings 221
Key Terms 223
Topic 9.1: Introduction to Nonqualified Plans 223
Topic 9.2: Funding Methods.... 231
Topic 9.3: Types of Nonqualified Deferred Compensation Plans.... 238
Topic 9.4: Stock Options.... 248
Topic 9.5: Equity-Based Compensation.... 257
Module 9 Answer Key for Practice Questions 271

MODULE 10

Case Study 273
Case Study Approaches 273
Nicholas and Katie Madison Case Study.... 274
Module 10 Answer Key for Practice Questions.... 286

Index 289

LEARNING OBJECTIVES (LOs)

Module 1: Qualified Plan Requirements and Regulatory Plan Considerations

When you have completed this module, you will be able to accomplish the following.

LO 1.1.1: Describe the role of the regulatory bodies and key legislation regarding qualified retirement plans. (page 3)

LO 1.2.1: Compare the attributes of qualified, tax-advantaged, and nonqualified plans. (page 7)

LO 1.3.1: Analyze a situation to determine if a retirement plan meets the regulatory requirements to be a qualified retirement plan, including coverage tests, contribution and benefit limitations, and top-heavy requirements. (page 10)

LO 1.3.2: Analyze a situation to determine the limitations on qualified plan contributions and benefits and the implications thereof. (page 18)

LO 1.3.3: Apply the requirements for integrating a retirement plan with Social Security. (page 22)

LO 1.4.1: Determine qualified plan reporting requirements, fiduciary obligations, and prohibited transactions under ERISA. (page 24)

Module 2: Defined Benefit and Other Pension Plans

When you have completed this module, you will be able to accomplish the following.

LO 2.1.1: Evaluate the characteristics of traditional defined benefit pension plans, including their advantages and disadvantages. (page 32)

LO 2.1.2: Analyze a defined benefit plan to determine a participant's plan benefit. (page 34)

LO 2.2.1: Interpret the features of cash balance pension plans. (page 39)

LO 2.2.2: Describe the attributes of fully insured (Section 412(e)(3)) pension plans. (page 41)

LO 2.3.1: Examine the characteristics of money purchase pension plans. (page 42)

LO 2.3.2: Examine target benefit pension plans and how they benefit participants. (page 43)

Module 3: Profit-Sharing and Other Defined Contribution Plans

When you have completed this module, you will be able to accomplish the following.

LO 3.1.1: Describe the characteristics and benefits of traditional profit-sharing plans. (page 49)

LO 3.2.1: Distinguish the advantages and disadvantages of age-based profit-sharing plans and new comparability plans. (page 53)

LO 3.2.2: Analyze the benefits of employee stock ownership plans (ESOPs) as they relate to profit-sharing plans. (page 54)

LO 3.3.1: Recognize the characteristics and tax benefits of traditional 401(k) plans. (page 60)

LO 3.3.2: Calculate actual deferral percentages and/or actual contribution percentages to determine if a 401(k) plan meets ADP/ACP tests. (page 65)

LO 3.3.3: Analyze the features, advantages, and disadvantages of SIMPLE 401(k), Roth 401(k), and Solo 401(k) plans. (page 68)

Module 4: Tax-Advantaged Plans and Nonqualified Plans

When you have completed this module, you will be able to accomplish the following.

LO 4.1.1: Compare tax-advantaged plans and qualified plans. (page 78)

LO 4.2.1: Analyze employer attributes to determine SIMPLE plan eligibility. (page 79)

LO 4.2.2: Determine the plan requirements for a simplified employee pension (SEP). (page 82)

LO 4.3.1: Examine the characteristics of tax-sheltered annuities (TSAs)/Section 403(b) plans to determine employer/employee attributes that would best be served by these retirement plans. (page 86)

LO 4.3.2: Analyze the benefits and taxation of Section 457 plans. (page 89)

LO 4.4.1: Determine the maximum amount of elective deferrals that may be made to multiple plans on behalf of an employee. (page 92)

Module 5: Traditional and Roth IRAs

When you have completed this module, you will be able to accomplish the following.

LO 5.1.1: Describe the basic attributes of traditional IRAs. (page 97)
LO 5.1.2: Calculate the deductible amount of an IRA contribution. (page 97)
LO 5.2.1: Compare rollover, inherited, and stretch IRAs. (page 103)
LO 5.3.1: Analyze a situation to determine the tax implications of a traditional IRA distribution. (page 106)
LO 5.4.1: Identify the basic characteristics of Roth IRAs. (page 108)
LO 5.4.2: Analyze the tax consequences of Roth IRA distributions and conversions. (page 110)
LO 5.4.3: Distinguish Roth IRAs, designated Roth 401(k)s, and pretax 401(k)s. (page 118)

Module 6: Plan Distributions

When you have completed this module, you will be able to accomplish the following.

LO 6.1.1: Analyze the options for receiving a preretirement distribution from a qualified retirement plan and the associated tax implications. (page 127)
LO 6.1.2: Interpret the tax consequences of net unrealized appreciation (NUA). (page 137)
LO 6.2.1: Examine the relationship between the required beginning date for an individual and the required minimum distributions. (page 138)
LO 6.2.2: Calculate the required minimum distribution (RMD) for a given situation. (page 140)
LO 6.3.1: Determine the early distribution penalty for qualified plans and Section 403(b) plans as well as exceptions to this penalty. (page 144)
LO 6.3.2: Apply the rules and tax implications of loans from qualified plans, Section 403(b) plans, and governmental Section 457 plans. (page 145)
LO 6.4.1: Analyze a retirement plan scenario to determine outcomes with proposed beneficiary designations. (page 148)
LO 6.4.2: Describe the automatic survivor benefits for plans in which they are required. (page 161)
LO 6.5.1: Apply retirement distribution rules when QDROs or the death of an IRA owner is involved. (page 162)

Module 7: Social Security

When you have completed this module, you will be able to accomplish the following.

LO 7.1.1: Relate how the Social Security program is funded, the coverage provided, and the eligibility for benefits. (page 168)
LO 7.2.1: Distinguish the Social Security retirement, disability, and survivorship benefits available to covered workers. (page 171)
LO 7.2.2: Analyze a situation to determine the amount of Social Security benefit a covered worker would receive. (page 179)

Module 8: Retirement Plan Selection for Employer-Sponsors and Needs Analysis

When you have completed this module, you will be able to accomplish the following.

LO 8.1.1: Distinguish the factors that should be considered for retirement plan selection. (page 189)
LO 8.1.2: Analyze the characteristics of employers that should be considered during retirement plan selection. (page 189)
LO 8.2.1: Analyze the characteristics of investment assets to assess the potential suitability for a retirement plan. (page 200)
LO 8.2.2: Discriminate the tax consequences of life insurance as a qualified retirement plan asset. (page 200)
LO 8.3.1: Analyze the key assumptions needed for a retirement needs analysis. (page 205)
LO 8.3.2: Calculate amounts needed for retirement considering client goals. (page 206)

Module 9: Deferred Compensation and Stock Plans

When you have completed this module, you will be able to accomplish the following.

LO 9.1.1: Distinguish among nonqualified plans. (page 223)
LO 9.1.2: Evaluate the taxation and regulation of nonqualified plans. (page 226)
LO 9.2.1: Analyze the alternative funding methods for nonqualified deferred compensation plans. (page 231)
LO 9.3.1: Differentiate among the various types of nonqualified deferred compensation plans used in retirement planning. (page 238)
LO 9.3.2: Analyze a situation to identify the tax implications of a nonqualified deferred compensation plan. (page 245)
LO 9.4.1: Compare incentive stock options (ISOs), nonqualified stock options (NQSOs), and employee stock purchase plans (ESPPs) to determine which is most appropriate for a given situation. (page 248)
LO 9.5.1: Identify the characteristics of various types of equity-based compensations used as incentives for executives. (page 257)
LO 9.5.2: Evaluate the appropriate use of various types of equity-based compensation plans used as incentives for executives. (page 257)

INTRODUCTION

PROGRAM OVERVIEW

Welcome to Course FP515, Retirement Savings and Income Planning —the fifth course in your journey to become a CERTIFIED FINANCIAL PLANNER™ certificant. The financial planning profession offers practitioners the opportunity to significantly impact people's lives. Guiding clients toward financial security brings more than just financial rewards—years in the future, your clients will recount how your services allowed them to maximize their potential to achieve goals and accomplish dreams they never thought possible. In addition, clients will tell you how financial planning reduced their stress, changed their lives, and set future generations on the path to success.

Hard work and diligent study are required to earn this certification. At the College for Financial Planning, we are committed to providing you state-of-the-art learning tools incorporated into a focused study plan. Our goal for you is that by the end of this program, you will pass the CFP® Certification Examination and develop a sound financial planning foundation.

There are seven courses you will complete as part of this program:

- FP511: General Financial Planning Principles, Professional Conduct, and Client Psychology
- FP512: Risk Management, Insurance, and Employee Benefits Planning
- FP513: Investment Planning
- FP514: Income Tax Planning
- FP515: Retirement Savings and Income Planning
- FP516: Estate Planning
- FP517: Financial Plan Development

Each of the first six courses has multiple modules with targeted learning objectives. It is a good idea to start reading your material before attending the virtual classes or viewing the OnDemand recordings (if you are enrolled in either), because the content is more likely to be retained.

RETIREMENT SAVINGS AND INCOME PLANNING

Your education journey continues with an introduction to the various aspects of retirement savings and income planning. The modules in this course are as follows:

- Module 1: Qualified Plans Requirements and Regulatory Plan Considerations
- Module 2: Defined Benefit and Other Pension Plans
- Module 3: Profit-Sharing and Other Defined Contribution Plans
- Module 4: Tax-Advantaged Plans and Nonqualified Plans
- Module 5: Traditional and Roth IRAs
- Module 6: Plan Distributions

- Module 7: Social Security
- Module 8: Retirement Plan Selection for Employer-Sponsors and Needs Analysis
- Module 9: Deferred Compensation and Stock Plans
- Module 10: Case Study

Retirement planning is an important and complicated process that is a vital part of financial planning. This course provides a comprehensive introduction to the basics of retirement planning. It includes retirement plan design, selection, and administration for employers. Helping an employer select, install, and administer the appropriate retirement plan is a critical component of retirement preparedness both for the employing organization and its employees. Congress has approved many types of retirement planning arrangements in an attempt to deal with the complications of the modern financial system. Thus, it is critical to understand the pros and cons of the various plans.

You will also learn about individual retirement planning using IRAs (both traditional and Roth IRAs), as well as people preparing for retirement using their employer retirement plans. Distributions are another major issue. There are various retirement distribution options, including required minimum distributions, which a competent financial adviser needs to thoroughly understand in order to help clients.

The course will include learning the Social Security program, especially Social Security retirement benefits. This complicated government program has become a cornerstone of the American retirement system. Financial planners need a comprehensive understanding of the various benefits and choices facing retirees.

Finally, you will learn how to calculate the amount needed at retirement and different savings methods to accomplish that goal.

STUDY PLAN

To be successful in this course, it is important that you follow the My Activities study plan on your online course dashboard. This plan, backed by learning science, will efficiently guide you through all the course modules incorporating state-of-the-art study tools, making the best use of your time.

It is important to fully understand the material as you are reading it. Unlike other exams you may have taken (e.g., FINRA Series exams or licensing exams), which only require the tester to memorize many facts without substantial analysis, the CFP® Certification Examination and the CFP® Certification Professional Education Program course exams require a higher level of comprehension. Many testers on other exams are able to successfully pass through question repetition and memorization alone. Do not plan on using that strategy for this program. The tests you will be taking throughout this program and on the CFP® Certification Examination require you to apply and analyze the material you have learned. To do so, you must fully comprehend the information and complete your online My Activities study plan.

COURSE ASSESSMENTS

This course is designed with four levels of learning assessments:

1. *QBank*. In your study plan, you will be directed to an online QBank for further practice. As you go through each question, read the answer and compare your answer to the provided rationales. This QBank is a supplementary study tool only, and it should be used in conjunction with the textbook, videos, and other course content.
2. *Module quizzes*. At the end of each module, you will take an online 30-question module quiz. You must score a minimum of 70% on the quiz to move to the next module. If you do not score 70% or higher on your first attempt, you will be given two additional attempts, each with a new quiz. If you are unable to score 70% on three attempts, you will be directed to review and remediation.
3. *Practice exams*. Two online timed practice exams are provided to help you prepare for the final exam. Each exam is 85 questions in length, similar to one session of the national CFP® exam.
4. *Final exams*. The online 85-question final exam tests your knowledge, understanding, application, and analysis of the module concepts. A passing score is 70% or higher; the final exam grade is your course grade. If you are unsuccessful on your first attempt, you will be given one additional attempt with a different exam.

SIGNIFICANCE OF LEARNING OBJECTIVES (LOS)

Throughout this course, you will see many learning objectives (LOs) that emphasize the knowledge and application skills you will gain from this course. These specific statements, based on the 2021 CFP Board's Principal Knowledge Topics list (the current exam blueprint), advise you regarding what you should know and be able to do at the completion of this course.

LOs form the foundation of each course reading. They direct you to the critical components for which you will be evaluated and represent the keys to successful completion of this course. A list of each reading and the associated LOs can be found in the introduction of each module.

MAKING IT REAL

Taking the time during your studies to explore real-life application of the concepts using your own circumstances or those of your clients will prove beneficial in your skill development. Here are some examples:

- Think about your business owner clients and what retirement plan would be best for them.
- For your clients who need cash flow, determine whether it is a good strategy to borrow or withdraw money from their retirement plans if allowable.
- Consider the types of retirement plan distributions that are most beneficial for your clients.
- Identify clients who need retirement advice to live their later years as desired.

TEXTBOOK STUDY COMPONENTS

Throughout this textbook, there are several elements that will help you with successful course completion:

- *Introduction*. An overview of the module content and a list of topics covered.
- *Table of LOs*. A listing of LOs and their associated readings.
- *Key terms*. Important words and phrases related to the module topics.
- *Readings*. Sections of content associated with each LO, which should be read and studied thoroughly.
- *Examples*. Applications of selected topics.
- *Practice questions*. Assessments of learning.

PROFESSOR'S NOTE icons highlight supplemental information to help you better understand concepts.

TEST TIP icons highlight examples of how a topic might be tested on the CFP Board exam.

PRINCIPAL KNOWLEDGE DOMAINS AND PRINCIPAL KNOWLEDGE TOPICS

The following are the CFP® certification principal knowledge domains and principal knowledge topics:

- *Eight principal knowledge domains*. These domains are based on the results of CFP Board's 2021 Practice Analysis Study, which is the blueprint for the CFP® Certification Examination beginning in 2022. Each question on the CFP® exam will be associated with one of these domains.

- *Principal knowledge topics*. Following the principal knowledge domains, you will find a list of the 2021 CFP® principal knowledge topics, 9 of which are covered in this course.

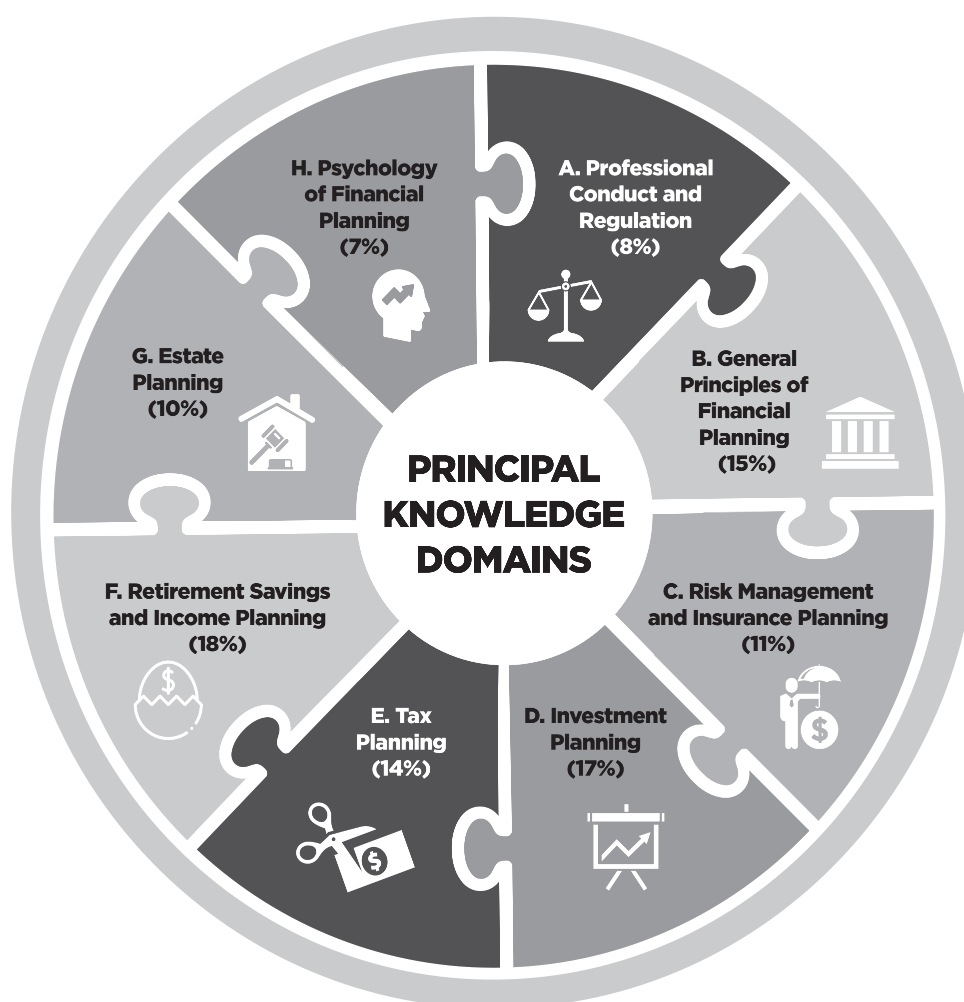
2021 PRINCIPAL KNOWLEDGE TOPICS (70)

The following Principal Knowledge Topics are based on the results of CFP Board's 2021 Practice Analysis Study.

The Principal Knowledge Domains will serve as the blueprint for the March 2022 CFP® Certification Examination and subsequent administrations of the exam. Each exam question will be linked to one of the following Principal Knowledge Topics, in the approximate percentages indicated following the domain headings.

The Principal Knowledge Topics also serve as a curricular framework for CFP Board's education coursework requirement and the topics CFP Board accepts for continuing education credit.

EIGHT PRINCIPAL KNOWLEDGE DOMAINS



2021 PRINCIPAL KNOWLEDGE TOPICS

A. PROFESSIONAL CONDUCT AND REGULATION

A.1 CFP Board's Code of Ethics and Standards of Conduct

A.2 CFP Board's Procedural Rules

A.3 Function, purpose, and general structure of financial institutions

A.4 Financial services regulations and requirements

A.5 Consumer protection laws

A.6 Fiduciary standard and application

B. GENERAL PRINCIPLES OF FINANCIAL PLANNING

B.7 Financial planning process

B.8 Financial statements

B.9 Cash flow management

B.10 Financing strategies and debt management

B.11 Economic concepts

B.12 Time value of money concepts and calculations

B.13 Education needs analysis

B.14 Education savings vehicles

B.15 Education funding

B.16 Gift/income tax strategies

C. RISK MANAGEMENT AND INSURANCE PLANNING

C.17 Principles of risk and insurance

C.18 Analysis and evaluation of risk exposures

C.19 Health insurance and health care cost management (individual and group)

C.20 Disability income insurance (individual and group)

C.21 Long-term care insurance and long-term case planning (individual and group)

C.22 Qualified and Non-Qualified Annuities

C.23 Life insurance (individual and group)

C.24 Business owner insurance solutions

C.25 Insurance needs analysis

C.26 Insurance policy and company selection

D. INVESTMENT PLANNING

D.27 Characteristics, uses and taxation of investment vehicles

D.28 Types of investment risk

D.29 Market cycles

D.30 Quantitative investment concepts and measures of investment returns

D.31 Asset allocation and portfolio diversification

D.32 Bond and stock valuation concepts

D.33 Portfolio development and analysis

D.34 Investment strategies

D.35 Alternative investments and liquidity risk

E. TAX PLANNING

E.36 Fundamental and current tax law

E.37 Income tax fundamentals and calculations

E.38 Characteristics and income taxation of business entities

E.39 Income taxation of trusts and estates

E.40 Tax reduction/management techniques

E.41 Tax consequences of property transactions

E.42 Tax implications of special circumstances

E.43 Charitable/philanthropic contributions and deductions

F. RETIREMENT SAVINGS AND INCOME PLANNING

F.44 Retirement needs analysis

F.45 Social Security and Medicare planning

F.46 Eldercare and special needs planning

F.47 Types of retirement plans

F.48 Qualified plan rules and options

F.49 Non-qualified plan rules and options

F.50 Key factors affecting plan selection for businesses

F.51 Distribution rules and taxation

F.52 Retirement income and distribution strategies

F.53 Business succession planning

G. ESTATE PLANNING

G.54 Property titling and beneficiary designations

G.55 Strategies to transfer property

G.56 Estate and incapacity planning documents

G.57 Gift, estate, and GST tax compliance and calculation

G.58 Sources for estate liquidity

G.59 Types, features, and taxation of trusts

G.60 Marital deduction

G.61 Intra-family and other business transfer techniques

G.62 Postmortem estate planning techniques

G.63 Planning for divorce, unmarried couples and other special circumstances

G.64 Planning for special needs and circumstances

H. PSYCHOLOGY OF FINANCIAL PLANNING

H.65 Client and planner attitudes, values, biases

H.66 Behavioral finance

H.67 Sources of money conflict

H.68 Principles of counseling

H.69 General principles of effective communication

H.70 Crisis events with severe consequences

YOUR LEARNING JOURNEY

After completion of this CFP® Certification Education Program, completing our CFP® exam prep review course, and passing the CFP Board exam, you should consider being a lifelong student, because the landscape of financial planning is always changing. We hope to have a relationship with you throughout your career as a provider of professional designations and continuing education, and someday perhaps you will return to earn your master's degree in financial planning.

MODULE 1

Qualified Plan Requirements and Regulatory Plan Considerations

INTRODUCTION

Qualified plan requirements and regulatory plan considerations are two of the most complicated topics covered throughout this course. Nevertheless, to provide effective client advice, a financial planner should understand how employer-sponsored retirement plans are structured, the benefits they can provide for clients, and the rules governing tax qualifications. Complying with Tax Code rules regarding plan qualification is critical because, if met, the rules allow the sponsoring employer of a retirement plan to take an immediate deduction for plan contributions made on behalf of an employee.

Sometimes, qualified retirement plans are referred to as Section 401(a) plans because the Internal Revenue Code section uses the same number and subsection. There are 31 technical requirements specified in the Internal Revenue Code (IRC) Section 401(a), which a retirement plan must comply with to be tax qualified. Because this topic is highly complex, we will only discuss a summary of the more important requirements that a financial planner should be familiar with in this unit.

TOPICS, LEARNING OBJECTIVES, AND READINGS

The topics covered in this module are the following:

- Topic 1.1: Introduction to Qualified Plan Regulation
- Topic 1.2: Qualified vs. Nonqualified Plans
- Topic 1.3: Qualified Plan Requirements
- Topic 1.4: Other Qualified Plan Considerations

Throughout this module you will see learning objectives (LOs) that emphasize the knowledge and application skills you will gain from this module. These specific statements, based on the 2021 CFP Board's Principal Knowledge Topics list (the

blueprint for the current CFP® exam), advise you regarding what you should know and be able to do at the completion of this module.

The following table shows a list of module topics, learning objectives, and readings.

Learning Objective		Readings
Topic 1.1: Introduction to Qualified Plan Regulation		
1.1.1	Describe the role of the regulatory bodies and key legislation regarding qualified retirement plans.	Fundamental Qualified Plan Regulation
Topic 1.2: Qualified vs. Nonqualified Plans		
1.2.1	Compare the attributes of qualified, tax-advantaged, and nonqualified plans.	Qualified vs. Nonqualified Plans
Topic 1.3: Qualified Plan Requirements		
1.3.1	Analyze a situation to determine if a retirement plan meets the regulatory requirements to be a qualified retirement plan, including coverage tests, contribution and benefit limitations, and top-heavy requirements.	Regulatory Requirements of Qualified Plans
1.3.2	Analyze a situation to determine the limitations on qualified plan contributions and benefits and the implications thereof.	Plan Contribution and Benefit Limits
1.3.3	Apply the requirements for integrating a retirement plan with Social Security.	Plan Integration with Social Security
Topic 1.4: Other Qualified Plan Considerations		
1.4.1	Determine qualified plan reporting requirements, fiduciary obligations, and prohibited transactions under ERISA.	Qualified Plan Reporting, Fiduciary Obligations, and Prohibited Transactions

KEY TERMS

1% owner
5% owner
21-and-1 rule
50/40 test
active participation
advance determination letter
annual additions limit
annual report (Form 5500 series)
average benefits percentage test
contributory plan
controlled group rules
covered
Department of Labor (DOL)
defined contribution plans
definitely determinable benefits
elective deferral limit
eligibility
Employee Retirement Income Security Act (ERISA)
excess method
fiduciary
forfeitures
greater than 5% owner
highly compensated employee (HCE)
includible compensation
individual accrued benefit statement
integrated plan
integration level
Internal Revenue Service (IRS)
non-top heavy
noncontributory plan
nonhighly compensated employees (non-HCE)
nonqualified plans
offset method
party in interest
Pension Benefit Guaranty Corporation (PBGC)
percentage test
permitted disparity rules
prohibited transactions
qualified plans
ratio test
summary annual report (SAR)
summary of material modification (SMM)
summary plan description (SPD)
top heavy
vesting

TOPIC 1.1: QUALIFIED PLAN REGULATORY BODIES AND KEY LEGISLATION

Reading: Fundamental Qualified Plan Regulation

LO 1.1.1: Describe the role of the regulatory bodies and key legislation regarding qualified retirement plans.

Internal Revenue Service (IRS)

The **Internal Revenue Service (IRS)** carries out the administrative duties of the qualified retirement plan system (and to a lesser extent, the nonqualified plan system) by

- supervising the creation of new retirement plans, and monitoring and auditing the operation of existing plans;
- interpreting federal legislation, especially with regard to the tax consequences of certain pension plan designs; and
- administering the qualified plan system.

Employee Retirement Income Security Act

The **Employee Retirement Income Security Act (ERISA)** is a federal law, established in 1974, that governs the nontax aspects of private retirement plans and other employee benefits (e.g., health and welfare benefit plans). It is intended to protect the retirement interests of plan participants. ERISA established equitable standards and curtailed potential plan abuse.

Qualified plans must meet ERISA requirements, including the following:

- Coverage
- Participation
- Vesting
- Reporting and disclosure
- Fiduciary requirements

ERISA requires plan sponsors to report and disclose plan information to the Internal Revenue Service (IRS), Department of Labor (DOL), Pension Benefit Guaranty Corporation (PBGC), and plan participants. There is some overlap between ERISA and the IRC in the areas of plan participation, vesting, and prohibited transactions.

ERISA includes four sections, called titles, describing its regulatory reach.

1. Title I protects employees' right to collect benefits and imposes nondiscrimination and funding requirements.
2. Title II establishes plan qualification requirements for special treatment under the Internal Revenue Code.
3. Title III creates the regulatory and administrative framework for ongoing ERISA implementation.
4. Title IV establishes the Pension Benefit Guaranty Corporation (PBGC) to insure defined benefit plan benefits.

PROFESSOR'S NOTE

One way to remember the contents of each title is to think of ERISA as a "**W**ay **T**o **R**eplace **P**ay:" W = Title I, T = Title II, R = Title III, and P = Title IV

- W—Workers' rights (collecting benefits, nondiscrimination, and funding requirements) = Title I
- T—Tax Code treatment = Title II
- R—Regulatory and administrative framework = Title III
- P—PBGC = Title IV

Department of Labor (DOL) Regulatory Responsibilities

The **Department of Labor (DOL)** is involved in retirement plans through the Office of Pension and Welfare Benefit Plans. The DOL ensures compliance with ERISA's plan reporting and disclosure rules. A summary plan description is the most significant disclosure requirement. Failure to comply with reporting and disclosure requirements can lead to fines and, in some cases, imprisonment. The DOL also oversees compliance with the prohibited transaction rules. The goal of the prohibited transaction rules is to keep the interests of the plan participants separate from the sponsoring entity. As part of this function, the DOL issues **prohibited transaction exemptions (PTEs)**. Prohibited transaction exemptions issued to the prohibited transaction rules may be limited or unlimited within the parameters of the requested exemption (i.e., for a single transaction or for all transactions within that requested exemption). The DOL also regulates the actions of plan fiduciaries, which include individuals or firms that exercise discretionary authority over plan assets, or that provide investment advice for a fee. In its role as interpreter, the DOL issues communications that explain existing laws.

Pension Benefit Guaranty Corporation

The **Pension Benefit Guaranty Corporation (PBGC)** was created under ERISA and is responsible for insuring vested plan participants against loss of benefits from plan termination. Benefit payments for the PBGC are financed by premiums paid by the sponsors of defined benefit plans.

The PBGC insures only defined benefit plans (i.e., traditional defined benefit plans and cash balance plans), not defined contribution plans. Professional service employers with 25 or fewer active participants are exempt from PBGC insurance requirements. There are limits to what is covered by the PBGC. The limit is determined by the age at which the person retired. For example, the PBGC maximum monthly benefit (at age 65) is $6,750.00 in 2023. The PBGC insures the retirement payments currently being paid from a terminated defined benefit plan. However, those who worked for an employer whose retirement plan was taken over by the PBGC but who are not receiving benefits from the plan may be entitled to something. Thus, these people should check with the PBGC. They may be able to recover something from the plan.

The PBGC can terminate a defined benefit plan if

- minimum funding standards are not met;
- benefits cannot be paid when due; or

- the long-run liability of the company to the PBGC is expected to increase unreasonably. This is true for both types of defined benefit plans (traditional defined benefit pension plans and cash balance plans).

TEST TIP

Students often think the PBGC will cover all types of retirement plans. It is important to emphasize that it only covers defined benefit plans, and there is a maximum amount covered depending on the age the person retired.

The SECURE Act

The SECURE Act advanced lifetime income options so defined contribution plans move towards parity with defined benefit plans. The act provides for portability of lifetime income options for defined contribution plans, 403(b) plans, and governmental 457(b) plans. There are also safe harbor rules for plan fiduciaries selecting lifetime income providers as long as the fiduciary engaged in an objective, thorough, and analytical approach involving the financial capacity of the insurer to satisfy the guaranteed income contracts and considers the costs and benefits of the insurance company offerings. If the fiduciary concludes that the insurance company is financially capable of meeting its obligations, and the relative cost and benefits of the guaranteed retirement income contracts are reasonable, then the fiduciary safe harbor is met and the fiduciary is not liable for the initial selection of the retirement income provider. But fiduciaries will need to monitor the financial state of the lifetime income providers. Thus, the SECURE Act really only offers fiduciary liability relief for the initial selection. The liability protection is only as good as the thoroughness of the advisor's documentation because a lawsuit could allege that the fiduciary was not thorough enough.

Lifetime income rules allow employees to understand the amount of income their current allocation would provide in retirement. For example, most people can not estimate the monthly income that a $100,000 retirement account balance represents. This may sound like a lot of money to many people. However, the lifetime monthly benefit turns out to be $300 to $600 per month. Considering inflation 20–30 years in the future, the purchasing power of $100,000 is roughly cut in half. If people understood inflation and the lifetime income option, they may be motivated to increase contributions to qualified retirement accounts. The DOL was supposed to publish model lifetime income disclosure language by December 2020.

The SECURE Act increased the credit for certain small employers starting an employer retirement account from $500 per year for three years for eligible employers with no more than 100 employees making $5,000 per year or more. The new credit is the lesser of 50% of the qualified plan start-up costs or the greater of $500 or $250 times the number of non-highly compensated employees eligible to participate in the plan.

The SECURE Act extended the deadline for adopting a new retirement plan to the due date for filing that year's tax return including extensions. Now all qualified retirement plans are like SEPs: they can be established after the year has started and even after the year has ended. Of course, this limits the effectiveness for the first year if the employees are expected to be contributing, as would occur with a 401(k), but it encourages the establishment of employer contribution plans.

Since 2021, multiple employers can join together under one plan document even if they are completely unrelated. Congress hopes this will encourage more employers to

offer retirement plans to their employees. Multi-employer plans have been available for a long time. However, there had to be a nexus between the employers (meaning the employers were related in some manner like in the same industry), and if one employer failed the plan requirements then all employers in the plan also failed. Since 2021, the need for a nexus is eliminated, and if one of the employers fails the plan requirements, then the other employers are safe as long as they actually meet the plan requirements. The hope is that multi-employer plans will lower administrative costs for the various employers. This could be especially true thanks to technology. It is possible to accommodate many plan participants with a broader use of the internet for processes such as enrollment and contribution changes.

The SECURE Act allows long-term part-time employees to be part of cash or deferred arrangements (CODAs) like 401(k) plans. Starting in 2023, employees who are at least age 21 and have three consecutive years of service with more than 500 hours but less than 1,000 per year will be eligible for the retirement plan. However, these part-time employees can be denied matching funds and non-elective employer contributions. Also, they will not count for nondiscrimination testing or top-heavy testing. In other words, they will be allowed to save using the employer plan, but the employer is not really required to count them for most discrimination tests. Also, these employees get a year of vesting for every 1,000 hours of work. If they work 1,000 hours in a year, they are no longer in this category. Finally, the first year that counted towards the three-year rule is 2021. Thus, part-timers will not benefit from this provision until 2024.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

1. Which of these federal agencies is tasked with supervising the creation of new qualified retirement plans?
   A. DOL
   B. ERISA
   C. IRS
   D. PBGC
2. In which of these situations can the Pension Benefit Guaranty Corporation (PBGC) terminate a defined benefit pension plan?
   I. The PBGC does not have the authority to terminate an employer's defined benefit pension plan.
   II. Anne's Aquatics, Inc., has not met the minimum funding standards for the corporation's defined benefit pension plan.
   III. Stacy has retired from her position and her former employer's defined benefit pension plan cannot pay her retirement benefit because it lacks the funds.
   IV. A professional service corporation with 20 active participants cannot meet the minimum funding standards of the defined benefit pension plan and has previously paid no PBGC premiums.
   A. II and III
   B. I and IV
   C. I and III
   D. II, III, and IV

TOPIC 1.2: QUALIFIED VS. NONQUALIFIED PLANS

Reading: Qualified vs. Nonqualified Plans

LO 1.2.1: Compare the attributes of qualified, tax-advantaged, and nonqualified plans.

Figure 1.1: Retirement Plans

Qualified plans[A]			Tax-advantaged plans	Nonqualified plans
Defined benefits (DB) plans[D]	**Defined contribution (DC) plans**	**DC profit-sharing (PS) plans[C]**		
DB Pension Plans[B] ■ Traditional DB pension plan ■ Cash balance pension plan	**DC Pension Plans[B]** ■ Money purchase pension plan ■ Target benefit pension plan[D]	■ Traditional profit-sharing plan ■ Section 401(k) plan[E] ■ Stock bonus plans ■ ESOP (employee stock ownership plan) ■ SIMPLE 401(k) plan ■ Age-based-profit-sharing plan[D] ■ New comparability plan[D] ■ Thrift plan	■ SEP plan ■ SARSEP plan ■ Traditional IRA ■ Roth IRA ■ SIMPLE IRA ■ Section 403(b)	■ Section 457 plan ■ Deferred compensation plans such as top-hat plans, etc.
DB(k) (hybrid plan combining defined benefit pension benefits with Section 401(k) provisions for elective deferrals)				

[A] Distributions from qualified plan may offer NUA and/or 10-year forward averaging. Tax-advantaged plans and nonqualified plans do not offer any special tax treatment.
[B] Pension plans promise either benefits or contributions; therefore, annual funding is mandatory.
[C] Profit-sharing plans do not require mandatory annual funding.
[D] These plans are tested for discrimination on the basis of benefits as opposed to contributions.
[E] These plans are tested for discrimination regarding employee elective deferrals and employer matching contributions.

At first look, trying to understand each of the types of retirement plans available can be quite overwhelming. Studying the various plans reveals there are many repetitive rules and plan similarities. It is sometimes helpful to start with the big picture in mind. For example, in the summary chart, notice there are three general categories: qualified plans, tax-advantaged plans, and nonqualified plans. Remembering the category that a plan operates under is a good start. Also, notice under the qualified plans category that a qualified plan is either classified as a defined benefit (DB) plan or a defined contribution (DC) plan. DB plans and DC plans are further classified as either a pension plan or a profit-sharing plan. The point of differentiating between pension plans and profit-sharing plans mostly deals with whether the annual retirement plan contribution is mandatory or flexible (discretionary). If the annual contribution is mandatory, the plan is a pension plan. If the annual contribution is not mandatory, the plan is a profit-sharing plan. There are two additional issues. Pension plans cap the contribution of employer securities to 10% of the overall contribution to the plan. Finally, pension plans have automatic spousal rights such as QPSA (Qualified Pre-Retirement Survivor Annuities) and QJSA (Qualified Joint Survivor Annuities). These rights will be covered in Module 6.

Later in the course we will discuss how this is an important factor in selecting an appropriate retirement plan for an employer. DB plans are pension plans; whereas a defined contribution plan may either be a pension plan or a profit-sharing plan (most DC plans are profit-sharing plans). A basic understanding of these broad categories is helpful because once the proper classifications are determined, the basic rules and limitations applicable to the classification are repetitive across various types of plans within the category.

Qualified plans are retirement plans that meet a number of requirements as specified in the IRC Section 401(a), immediate subsequent sections of Section 401(a), and ERISA. As such, two government agencies are involved in the regulation of qualified plans: the IRS (interested in the tax aspects of such a plan) and the Department of Labor (interested in the labor law and employee relations aspects). In return for meeting these requirements, the employer-sponsor of the plan is afforded a major tax advantage, namely, the immediate deductibility of all contributions made to the plan. Employer contributions are not subject to payroll taxes. In addition, the employee does not pay income tax on plan contributions or the earnings from plan contributions as long as a plan distribution does not occur.

There are four elements of a qualified plan:

a. The plan document provides the terms and benefit amounts provided by the plan.
b. Once adopted, the plan is recognized as a separate legal entity (must be in writing).
c. The trust holds the plan assets. The trustee is usually selected by the employer.
d. The funds, once contributed, become the plan funds and, except in unusual circumstances, cannot be returned to the employer.

A tax-advantaged plan does not meet all of the requirements to be classified as a qualified plan, but it often operates very similarly to a qualified plan with tax-deferred earnings and pretax, or tax-deductible contributions, Roth elective deferrals are also allowed for 403(b) and eligible 457 plans.

Nonqualified plans are much more flexible than qualified plans. However, they do not benefit from all of the tax advantages that apply to qualified plans or other tax-advantaged plans. They are benefit arrangements that do not meet the IRC Section 401 requirements for qualified plans. They are used to provide benefits to certain highly-valued employees beyond the qualified plan IRC Section 415 limits. These plans typically are referred to as nonqualified plans or nonqualified deferred compensation (NQDC) plans. Nonqualified plans may supplement qualified plans and may defer taxes for the employee-participant.

One of the advantages of nonqualified plans is that they do not have to meet the nondiscrimination requirements of qualified plans. Also, the benefits and contributions can exceed IRC Section 415 limits. Nonqualified plans are not subject to the same ERISA requirements as qualified plans. Generally, they are merely a promise by the employer to pay the employee benefits. Benefits must be subject to a substantial risk of forfeiture (i.e., subject to the claims of general creditors); otherwise, there will be constructive receipt and taxable income to the

participant. Benefits are not deductible by the employer until paid and are includible in the employee's taxable income at the time of receipt. There are several types of nonqualified deferred compensation plans including top hat plans (deferred compensation salary reduction plans) and executive employee benefit plans. Following is a list of the different types of executive employee benefit plans.

1. Excess benefit plans—provide salary continuation through excess benefits or contributions that exceed qualified plan annual additions limits
2. Supplemental executive retirement plan (SERP)—may be used to provide contributions and benefits in excess of IRC limits for key executives
3. Phantom stock plans—an accounting entry without actual stock ownership
4. Restricted stock—actual company stock provided to executives when certain conditions have been met
5. Stock options—incentive stock options (ISOs) and nonqualified stock options (NQSOs)
6. Employee stock purchase plans (ESPPs)—permit employees to purchase company stock, often at a discount
7. Junior class shares—a separate class of common stock typically convertible into common shares upon certain specified events
8. Stock appreciation rights—gives the right to the monetary equivalent of the company's stock price increase for a hypothetical number of shares over a specified period of time. Note that it is the value of the increase in the shares only. No actual shares are transferred.

A summary of several of the major differences between qualified and nonqualified retirement plans follows.

Figure 1.2: Qualified Plans vs. Nonqualified Plans

Attribute/Characteristic	Qualified Plans	Nonqualified Plans
Discrimination in favor of select employees	No	Yes
Subject to the full ERISA requirements	Yes	No (either in total or in part)
Tax benefits	Immediate employer deduction and employee deferral of tax on earnings	Postponed employer deduction and possible employee deferral of tax
Funding	By due date of return (includes extensions)	Not required/informal funding possible
Distributions	Taxed as ordinary income; some tax reduction options available	Taxed as ordinary income; may be taxed before actual receipt of funds

PROFESSOR'S NOTE

These rules are the highlights only. The details will be covered in Module 9.

TOPIC 1.3: QUALIFIED PLAN REQUIREMENTS

Reading: Regulatory Requirements of Qualified Plans

LO 1.3.1: Analyze a situation to determine if a retirement plan meets the regulatory requirements to be a qualified retirement plan, including coverage tests, contribution and benefit limitations, and top-heavy requirements.

ERISA and IRC requirements that apply to qualified plans are numerous and complex. Qualified plans must meet the following ERISA requirements: coverage, participation, vesting, reporting and disclosure, and fiduciary requirements. As they relate to the CFP® Certification Examination, the following will be covered in respective order:

1. Eligibility
2. Coverage (including the nondiscrimination tests and controlled group rules)
3. Limitations on contributions and benefits
4. Vesting requirements
5. Top-heavy plans
6. Integration with Social Security (also known as the permitted disparity rules)

Plan Eligibility

Under a qualified plan, any employee who has attained the age of 21, and has one year of service with the company, must be permitted to enter the plan within six months. For **eligibility** purposes, a year of service means a 12-month period during which the employee has worked at least 1,000 hours. As an alternative to this **21-and-1 rule**, the waiting period to enter the plan may be increased to two years of service. However, if adopting this rule, the employer-sponsor cannot use the normal vesting schedules for employer contributions and, instead, must immediately vest all employer contributions for employees (100% immediate vesting). Note that the popular Section 401(k) retirement plan cannot use the two-year waiting period alternative. Once an employee has met the eligibility requirements, entrance to the plan is on the next available entrance date. However, under ERISA, a plan cannot require an employee to wait more than six months to enter into a plan after becoming eligible. Because of this rule, many qualified plans will adopt two entrance dates, usually January 1 and July 1.

Finally, plan eligibility is important because that is when the employer begins to make plan contributions on behalf of the participant. This should be distinguished from plan vesting percentages that accrue from the date of the employee-participant's hiring and not the plan eligibility date.

Highly Compensated Employee (HCE)

A **highly compensated employee (HCE)** is an employee who meets one of the following criteria:

- Was a greater than 5% owner (either individually or by family attribution) of the employer at any time during the current year or preceding year
  - Notice that owning more than 5% of the employer makes someone a highly compensated employee regardless of income

- An employee owning exactly 5% does not make them a highly compensated employee due to ownership
- For family attribution rules, family members are defined by IRC Section 318 as the individual's spouse, children, grandchildren, and parents. Siblings do not count for family attribution purposes.

- In the preceding year, had compensation greater than $135,000 (in 2022) from the employer, or if the compensation will exceed $150,000 in 2023.

If the employer makes an election, only employees in the top 20% of compensation AND earning greater than $135,000 in 2022, or those who will make more than $150,000 in 2023 are included in the highly compensated group. This exception is often for large employers. It helps the plan pass the coverage or actual deferral percentage (ADP) test for Section 401(k) plans (see next section). Note that the 20% election only removes a participant from the HCE group if the participant qualifies as an HCE based on compensation only. The election will not remove a participant from HCE status if the participant qualifies as an HCE based on being a greater than 5% owner, even if the participant no longer ranks in the top 20% based on compensation under the election. Thus, a greater than 5% owner will always be included in the HCE group. **Nonhighly compensated employees (non-HCE)** are those employees who do not fit the HCE criteria stated previously.

In IRS publications, the terms 5% owner and 1% owner are used interchangeably with the terms greater than 5% owner and greater than 1% owner. This is because in the Tax Code, "5% owner" and "1% owner" are titles, not specific percentages of ownership. An HCE is defined in the Tax Code as an employee who is a 5% owner (meaning they own more than 5%) at any time during the current or preceding year, as defined in Section 416(i)(1). A percentage owner is specifically defined in Section 416(i)(1) as

- **5% owner**—an individual who owns more than a 5% interest in the company; and
- **1% owner**—an individual who owns more than a 1% interest in the company.

For IRS purposes, if an individual owns 2% of the company, the taxpayer is considered a 1% owner and if an individual owns 7% or 90% of a company, the taxpayer is considered a 5% owner. The 1% owners are discussed further in the Key Employees section of this module.

PROFESSOR'S NOTE

It is important to emphasize that the two tests (ownership and earnings) are independent of each other. For example, if someone owns more than 5% of the firm, they are an HCE regardless of how much they make. This is also true if the firm makes the 20% election. A person owning more than 5% is still an HCE even if she is not in the top 20%. Students are often confused on determining the top 20% of compensation. Note that it is the top 20% of individuals (not of compensation) in the plan. If there are 10 people in the plan, only the top two earners are the top 20% when ranked by compensation.

Coverage Under the Plan

As a general rule, Section 410(b) of the Tax Code requires the employer-sponsor of the qualified plan to cover at least 70% of the eligible non-HCEs. This is

referred to as the **percentage test**. It can also be called the safe harbor test. For purposes of the coverage tests, **covered** means an employee is benefiting under the plan. For the popular 401(k) retirement plan, an employee is considered covered as long as he is eligible to defer part of his compensation. He does not have to actually make contributions. **Active participation** for purposes of determining deductibility of IRA contributions differs from being covered under a qualified plan. Specifically, an employee must be contributing to the plan, having employer contributions or forfeitures allocated on his behalf, or accruing a benefit in a DB plan before she is considered an active participant in a qualified plan for IRA purposes.

Plans that do not meet the percentage test must satisfy either

- the ratio test, or
- the average benefits percentage test.

Under the **ratio test**, the percentage of nonhighly compensated employees (non-HCEs) covered by the plan must be at least 70% of the percentage of highly compensated employees (HCEs) who are covered. In formula terms, this may be written as the following:

$$\text{ratio test} = \frac{\text{\% of non-HCEs covered}}{\text{\% of HCEs covered}} \geq 70\%$$

Under the **average benefits percentage test**, the average benefits percentage accrued for non-HCEs as a group must be greater than or equal to 70% of the average benefits percentage accrued for the HCEs. In formula terms, this may be written as the following:

$$\text{average benefits percentage test} = \frac{\text{average benefits \% non-HCEs}}{\text{average benefits \% HCEs}} \geq 70\%$$

EXAMPLE: Coverage tests

An employer employs 200 eligible employees, 10 of them are HCEs. Nine out of the 10 HCEs, and 120 out of 190 non-HCEs benefit from the plan. The average benefit for the HCEs is 8%, and the average benefit for the non-HCEs is 6%. Therefore, the results of the coverage tests are as follows:

$$\text{percentage test} = \frac{\text{120 non-HCEs}}{\text{190 non-HCEs}} = 63\% \text{ of all non-HCEs covered}$$

$$\text{ratio test: } \frac{\text{(120/190) non-HCEs}}{\text{(9/10) HCEs}} = \frac{0.6316}{0.90} = 0.7018 \text{ (or 70.18\%)}$$

$$\text{average benefits percentage test: } \frac{6\%}{8\%} = 75\%$$

Although this plan fails the percentage test, it passes both the ratio and the average benefits percentage test. However, the following two consequences are notable here:

- Seventy-one employees are not participating, even though they are eligible under the participation test (21-and-1 or 2-year) and eligibility test. It should be noted that employers are permitted to design qualified plans that exclude certain classes of employees from coverage, as long as the plan meets one of the coverage tests. For example, an employer may exclude salaried employees, commissioned employees, or hourly employees. However, employers may not exclude classes of employees based on age and service because there are already rules (eligibility rules) related to age and service. If an employer excludes certain classes of employees because they have a different retirement plan (e.g., employees covered under a collective bargaining agreement where retirement benefits were negotiated), those employees would also be excluded from the participation tests for the general plan. In other words, these classes of people with another retirement plan would not be listed as nonparticipating in the general plan and the total employees number for the general plan would be reduced by that number as well.
- In the example, the average benefit percentages for both non-HCEs and HCEs were given as a stipulated fact. In reality, these percentages are not easy to determine and often require an actuary or professional plan administrator. Therefore, if the percentage test is not satisfied, most employer-sponsors use the ratio test to determine plan compliance under the coverage rules.

A qualified plan may not discriminate against non-HCEs. If the employer wants to discriminate in favor of HCEs it would need a nonqualified plan.

PROFESSOR'S NOTE

These rules are difficult to apply for most students. Repetition is required. On the other hand, the math involved is not difficult.

50/40 Test

In addition to meeting one of the three coverage tests identified previously (percentage, ratio, or average benefits percentage test), defined benefit pension plans must meet the **50/40 test**. It mandates that all defined benefit pension plans must benefit the lesser of

- 50 employees, or
- 40% of all eligible employees.

PROFESSOR'S NOTE

One way to remember which number is for people and which number is for the percentage in the 50/40 test is to remember *people before percentages* (50 people or 40%). Note that there are no qualifiers on who the 50 people are. For this test, all types of employees are the same. If the employer has five or fewer employees and maintains a defined benefit pension plan, at least two employees must be covered by the plan.

Controlled Group Rules

Controlled group rules are designed to prevent discrimination against non-HCEs. Employers that have a significant degree of common ownership are treated as a single employer for purposes of meeting the participation and coverage rules. Types of controlled groups include businesses that are related as either brother-sister or parent-subsidiary corporations (as defined in the Tax Code). Other types of related employers are those that employ individuals through any form of affiliated service organization or lease employees from a leasing organization for an inordinately long period of time.

PROFESSOR'S NOTE

This is a very abbreviated coverage of the controlled group rules. The point of the controlled group rules is to prevent top management or owners from organizing their way out of providing a qualified retirement plan for many rank-and-file employees. For example, a business owner controls two organizations, a factory management firm with three employees (including the owner), and a large factory with 1,000 employees. The control group regulations prevent the owner from having a generous retirement plan for the factory management firm, but no retirement plan for the actual factory firm. The controlled group regulations prevent this by counting all the employees of both firms in the nondiscrimination tests.

Vesting Requirements

Vesting occurs when an employee's nonforfeitable right to receive a present or future retirement plan benefit is accrued over time, per the schedule identified in the employer-sponsored retirement plan document.

A year of service for purposes of vesting is considered 1,000 hours within a 12-month period. All years of service must be counted with few exceptions. Two of the more common exceptions are as follows:

1. Years before the implementation of the plan
2. Years before age 18

Both years before the implementation of the plan and years before age 18 may be considered at the choice of the employer (as stated in the plan document). Service time with a subsidiary of the employer-sponsor must be included for determining vesting eligibility.

A **non-top-heavy** defined benefit pension plan must vest at least as rapidly as one of the following two schedules:

- *Five-year 100% or cliff vesting*. In this schedule, no vesting is required before five years of employee service, with 100% vesting then required at the end of five years of service.
- *Three-to seven-year graduated or graded vesting*. Using this schedule, the plan must provide vesting that is at least as fast as those listed in the following table.

Figure 1.3: 3-to-7-Year Graded Vesting Schedule

Years of Service	Vesting Percentages
3	20%
4	40%
5	60%
6	80%
7 or more	100%

Note: If the two-year eligibility rule is used, 100% immediate vesting is required upon the date of employee enrollment.

Employer contributions to defined contribution plans must vest at least as rapidly as a three-year cliff vesting schedule, or a two-to-six-year graded vesting schedule illustrated as follows. A top-heavy defined benefit pension must also use three-year cliff or two-to-six graded vesting. Top-heavy plans are discussed later in this module.

Figure 1.4: 2-to-6-Year Graded Vesting Schedule

Years of Service	Vesting Percentages
2	20%
3	40%
4	60%
5	80%
6 or more	100%

- For vesting purposes, the years of service schedule begins with an employee's hire date, not the employee's entrance into the plan. In a plan with the traditional 21-and-1 eligibility requirement, an employee with one year of participation in the plan would normally have two years of service for vesting purposes, and so forth.
- With a three-year cliff vesting schedule, no vesting is required before three years of service. Upon completion of three years of service, 100% vesting is required.
- The employer may choose a vesting schedule that is more favorable to the employees but not less favorable than the listed maximum cliff or graded vesting schedules.
- If a qualified plan provides for employee contributions (on a before-tax or after-tax basis), the portion of the benefit or account balance attributable to those contributions must be 100% vested at all times.
- When an employee attains normal retirement age (as defined by the retirement plan document), the employee will automatically be 100% vested.
- In the event the qualified plan is terminated, the employee-participant immediately becomes 100% vested in all plan contributions and benefits.

PROFESSOR'S NOTE

When considering which vesting schedule to adopt, a major key is usually saving the firm money. Thus, a graded vesting schedule is often

chosen because it makes the rank-and-file workers wait the longest to fully vest. The assumption is that the decision makers have been or will be at the firm for a long time. On the other hand, if all the rank and file employees leave before three years, then the firm could select three year cliff vesting. Remember, to answer vesting schedule questions from the owner's perspective unless asked about recruiting.

Key Employees

A key employee, for purposes of the top-heavy rules, is an employee who at any time during the plan year is

- an officer of the employer having annual compensation from the employer of more than $215,000 (2023),
- a greater than 5% owner of the employer, or
- a greater than 1% owner of the employer having annual compensation from the employer of greater than $150,000 (not indexed for inflation).

In addition, for these purposes, no more than 50 employees (or, if less than 50 employees, the greater of three or 10% of the employees) will be treated as officers.

Top-Heavy Requirements

A defined benefit plan that provides more than 60% of its aggregate benefits or account balances to key employees is considered top heavy. If a DB plan is **top heavy**, there are two consequences. These consequences include the following:

- It must provide accelerated three-year cliff or two-to-six-year graded vesting.
- It must provide a minimum defined benefit accrual of 2% times the number of years of service (up to ten years) for all nonkey employees. For example, James Meridith worked for UM, Inc. as a non-key employee for 25 years. The plan was top-heavy all those years. The defined benefit formula gives a 1% benefit for each year of service. What percentage would James receive from this defined benefit plan? The answer is 35%. He would accrue a 2%/year benefit for the first 10 years years. This would give him a 20% benefit for those years. He gets a 1% benefit for the remaining 15 years. Thus, his final benefit percentage is 35%.

Under a top-heavy defined contribution plan, the employer must make a minimum contribution of at least 3% of annual compensation to each non-key employee's account. If the contribution for key employees is less than 3%, the contribution for non-key employees can be equal to the contribution for key employees. For example, the employer can make a 1% contribution for all participants, both key employees and non-key employees.

PROFESSOR'S NOTE

Notice that a defined contribution plan already requires a three-year cliff or two-to-six-year graded vesting schedule. Thus, it is easy to think being top heavy does not really matter for defined contribution

plans. However, a top-heavy defined contribution plan must provide a 3% contribution for the non-key employees (unless the key employees are receiving less than a 3% contribution). If the key employees get less than 3%, the non-key employees must get the same contribution percentage as the key employees.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

3. If a qualified plan has been designed using normal eligibility requirements, which of these would require an employee to be eligible to participate in the plan?
   I. 18 years of age
   II. 21 years of age
   III. Completion of 1 year of service; at least 1,000 hours worked per year
   IV. Completion of 3 years of service; average 600 hours per year
   A. I and III
   B. I and IV
   C. II and IV
   D. II and III
4. Which of these employees are HCEs of Underwood Corporation for the year 2023? Assume the top 20% election was made by Underwood Corporation.
   I. Benson, who owns 10% of Underwood and is an employee
   II. Meredith, the president of Underwood, whose compensation was $160,000 last year and is in the top 20% of all paid employees
   III. Janet, an employee salesperson, who earned $200,000 last year and was the top paid employee at Underwood this year
   IV. Jeremy, who earned $115,000 last year as Underwood's legal counsel and is not in the top 20% of all paid employees
   A. I and II
   B. II and III
   C. I, II, and III
   D. II, III, and IV
5. Merriweather Co. employs 200 eligible employees, 20 of them are HCEs. Sixteen of the 20 HCEs, and 125 of the 180 non-HCEs benefit from the Merriweather qualified pension plan. The average benefits accrued for the HCEs are 8%. The average benefits accrued for the non-HCEs are 3%. Which of these is CORRECT with respect to the coverage tests applied to the Merriweather plan?
   A. The plan meets the ratio test and the average benefits percentage test.
   B. The plan does not meet the average benefits percentage test, but it meets the ratio test.
   C. While the plan does not meet the ratio test, it meets the average benefits percentage test.
   D. The plan does not meet the ratio test or the average benefits percentage test.

6. Grant, age 42, wants to establish a qualified defined contribution plan for his small business. He currently earns $115,000 annually. Grant employs four people whose combined salaries are $58,000 annually and ages range from 24 to 30. The average employment period is 3½ years. Which vesting schedule is best suited for Grant's qualified plan?
   A. Two-to-six-year graded vesting
   B. Five-year cliff vesting
   C. Three-year cliff vesting
   D. Three-to-seven-year graded vesting
7. Which of these plan contributions must be immediately (100%) vested to the employee-participant?
   I. Employer contributions to a defined benefit plan
   II. Employer contributions in a terminated qualified plan
   III. Employee contributions to a defined contribution plan
   IV. Employer contributions on behalf of an employee made eligible according to the 21-and-1 rule
   A. II and III
   B. I and III
   C. II and IV
   D. I and IV
8. Which of these is CORRECT when describing the purpose of the controlled group rules?
   A. They are intended to prevent discrimination against nonhighly compensated employees through the use of separate entities.
   B. They are intended to promote the use of separate entities.
   C. They are intended to afford an employer or qualified plan sponsor flexibility in plan design.
   D. They are intended to prevent discrimination against highly compensated employees through the use of separate entities.

Reading: Plan Contribution and Benefit Limits

LO 1.3.2: Analyze a situation to determine the limitations on qualified plan contributions and benefits and the implications thereof.

Limitation on Contributions and Benefits

To prevent a qualified plan from being used primarily as a tax shelter for HCEs and executives, the Tax Code imposes a limitation on plan benefits and contributions. For purposes of determining these benefits, employee compensation is capped at a specified amount. For 2023, this cap on **includible compensation** is $330,000 annually. Thus, only the first $330,000 of any participant's compensation may be used to determine contributions for a qualified plan.

The IRC imposes limits on defined benefit pension plans, defined contribution pension plans, and profit-sharing plans, but does so in different methods. The IRC limitation for defined benefit pension plans is applied to the actual benefit the participant will receive at retirement, while the limitation for defined contribution

plans is applied to the amount of annual contributions that may be made by the employer and participant, which is referred to as the **annual additions limit**.

With respect to defined benefit pension plans, the benefit paid at normal retirement age, as specified in the plan documents (usually age 65 or the Social Security normal retirement age), cannot exceed the lesser of

- 100% of the participant's compensation averaged over the three highest consecutive years of compensation, with includible compensation considered in the average being limited to $330,000 (as of 2023); or
- $265,000 annually (as of 2023).

Regarding defined contribution plans, the annual additions limit for a plan sponsored by any one employer, including a related employer (A related employer is a second employer with a lot of common ownership. This was covered previously in this module under controlled group regulations) cannot exceed the lesser of

- 100% of the participant's annual compensation, or
- $66,000 annually (as of 2023).

For this purpose, annual additions include

- employer contributions,
- employee contributions (both pretax and after-tax contributions), and
- forfeitures allocated to the defined contribution plan on behalf of the employee.

Forfeitures are nonvested amounts returned to the plan when a participant separates from service without being 100% vested.

Note, however, that the annual additions limit does not include **catch-up contributions** for participant-employees age 50 or older. Catch-up contributions are covered in Module 3 of this course. Also, a taxpayer who has two separate sources of income (for example, works for two unrelated employers) is eligible for two annual additions limits—one for each unrelated employer—or a contribution total of $132,000 for 2023. However, elective deferrals by a participant are aggregated between all plans in applying the annual limit. For example, an employee would not be able to defer $22,500 in 2023 in a Section 401(k) plan at one employer and an additional $22,500 in 2023 in a Section 401(k) plan at a second employer in the same year.

The one exception is that elective deferrals into a Section 457 plan are not aggregated with elective deferrals into other plans.

EXAMPLE: Annual additions limit

In 2023, Tonia, who is age 49, works for Best Technologies Corporation and earns compensation of $400,000. Best Technologies maintains a defined contribution plan for the benefit of its employees. Therefore, for purposes of the annual additions limit to Tonia's account, Best Technologies can only consider $330,000 of her compensation in making contributions on her behalf. Further, Best Technologies can contribute no more than $66,000 (less Tonia's contributions and reallocated forfeitures) to the defined contribution plan on her behalf. Tonia is not eligible for catch-up contributions until next year when she reaches age 50.

Contributory vs. Noncontributory

Qualified retirement plans may be distinguished as either a **contributory plan** (employee makes some contribution) or a **noncontributory plan** (employer pays all). Most pension and profit-sharing plans are noncontributory. The common exceptions are the Section 401(k) plan and the thrift plan (an after-tax savings plan). A thrift plan is not a Roth elective deferral plan. A thrift plan is similar to a nondeductible IRA in the sense that contributions establish a basis inside the retirement plan. Thrift plans became outdated arrangements when Roth elective deferrals were allowed for 401(k), 403(b), and 457 plans. Still a few thrift plans exist and planners need to be generally aware of them.

The reason most qualified plans are noncontributory is that both employers and employees view them as part of an overall compensation package paid for by the employer.

Deduction Limit

Keep in mind the difference between employer contributions made on behalf of an employee (generally subject to a limit of 100% of employee includible compensation) and employer tax deductions taken for those contributions (generally subject to a limit of 25% of includible employee compensation). The limit on contributions is determined with respect to individual employee includible compensation, whereas the limit on the deduction is determined with reference to the aggregate includible compensation of the company. Thus, it is indeed possible that the employer contribution, on behalf of one employee, can exceed 25% of the worker's compensation as long as it is balanced out by another employee's percentage contribution so as not to exceed the overall 25%-of-includible-compensation employer deduction limit for contributions to a defined contribution plan.

An employer's maximum annual deduction for contributions to a defined benefit pension plan is limited to an amount determined actuarially in the standards of Section 404(a) in the IRC, or the amount required to meet minimum funding standards, whichever is greater. The 25%-of-includible-compensation limit does not apply to the funding of a defined benefit pension plan, and the deduction is restricted only to that actuarial amount necessary to fund the employee's promised benefit. As a result, an employer who wants a substantial, immediate, tax deduction for plan contributions should consider implementing a defined benefit (DB) plan as long as employee demographics and long-term company finances also favor such a plan.

Regarding defined contribution, Section 403(b), Section 457, SARSEP, and SIMPLE plans, the includible compensation amount upon which the 25% limit is based is not reduced by the aggregate amount of employee elective deferrals being made into the DC plan.

> **EXAMPLE: Profit-sharing contributions by employer**
>
> In 2023, Keith receives $50,000 in compensation and defers $10,000 of his salary under the Section 401(k) profit-sharing plan sponsored by his employer. Mandy, the only other employee, receives $100,000 in

> compensation and defers $8,000 of her salary. In applying the annual additions limit, the employer is limited to a $40,000 ($50,000 – $10,000) profit-sharing contribution on Keith's behalf because 100% of his compensation is $50,000 and $58,000 ($66,000 – $8,000) on Mandy's behalf. However, the employer may only take an income tax deduction of up to $37,500 (25% of $150,000). In this example, note the application of the maximum annual additions limit illustrates both the lesser of (1) 100% of includible compensation or (2) $66,000 in 2023. In Keith's case, the maximum contribution is limited by 100% of compensation. In Mandy's case, the maximum contribution is limited by the annual additions limit.

What if the employer wants to have a defined benefit plan and also a defined contribution plan? In this case, if the amount required to fully fund the defined benefit plan takes up all or a lot of the 25% of company compensation limit, there is a special rule from the Pension Protection Act that still allows the company to have a defined contribution plan up to 6%. For example, if it took 30% of the company's total compensation to fully fund their defined benefit plan, the company can still have a 6% defined contribution plan. Very few employers make such large contributions to retirement plans.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

9. Beta Corporation maintains a profit-sharing plan with Section 401(k) provisions on behalf of its employees. The company matches dollar for dollar up to 3% of employee compensation. Daniel, age 40, is an employee of Beta Corporation and is paid $100,000 for 2023. Assuming he defers the maximum employee contribution amount for 2023 and that Beta allocates no forfeitures to his account for that year, how much can the company contribute as a profit-sharing contribution to Daniel's account (exclusive of the mandatory employer-match)?
   A. $3,000
   B. $22,500
   C. $40,500
   D. $48,000

10. Treetop Corporation maintains an employee includible compensation totaling $100,000. The employees of Treetop also make elective deferrals to the company's defined contribution qualified plan of $10,000. What is the total amount that Treetop may take as an employer deduction for employer contributions made to its qualified plan this year?
    A. $10,000
    B. $25,000
    C. $27,000
    D. $100,000

Reading: Plan Integration with Social Security

LO 1.3.3: Apply the requirements for integrating a retirement plan with Social Security.

Integration with Social Security (Permitted Disparity Rules)

Integrating retirement plans with Social Security allows for a certain amount of extra contributions or benefits to go to highly paid employees. These rules are some of the most difficult in the CFP program. They will require extra effort to master them.

The formula used to calculate a worker's retirement benefit from Social Security inherently discriminates against workers whose compensation is above the annual Social Security taxable wage base because compensation above the wage base is not considered in the benefit formula. To help remedy this inequality, the law allows most qualified plans and the tax-advantaged SEP to utilize a concept known as Social Security integration, sometimes called the **permitted disparity rules**. An **integrated plan** accounts for the disproportionate benefit accrual under Social Security and provides for a tiered benefit formula, providing a base benefit for compensation below an **integration level**. The integration level is typically the Social Security taxable wage base ($160,200 in 2023), and the retirement plan provides a higher benefit for compensation above the integration level.

Integration of Defined Benefit Plans

There are two methods of integrating defined benefit formulas with Social Security: the **excess method**, which is more common, and the **offset method**. Under the excess method of integration, the plan defines a level of compensation (referred to as the integration level) and then provides a higher rate of benefits for compensation above this level. Under the **offset method** of integration, a formula approximates the existence of Social Security benefits and reduces the plan formula. However, considering either method, the maximum permitted disparity between the defined benefit percentage below and above the covered compensation level is three-fourths of 1% times the employee's years of service, up to 35 years. Thus, the maximum percentage difference is 26.25%.

base benefit percentage + permitted disparity = excess benefit percentage

Integration of Defined Contribution Plans

Defined contribution plans can only be integrated with Social Security using an excess method of integration; the offset method is not permitted for defined contribution plans. The excess method provides higher contributions above the integration level than below the integration level. The contribution level below the integration level is called the base contribution percentage, whereas the contribution level above the integration level is referred to as the excess contribution percentage. Under the permitted disparity rules, applying to the integration of defined contribution plans, the maximum allowable excess contribution percentage is the lesser of

- two times the base percentage, or

- the base percentage plus 5.7%. 5.7% is essentially the amount of the worker's pay that is going toward Social Security retirement benefits from their 7.65% FICA.

> **EXAMPLE: Permitted disparity**
>
> If the base contribution percentage for an integrated defined contribution plan is 5%, the permitted disparity is also 5%, making the excess percentage no more than 10% (5% + 5%) of compensation above the integration level. Alternatively, if the base contribution percentage is 6%, the permitted disparity is 5.7%, resulting in an excess percentage amount of no more than 11.7% (6% + 5.7%).

As noted, the integration level for integrated defined contribution plans is usually equal to the Social Security taxable wage base. The integration level may be lower than the Social Security wage base, which allows more income to be considered for the excess contribution percentage. However, if the integration level is lowered, so is the maximum difference between the base percentage and the excess percentage. The details of these reductions for lowering the integration level below the current year's taxable wage base are beyond the scope of the CFP program. Plans prohibited from integration with Social Security include employee stock ownership plans (ESOP), SARSEP, and SIMPLE plans. In addition, employee elective deferrals (e.g., to a Section 401(k) plan) and employer matching contributions cannot be integrated with Social Security. The calculation for excess contribution percentage is as follows:

base contribution percentage + permitted disparity = excess contribution percentage

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

11. Sunset Company sponsors a defined contribution plan that provides a base contribution of 12.3% of employee compensation. Assuming the integration level equals the Social Security taxable wage base, what is the maximum excess contribution percentage allowed under the permitted disparity rules?
    A. 5.7%
    B. 12.3%
    C. 25.0%
    D. 18.0%
12. James Somerset earns $170,200 in 2023 working for Jamaica Imports of New York, NY. The firm has a 10% money purchase plan that is integrated with Social Security. The taxable wage base for 2023 is $160,200. What would the maximum contribution to the money purchase plan for James in 2023?
    A. $16,020
    B. $17,590
    C. $18,361
    D. $26,721

TOPIC 1.4: OTHER QUALIFIED PLAN CONSIDERATIONS

Reading: Qualified Plan Reporting, Fiduciary Obligations, and Prohibited Transactions

LO 1.4.1: Determine qualified plan reporting requirements, fiduciary obligations, and prohibited transactions under ERISA.

Establishing a Qualified Plan and Reporting Requirements

An employer-sponsor must legally establish and adopt a qualified plan no later than the due date for the firm's tax return (including extensions). If the plan will use a tax-exempt trust for funding (the usual case), the trust must also be established by the same time and must be valid under the law of the state in which it is established. Certain small employers are eligible for a tax credit of up to $5,000, for three years in start-up costs or employee education expenses incurred with the adoption of a qualified plan, SEP, or SIMPLE IRA. Additionally, an eligible employer that adds auto-enrollment can claim a credit of $500 per year for a three-year period beginning with the first year auto-enrollment is enacted. The main requirement for these credits is the employer having 100 or fewer workers making at least $5,000 in the preceding year.

Because of the complexity of qualified plan technical requirements and the tax cost of having the plan potentially disqualified by the IRS, some employers apply to the IRS for a favorable ruling that the plan provisions meet the Tax Code requirements. This ruling is known as an **advance determination letter** and is issued by the District Director of the IRS district in which the employer is located. An alternative to the time and cost of such a letter is for the employer to adopt either a master or prototype plan. These are standardized plans of various types (e.g., a profit-sharing plan) that use standardized language approved by the IRS. A master plan is distinguished from a prototype plan because a master plan uses only a single financial institution for funding, while a prototype plan usually allows more funding possibilities.

The organizations that can provide plan services include trust companies, commercial banks, investments firms, asset management groups, professional trade organization and insurance companies.

The SECURE Act made the deadline for establishing and funding employer retirement plans the due date of the organization's tax return, including extensions. Previously, only SEPs had this late a date. Also, notice that waiting so late to establish an employer retirement plan means the employees are not allowed to contribute to the plan for the first year. Employees must make the election to contribute to an employer retirement plan prior to earning the money. If the plan is not established before the end of the year, there will not be time for a worker to contribute for that year. Finally, there are different deadlines for worker and employer contributions. Employer contributions are not required until the due date of the tax return including extensions. On the other hand, ERISA says worker deferrals must be contributed to the retirement plan "as soon as possible" after the money is deducted from the worker's pay. In general this means the deadline is the 15th business day of the next month and small businesses (less than 100 workers)

have a safe harbor of seven days after the payroll date. Most employers contribute the money much faster than these deadlines.

Reporting and Disclosure Requirements

Qualified plans must satisfy the reporting and disclosure requirements specified by the ERISA legislation. The following are major elements of reporting and disclosure:

- A **summary plan description (SPD)**. This must be provided automatically to all plan participants within 120 days after the plan is established or 90 days after a new participant enters an existing plan. The SPD explains how the plan works, what benefits are available, and how to get the benefits. It must be provided to all plan participants, noting the limitations, exceptions, reductions, and other restrictions on plan benefits, and it must be issued at least every 10 years.
- An **annual report (Form 5500 series)**. This must be filed with the IRS annually by the end of the seventh month period after the plan year ends. The Form 5500 is also required to be filed with the DOL, so it consolidates annual report forms for the IRS, DOL, and PBGC. Form 5500 contains detailed financial information (including actuarial information if the plan is a defined benefit plan). A simplified Form 5500 (the Form 5500 SF) is available for smaller qualified plans.

  Form 5500-SF is available to plans that meet all of the following criteria:

  a. Have fewer than 25 participants
  b. Are eligible for the small plan audit waiver
  c. Hold no employer securities
  d. Have 100% of assets in investments that have a readily determinable fair market value.

One-participant plans may use Form 5500-EZ. Form 5500-EZ can be used by small plans consisting of an individual and spouse or two partners and their spouses. It satisfies the minimum coverage requirements without being combined with any other plan maintained by the same employer. It does not cover a business that is part of a controlled group, or a business for which leased employees perform services. One-participant plans with assets of $250,000 or less are exempt entirely from filing Form 5500-EZ or any other 5500 form (except in the plan's final year).

- A **summary annual report (SAR)**. This summarizes the basic information included in the Form 5500 series, and must be provided to plan participants each year within nine months of the end of the plan year. Participants also have a right to see the full annual report (Form 5500 series) if they need information about the plan's financial status.
- An **individual accrued benefit statement**. This must generally be provided to a plan participant within 30 days of the request. Under the Pension Protection Act (PPA), defined contribution plans must provide benefit statements at least quarterly to participants who direct their own investments and annually to those who cannot.
- A **summary of material modification (SMM)**. This will explain any substantive changes, such as vesting provisions, that occurred to the SPD within the past year, and must be issued as needed.
- Certain reports must also be filed with the PBGC.

Fiduciary Considerations and Prohibited Transactions Under ERISA

The DOL regulates the actions of qualified plan fiduciaries, which are generally the plan sponsor, administrator (if different than the plan sponsor), and plan trustee. Note that plan fiduciaries are not limited to investment advisors. The point is that all those making important decisions about an employer's retirement plan are fiduciaries. Thus, all decisions for any aspect of an employer retirement plan should be viewed through the lens of what is best for the plan participants. This does not require all retirement plans to be Cadillac plans, but it does require the plan to be administered properly. For example, the plan fiduciaries should have a periodic review process to make sure the plan is not being overcharged, etc. In addition, ERISA specifies that any investment adviser who renders investment advice for a fee is also a **fiduciary**. Financial advisors are exempt from fiduciary liability under ERISA if they are one of the following:

1. A person registered as an investment advisor under the 1940 Act or under the laws of the state in which it maintains its principal office and place of business, These people are not considered fiduciaries under ERISA because they are already considered fiduciaries under either the Investment Advisors Act of 1940 or state law.
2. A financial institution
3. An insurance company
4. A person registered as a broker or dealer under the 1934 Act
5. An affiliate of one of the previous or an employee, agent, or registered representative of a person described previously who satisfies certain requirements. The exemption covers transactions such as providing investment advice to a participant or beneficiary under the plan; acquiring, holding, or selling a security pursuant to such investment advice; and receiving fees or other compensation, directly or indirectly. Even so, retirement plan providers can recommend their own products without violating fiduciary rules. The exemption is only valid if the fiduciary advisor provides the investment advice under an eligible investment advice arrangement. As a result, plan service providers (such as mutual fund families) and investment adviser representatives have been reluctant to provide full advice about retirement plan investing for fear of fiduciary liability. The PPA permits retirement plan service providers and investment adviser representatives to give advice to qualified plan participants and, if warranted, recommend their own funds without violating fiduciary rules. The legislation does this by providing an exemption to the prohibited transaction rules for advice provided under an eligible investment advice arrangement. As defined in the PPA, an eligible investment advice arrangement exists where either

- the investment adviser's fees are neutral (meaning the fees do not vary on the basis of which investment options are chosen), or
- an unbiased computer model certified by an independent expert to create a recommended portfolio for the client's consideration is used.

Before initially advising clients, the investment adviser must provide written notice (on paper or electronically) including information on past performance and rates of return for each of the plan's investment options, and any fees or other compensation to be received by the adviser. Finally, it should be noted that investment advisers for

IRAs may only use the neutral fee option and not the computer model option when providing eligible investment advice.

The fiduciary standards of ERISA include a prudence and diversification requirement. Under the prudence standard, the fiduciary is required to act with the care, skill, and prudence of an individual familiar with the circumstances. The diversification requirement does not mandate a specific percentage limit on any one investment (or investment class). Instead, the diversification depends on the facts and circumstances of each plan and plan participant.

A fiduciary may not be paid for services if already receiving full-time pay from an employer or union whose employees or members are participants. Fiduciaries cannot act in a transaction involving the plan on behalf of a party whose interests are adverse to those of the plan or its participants or beneficiaries. Causing a plan to engage in certain transactions with parties in interest is also not allowed.

One fiduciary may become responsible for the acts or omissions of another if the fiduciary participated in the breach of duty, knowingly concealed it, or imprudently allowed it to occur.

Prohibited Transaction Rules

ERISA also prohibits certain transactions between a qualified plan and a **party in interest**, or a fiduciary with respect to the plan. While the term party in interest is broad, a party in interest does include any administrator, officer, trustee, custodian, counsel, or employee of a plan; a fiduciary; any person providing services to the plan; the employer or employee union; a 50% or greater owner of the company; certain relatives of parties of interest; and certain other related corporations, employees, officers, directors, partners, and joint ventures. **Prohibited transactions** include

- the sale, exchange, or lease of any property between the plan and a party in interest;
- loans between the plan and any party in interest;
- the transfer of any plan assets or use of plan assets for the benefit of a party in interest;
- the plan's acquisition of employer securities or real property in excess of legal limits; and
- self-dealing, which is when a fiduciary acts in his own best interest in a transaction rather than in the best interest of his clients.

Loans from the plan given to plan participants are generally prohibited transactions unless such loans meet the requirements of IRC Section 4975(d)(1). For example, the owner of the company can get a retirement plan loan based on the same rules as any other participant. However, the retirement plan itself may not lend money to the owner as a plan investment. Retirement plan loan requirements will be discussed in detail in LO 6.3.2.

If there is a violation of these rules, the penalty imposed is 15% of the amount involved in each transaction from the date of first occurrence until the date of its

correction. To correct the transaction, it must be undone to the extent possible so as to place the plan in a position no worse than it would have been had the party in interest acted under the highest fiduciary standards. If the transaction is not corrected, there is an additional penalty tax of 100% of the amount involved, including the potential personal liability of the party in interest if the plan assets are not sufficient to pay the penalty.

Definitely Determinable Benefits

Qualified retirement plans must provide **definitely determinable benefits.**

DB plans provide definitely determinable benefits by being obligated to pay retirement benefits according to the details promised in the retirement plan document. For example, a DB plan may specify that a retiree will receive 2% of their final salary for every year of service, up to 35 years.

Defined contribution plans provide definitely determinable benefits by defining what contributions the employer will make to the plan. For example, the employer may choose to be obligated to match up to 5% of a worker's salary reductions into the retirement plan.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

13. What is the latest an employer can establish and/or fund a retirement plan?
    A. January 1st of the year the plan starts.
    B. Oct 15th of the year the plan starts
    C. The due date of the tax return for the year not including extensions.
    D. The due date of the tax return for the year including extensions.

MODULE 1 ANSWER KEY FOR PRACTICE QUESTIONS

1. **C** The Internal Revenue Service (IRS) supervises the creation of new, qualified retirement plans.

2. **A** The PBGC can terminate a defined benefit plan if:
   - minimum funding standards are not met;
   - benefits cannot be paid when due; and
   - the long-run liability of the company to the PBGC is expected to increase unreasonably.

   A professional service corporation with 25 or less participants is not required to maintain PBGC coverage.

3. **D** The participation requirements for a plan using normal eligibility requirements (non-2-year eligibility standards) are attained at the age of 21 by the employee and at the completion of 1 year of service of at least 1,000 hours annually (the 21-and-1 rule).

4. **C** Jeremy is not an HCE because he did not earn more than $135,000 in 2022 and nothing indicates he is expected to earn more than $150,000 in 2023, is not in the top 20% of all paid employees, and does not have any ownership of the corporation. Even if Jeremy was in the top 20% of paid employees, he would not be considered highly compensated because he does not make enough money. On the other hand, if he owned more than 5% of the company, then he would be an HCE due to the ownership test.

5. **B** The ratio test is satisfied because the plan covers 86.8% of the non-HCEs in proportion to the HCEs that are covered. The calculation is as follows:

   $$\text{ratio test: } \frac{125/180 \text{ non-HCEs}}{16/20 \text{ HCEs}} = \frac{0.6944}{0.80} = 0.8681 \text{ (or 86.8\%)}$$

   The average benefits percentage test is not met because that percentage is only 37.5% (3% divided by 8%).

6. **A** Because the plan is a defined contribution plan, Grant must adopt a vesting schedule that is at least as generous as the three-year cliff vesting, or two-to-six-year graded vesting for all employer contributions, to a defined contribution plan. Given the average length of employment, the most suitable vesting schedule from Grant's perspective is two-to-six-year graded vesting. This way, the employees have to work six years before they are fully vested.

7. **A** Employer contributions must be 100% vested immediately in the case of terminated plans and employees required to meet the two years of service eligibility requirement. Employee contributions are always 100% vested.

8. **A** The purpose of the controlled group rules is to prevent discrimination against nonhighly compensated employees through the use of separate entities.

9. **C** In 2023, the maximum employee contribution amount here is the lesser of 100% of Daniel's compensation ($100,000) or $66,000. Therefore, subtract the total of Daniel's elective deferrals ($22,500) and the already-contributed company match ($3,000) from the $66,000 limit. This leaves an additional profit-sharing contribution of $40,500 ($66,000 – $25,500) that may be made to Daniel's account by Beta Corporation.

10. **B** The 25% employer deduction limit is based on the gross includible compensation of $100,000. The employee elective deferrals do not count toward the $25,000 limit; therefore, Treetop may contribute and deduct as much as $25,000.

11. **D** The excess contribution percentage cannot exceed the lesser of two times the base percentage (24.6%) or the base percentage plus 5.7%. Therefore, the maximum excess contribution percentage is 18.0% or (12.3% + 5.7%).

12. **B** The base contribution percentage is made up to the Social Security taxable wage base of $160,200 in 2023. Thus, James gets 10% of the first $160,200 for 2023 ($16,020). Next you must calculate the permitted disparity. The permitted disparity is the lesser of: the base contribution percentage (10% in this case) or 5.7%. Thus, the permitted disparity is 5.7%. That makes the excess contribution percentage 15.7% (10% + 5.7%). 15.7% of the remaining $10,000 is $1,570. Thus the total contribution for 2023 is $17,590.

13. **D** The latest an employer can establish and/or fund a retirement plan is the due date of the tax return for the year including extensions. This is an attempt to encourage more new employer retirement plans. This deadline really only applies to employer contributions. A worker must agree to place future earnings into a retirement plan before the money is earned. Thus, a worker cannot defer any compensation into a plan for the first year if that plan is not established until after that year if over. Finally, this rule used to apply only to SEPs. Now it applies to all employer retirement plans except SIMPLEs.

MODULE 2

Defined Benefit and Other Pension Plans

INTRODUCTION

This is the first of three modules discussing the various types of employer-sponsored retirement plans. This module addresses the first broad category of qualified plans: those that provide retirement benefits on the basis of defining benefits, also known as defined benefit plans. Sometimes, the word *pension* is substituted for the traditional form of *defined benefit plan* and, while that word is technically correct, defined benefit plans are not the only types of pension plans. There are also pension plans that fall under the defined contribution type of qualified plans—notably, the money purchase and target benefit forms of pension plans. Nonetheless, pension plans promise either benefits or contributions building toward a benefit. Mandatory annual funding and no in-service withdrawals (except to employees age 59½ or older) are hallmarks of these types of plans. Two forms of defined benefit pension plans are the traditional defined benefit pension plan and the cash balance pension plan. Both are tested for discrimination based on benefits rather than contributions.

TOPICS, LEARNING OBJECTIVES, AND READINGS

The topics covered in this module are as follows:

- Topic 2.1: Traditional Defined Benefit Pension Plans
- Topic 2.2: Other Types of Defined Benefit Pension Plans
- Topic 2.3: Defined Contribution Pension Plans

Throughout this module, you will see learning objectives (LOs) that emphasize the knowledge and application skills you will gain from this module. These specific statements, based on the 2021 CFP Board's Principal Knowledge Topics list (the blueprint for the current CFP Board exam), advise you regarding what you should know and be able to do at the completion of this module.

The following table shows a list of module topics, LOs, and readings.

Learning Objective		Readings
Topic 2.1: Traditional Defined Benefit Pension Plans		
2.1.1	Evaluate the characteristics of traditional defined benefit pension plans, including their advantages and disadvantages.	Traditional Defined Benefit Pension Plans
2.1.2	Analyze a defined benefit plan to determine a participant's plan benefit.	Plan Benefits
Topic 2.2: Other Types of Defined Benefit Pension Plans		
2.2.1	Interpret the features of cash balance pension plans.	Cash Balance Pension Plans
2.2.2	Describe the attributes of fully insured (Section 412(e)(3)) pension plans.	Fully Insured Pension Plans
Topic 2.3: Defined Contribution Pension Plans		
2.3.1	Examine the characteristics of money purchase pension plans.	Money Purchase Pension Plans
2.3.2	Examine target benefit pension plans and how they benefit participants.	Target Benefit Pension Plans

KEY TERMS

career average method
cash balance pension plan
DB(k) plan
defined benefit pension plan
final average method
flat amount formula
flat percentage formula
forfeitures
interest rate credit
money purchase pension plan
Pension Protection Act of 2006 (PPA)
Section 412(e)(3) plan
Section 415
tandem plan
target benefit pension plan
unit benefit formula

TOPIC 2.1: TRADITIONAL DEFINED BENEFIT PENSION PLANS

Reading: Traditional Defined Benefit Pension Plans

LO 2.1.1: Evaluate the characteristics of traditional defined benefit pension plans, including their advantages and disadvantages.

The traditional **defined benefit pension plan** is an employer-sponsored qualified retirement plan that guarantees a specified benefit level (monthly pension amount) at the employee-participant's date of retirement. As such, the objective of the plan is to provide a certain level of retirement income to each employee, regardless of age at plan entry. Since the benefits are the responsibility of the employer (regardless of employer profits) and not the employee, all retirement plan assets are pooled into a single overall retirement fund. Workers do not have individual account balances with a defined benefit plan like they have with a defined contribution plan. Workers also do not make any investment choices with a defined benefit plan. The plan requires the services of an actuary to calculate employer contributions and demonstrate that minimum funding standards for the plan have been met. The

calculation is based on numerous variables like the participant's age, compensation, length of service, expected investment results, and administration expenses. Workers who are covered by a defined benefit plan often assume their retirement is set. Yet, if they leave the employer with the defined benefit plan before their normal retirement date, there can be a significant loss of retirement benefits, and the need to save for retirement at their next job is greatly enhanced. Additionally, for those with less than 10 years of service, the actual retirement benefit will be reduced by 10% for every year of service below 10. For example, Mandy earned a defined benefit amount of $1,000 per month. However, she had only worked for the employer for seven years. Thus, her actual benefit would be reduced by 30% (10% times the three years she is short) and her final benefit would be $700 per month.

Also, ERISA requires reporting and disclosure of defined benefit plan information to the plan participants, the IRS, the DOL, and the PBGC. In all, defined benefit plans are typically most suitable for businesses that have two distinguishing features:

1. The first is a predominantly older workforce, typically with owners and highly valued executives age 50 or older. Defined benefit plans favor older employees because the plan must fund the benefit in a shorter period and, thus, make a larger contribution for an older worker than for a younger worker who is making the same salary. Defined benefit plans are especially good for a highly profitable business with a small number of owners and upper management who are much older than the rank-and-file workers.
2. The second is a stable cash flow, because the requirement to make annual contributions to this type of plan is mandatory.

There are several advantages and disadvantages of the traditional defined benefit pension plan. Among the advantages are the following:

- The benefit levels are guaranteed, both by the employer and, to a limited extent, by the Pension Benefit Guaranty Corporation (PBGC)—the governmental entity that insures defined benefit pension plans.
- For older, highly paid employees, a defined benefit pension plan generally allows the maximum amount of contributions to be made for their benefit. In fact, the only limit on the contribution each year is the amount needed to meet the minimum funding standard. The minimum funding standard is the amount required to keep the plan on track to provide the promised benefits. This amount can even exceed the annual contribution limit for defined contribution plans of $66,000 in 2023. For example, if an actuary determines the contribution to the defined benefit plan for an employee is $100,000, then $100,000 can be contributed to the defined benefit plan for that employee's portion of the overall retirement plan. However, Section 415(b) limits the pension benefits that may be provided under the plan to the lesser of $265,000 (2023) or 100% of the participant's highest consecutive three-year average compensation. Therefore, a defined benefit plan has a benefit limit, whereas a defined contribution plan has a contribution limit.
- Defined benefit pension plans may encourage early retirement. This can help prevent a firm from having a large component of its workforce be older and highly paid, but not have the means to have the desired retirement lifestyle.
  - In traditional defined benefit pension plans, employees are not taxed until benefits are received.

  - Retirement benefits, at adequate levels (according to the employer's goals), can be provided to all employees regardless of age at plan entry.

- Because of the actuarial and PBGC costs necessary to administer the plan, defined benefit pension plans tend to be expensive to administer.
- They are complex, both in operation and design.
- The employer assumes the risk of poor investment results in the plan.
- A defined benefit plan determines the adequacy of retirement income that will be addressed by the plan. For example, an employer might choose for the retirement plan to replace 50% of long-term workers' salaries. It then might assume that Social Security will replace 25%. Thus, the retirement plan assumes that, for plan purposes, retirement adequacy is about 75% of employment income. It is important for the workers to understand this because the plan-determined adequacy of income might not be enough for a worker's individual situation.

PROFESSOR'S NOTE

The CFP® exam program does not cover the intricate details of the administration, accounting, and actuarial assumptions for a defined benefit plan. However, a student who understands the retirement savings calculation is approximating many aspects of funding a defined benefit plan. First, the assumed retirement benefit is calculated. Next, using the plan assumptions for longevity and asset growth, the amount needed at retirement is determined. Finally, the required savings amount is determined. In fact, the individual retirement savings calculation method taught in the CFP® course is superior to most defined benefit actuarial calculations because it funds an inflation-adjusted retirement income, while most defined benefit plans only provide a fixed retirement benefit. Also, remember that only the two defined benefit pension plans (defined benefit and cash balance) have PBGC insurance.

Reading: Plan Benefits

LO 2.1.2: Analyze a defined benefit plan to determine a participant's plan benefit.

The defined benefit plan is more costly to administer than a defined contribution plan, and it specifies the final benefit an employee receives. Under **Section 415** of the Tax Code, there is a limit on the projected annual benefit that a defined benefit plan can provide to the employee-participant at age 65. For 2023, this maximum benefit is the lesser of

- $265,000 of annual compensation, or
- 100% of the participant's compensation averaged over the participant's highest three *consecutive* years of earnings.

If plan provisions permit, it is possible for the employee to retire earlier (at age 62) with no reduction in benefits. However, retiring before age 62 or with less than 10 years of plan participation generally will reduce a participant's retirement benefit from a defined benefit plan. To encourage early retirement, a defined benefit pension plan can allow benefits to fully accrue after a specified period (e.g., 25 years). Also, a

subsidized early retirement benefit can provide a benefit at age 62 that is more than the actuarial equivalent of what the retiree would receive at normal retirement age.

Benefit payments by the PBGC are financed through the payment of premiums by defined benefit plan sponsors. This premium consists of both a base premium (based on the number of plan participants per year) and a variable premium. Under the **Pension Protection Act of 2006 (PPA)**, a special reduced premium is effective for employers with 25 or fewer employees. In addition, a defined benefit plan that is maintained by a professional service employer with 25 or fewer employees does not have to be covered by the PBGC. Professional service employers include Actuaries, Doctors, Dentists, Attorneys, Accountants, Architects, and Engineers. One way to remember this group is ADD AAA Engineers. Finally, the PBGC does not cover church groups or government plans (federal, state and local governments).

For 2023, the maximum monthly benefit (for those who retire at age 65 in 2023) guaranteed by the PBGC for any type of defined benefit plan for which it assumes financial responsibility is $6,750.00 per month ($81,000.00 annually). This is not a number to memorize, it is a number to have a feel for. The point is to know that there is a limit to the PBGC's guaranteed monthly benefit and that the PBGC's promise might be significantly less than employer plan's promised amount. For example, a retiree with a $40,000/year defined benefit plan is totally protected by the PBGC. However, a retiree receiving $120,000/year from their defined benefit plan is only partially protected by the PBGC.

One of the following three formulas is typically used by the defined benefit plan to calculate the amount of a participant's promised benefit:

1. With the **flat amount formula**, a specified dollar amount is promised to the employee per month for life, beginning at age 65 (or otherwise specified date). The formula does not differentiate among employees with different compensation and does not use an accrued benefit actuarial cost method. This is typical of union plans.
2. With the **flat percentage formula**, this provides a retirement benefit that is a percentage of the employee's average earnings and will usually require a certain amount of minimum years of service before the full percentage benefit is payable.
3. With the **unit benefit formula**, a percentage of earnings is paid for each year of employee service, usually 1%–2%. For example, with a 30-year service career and a 2% per year accrual, the employee would receive a retirement payment equal to 60% (30 × 2) of her preretirement income. Under IRS safe harbor rules, a successor entity may recognize up to five years of service when establishing a defined benefit plan. The plan may not discriminate in favor of the highly compensated employee-owner(s).

Average earnings under the benefit formulas are calculated by the **career average method** or the **final average method**. Generally, use of the final average method (average earnings over the final three to five years of service) will generate a larger benefit for the employee. Keep in mind (as discussed in Module 1) that only the first $330,000 (2023) of employee compensation may be taken into account when calculating the promised benefit, regardless of the earning method used.

Annual funding of a defined benefit pension plan is mandatory on the part of the employer-sponsor, and contributions may be waived only with the consent

of the IRS and DOL. Earnings generated on these contributions, as well as other factors (such as forfeitures, the age of new employees, inflation, etc.) affect the required funding. The employer bears the risk of poor investment performance. For example, plan earnings in excess of projected earnings lower annual funding costs, while underperforming plan assets increase annual funding costs. Regardless, in a traditional defined benefit pension plan, the present value amount of funding required (to fund future benefits due) must be determined with the assistance of a licensed actuary. This is in contrast to the defined contribution approach that does not fund a future promised benefit and does not require the services of an actuary.

Defined benefit pension plan forfeitures (unvested amounts in the plan that accrue from departing employees) must be used to reduce the employer contributions for that plan year. When employee turnover increases, the employer contribution can be lowered. The employer contribution, as calculated by the actuary each year, is tax deductible by the employer. There is no limit on this deduction as it is the amount required by the plan to pay projected benefits. Contrast this with the limits imposed on the employer's deductible contribution to other types of retirement plans covered in this course.

Multiple variables affect the costs of a defined benefit pension plan. Many are related, either inversely or directly, in that a change in one variable affects change in another. An inverse relationship between variables exists when the increase or decrease in Variable A causes the opposite effect in Variable B. If plan investment returns increase and the plan increases in value, the cost to the employer in the form of a plan contribution for that year decreases. If the investment return decreases, the plan costs increase. A direct relationship occurs where the increase in Variable A causes an increase in Variable B. If the life expectancies of plan participants increase, the plan costs to the employer also increase.

A summary of the defined benefit variables and impact on the potential costs of the plan follows.

Figure 2.1: Analysis of Defined Benefit Variables and Impact on Plan Costs

	Direction Compared to Expected	Impact on Plan Costs	Relationship of Variable to Plan Costs
Investment returns	↑ ↓	↓ ↑	Inverse
Turnover of employees	↑ ↓	↓ ↑	Inverse
Mortality	↑ ↓	↓ ↑	Inverse
Life expectancies	↑ ↓	↑ ↓	Direct
Wages	↑ ↓	↑ ↓	Direct
Average age of new employees	↑ ↓	↑ ↓	Direct
Cost-of-living adjustments (Inflation)	↑ ↓	↑ ↓	Direct

TEST TIP

It is important to remember that the retirement plan already has assumptions built in that impact the required contribution. For example, if the retirement plan assumed an investment return of 6% and the actual return for the previous year was less than 6%, then the required contribution would increase even though the plan had positive earnings. Also, if the plan assumed wages would rise by 3% per year, but last year they rose by 2%, the required funding would decrease. In other words, the important issue is how factors have changed relative to the planned change—not relative to zero.

DB(k) Plans

The potential shortfalls in Section 401(k) plans and a decline in the establishment of defined benefit pension plans have opened the door for DB(k) plans. A **DB(k) plan** allows a traditional defined benefit pension plan to accept Section 401(k)–type (pretax) employee contributions. A sponsoring employer with no more than 500 employees may offer the DB(k) plan. As a part of this plan, the Section 401(k) component must include an automatic enrollment feature and a fully vested 50% match on the first 4% of compensation deferred by an employee. Additional requirements apply.

Employee advantages of a DB(k) plan include the following:

- Guaranteed monthly income at retirement from the defined benefit portion of the plan
- Encourages employers without defined benefit plans to establish a plan
- Combines the security employees get through traditional defined benefit pension plans with individual investment control of the 401(k) portion
- Allows automatic enrollment provisions, which encourage employees to save more than they may have in a traditional Section 401(k) plan

Employer advantages of a DB(k) plan include the following:

- Exemption from the top-heavy rules
- Allows small employers to sponsor a defined benefit pension plan with more predictable costs because the Section 401(k) matching contribution is not contingent upon factors such as employee mortality, plan investment returns, and other factors that affect defined benefit pension plan contributions
- Specifications of the defined benefit formula are defined in advance
- Offers simplified administration and potentially lower costs than having two individual plans
- Requires only one plan document, one trust, one Form 5500 filing, one summary plan description (SPD), and one set of statements

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

1. The state teacher's retirement plan pays 2.3% of the average of the highest-paid three years while in service. Mary taught for 18 years. Her highest years of service averaged $60,000. How much will Mary receive in retirement each month?
   A. $1,950
   B. $2,070
   C. $2,560
   D. $24,840

2. Michelle is 52 years old and just started a new job with ABC Industries. She is concerned about having enough income during her retirement that will begin when she reaches age 65. Michelle recently left XYZ Industries, her former employer, in part because XYZ did not sponsor a traditional defined benefit pension plan. ABC does sponsor a plan defined benefit plan, and Michelle has requested information from you about the plan's general provisions. Which of the following statements regarding defined benefit pension plans is CORRECT?
   I. They allow discretionary employer contributions.
   II. They favor older employee-participants.
   III. They require the services of an actuary on an annual basis.
   IV. They are insured by the PBGC.
   A. I only
   B. II and III
   C. I, II, and IV
   D. II, III, and IV

3. Which of the following would increase the employer's annual contribution to a defined benefit pension plan using a unit benefit formula?
   I. Forfeitures are lower than expected.
   II. Salary increases are higher than expected.
   III. Investment returns are less than expected.
   IV. Benefits are cost-of-living adjusted as expected.
   A. I and II
   B. II and III
   C. III and IV
   D. I, II, and III

4. Gina is 59 years old and a new client for Connor, a CFP® professional. They have just signed the client engagement letter. Gina's financial planning goals include determining where she stands in her retirement planning. She would like to retire a few years earlier than her normal retirement age of 67, but she is not certain she has the retirement assets in place to do so. Gina has worked for Greenhouse, Inc., for 20 years and is a participant in the company's traditional defined benefit pension plan. Her employer's retirement plan offers retirement at age 60. Her salary is $280,000 annually and her salary increases should continue to be as consistent as they have been in the past. Gina is wondering what her projected benefit will be, and if it will be enough for her early retirement. What should Connor do next to assist Gina in attaining her retirement planning goal?
   A. Connor should call the plan administrator and ask what Gina's benefit will be if she retires earlier than her normal retirement age.
   B. Connor should request all the documents Gina has available on her retirement plan, her income history, all of her other assets and liabilities, income and expenses, and any other documentation she has on any other investments she has that could be available for retirement planning.
   C. For the next few months, Connor should monitor the performance of Gina's investments and calculate Gina's anticipated retirement plan benefit to see if her goal is achievable.
   D. Connor should recommend that Gina continue to work until her normal retirement age to allow time to accrue an increase benefit from her defined benefit pension plan.

TOPIC 2.2: OTHER TYPES OF DEFINED BENEFIT PENSION PLANS

Reading: Cash Balance Pension Plans

LO 2.2.1: Interpret the features of cash balance pension plans.

A c**ash balance pension plan** is a type of defined benefit pension plan that includes features of a defined contribution plan. Instead of having actual individual accounts with the worker making the investment decisions like a defined contribution plan, a cash balance pension plan provides for annual employer contributions at a specified rate to a hypothetical individual account—but, like other defined benefit plans, all investment decisions are made by a fiduciary employed by the plan. Thus, it stays true to the pooled concept of defined benefit pension plans, but it credits an **interest rate credit** (also known as a guaranteed return). This rate of return may be fixed or tied to some market rate of interest, usually a Treasury security. The employer often attempts to minimize the future annual contribution by investing contributed funds in securities with returns exceeding the return guaranteed to employees. Since the rate of return is guaranteed by the plan and the employer may lower contributions after periods of above-plan rate returns, cash balance plan participants do not usually get a benefit when actual plan investment returns exceed the plan stipulated rate. Section 415(b) limits the pension benefits that may be provided under the plan

Module 2

to the lesser of $265,000 (2023) or 100% of the participant's highest consecutive three-year average compensation. Like other plans, employer contributions are tax deductible when made and grow tax deferred.

Like traditional defined benefit pension plans, a cash balance plan also has several advantages and disadvantages. Advantages include the following:

- A certain level of plan benefits are guaranteed by the PBGC. However, PBGC participation can require an increased contribution under certain circumstances.
- There are significant cost savings for the employer as compared to the traditional defined benefit pension plan. In fact, cash balance plans are often implemented when looking for cost savings when compared to traditional defined benefit plans.

Among the disadvantages are the following:

- The employer bears the risk of poor investment performance (this is a disadvantage to the employer, but an advantage to the workers).
- Like all qualified retirement plans, cash balance plan withdrawals are subject to income taxes and the 10% early withdrawal penalty rules.
- Cash balance plans are subject to the minimum funding standard rules.
- The retirement benefits may be inadequate for older plan entrants.
- If the plan is converted from a traditional defined benefit pension plan, the lump-sum payout at the employee's retirement date may be considerably less under the cash balance formula. This is a disadvantage to the workers but a huge advantage to employers.
- Actuaries are still required for cash balance plans.

A cash balance plan is typically most appropriate when the workforce is relatively large and young (younger than age 50). Also, the employees are primarily middle-income wage earners. The type of employer that would use the cash balance plan is a midsize or large company that already has a well-funded traditional defined benefit pension plan and is desirous of cost savings with respect to its sponsored retirement plans. A classic example would be a fire department.

PRACTICE QUESTIONS

Choose the best answer for the following question. The answer can be found at the end of this module.

5. Which of the following is a feature of a cash balance pension plan?
   A. It tends to favor older plan entrants.
   B. There is a guaranteed minimum investment rate of return.
   C. It allows for investment discretion on the part of each employee-participant.
   D. The plan is not subject to the minimum funding standards that apply to traditional defined benefit pension plans.

Reading: Fully Insured Pension Plans

LO 2.2.2: Describe the attributes of fully insured (Section 412(e)(3)) pension plans.

A fully insured pension plan, also known here as a **Section 412(e)(3) plan**, is a type of traditional defined benefit pension plan funded exclusively by cash value life insurance (typically whole life) or annuity contracts. In such a plan, no qualified plan trust exists as is common with other retirement plans. In addition, using insurance as a funding vehicle guarantees the payment of a death benefit to plan beneficiaries, usually a surviving spouse and children.

A traditional defined benefit pension plan that is fully insured is exempt from minimum funding standards, unless there is an outstanding loan against the insurance policy funding the defined benefit pension plan. While these policy loans may be available to plan sponsors, there are no retirement plan loans available to participants with these fully insured pension plans. In addition, such plans are eligible for simplified reporting requirements and are not required to be certified by an enrolled or licensed actuary because the law assumes the insurance company that is responsible for the payments is already providing these services.

Fully insured funding may be incorporated into a new or existing traditional defined benefit pension plan, but it is most prevalent with a newly designed plan. Benefits from the plan are guaranteed by the insurance company so the employer is transferring all investment risk to the third party. Because of the conservative nature of the guaranteed cash values used in the funding formula, fully insured pension plans often allow far greater deductible contributions to be made into the plan. This element was originally one of the attractive features of this type of plan, but in recent years, the limited opportunity for growth due to low interest rates has made the plans far less common.

A fully insured plan is inappropriate for an employer who cannot commit to large regular premium payments. A stable business, rather than one experiencing (or expecting to experience) fluctuating cash flow, is the best prospect for a Section 412(e)(3) plan.

PRACTICE QUESTIONS

Choose the best answer for the following question. The answer can be found at the end of this module.

6. Can a policy loan be outstanding under a fully insured plan funding approach and still be exempt from the minimum funding standards of Section 412 of the Tax Code?
   A. Yes
   B. No

TOPIC 2.3: DEFINED CONTRIBUTION PENSION PLANS

Reading: Money Purchase Pension Plans

LO 2.3.1: Examine the characteristics of money purchase pension plans.

A **money purchase pension plan** is a type of defined contribution pension plan in which an employer makes annual mandatory contributions to each employee's individual account and the employee bears the investment risk. While the amount of final benefit is not guaranteed or promised, there is an employer promise to contribute to the plan each year. Plan investment earnings and losses do not affect employer contributions. The formula under the plan typically requires a contribution of a specified percentage of each employee's annual compensation by the employer, although it can also be a flat dollar amount per employee. The plan does not require the services of an actuary and, because it uses a defined contribution approach, insurance cannot be purchased by the employer from the PBGC. Like all defined contribution plans, the maximum annual contribution to the participant's account under the plan is the lesser of 100% of the eligible employee's compensation or $66,000 (2023). The maximum includible compensation that may be considered for a participant in the plan is limited to $330,000 (2023). The deduction for employer contributions is limited to 25% of aggregate includible compensation. If the plan maintains its tax-qualified status, the tax benefits to the employer are also known year to year.

Advantages of the plan are as follows:

- It is relatively straightforward and simple to explain to potential participants. The plan sponsor's costs are also predictable, and the plan is easily administered.
- The account balance generated under the plan may be distributed as a lump sum, an annuity, or rolled over to an IRA at separation from service or retirement.
- A percentage of compensation is used to determine the contribution. A younger and an older employee with the same salary will get equal contributions. This is different than with a target benefit plan or an age-weighted profit-sharing plan. In those plans, the older employee will receive a larger contribution than the younger employee with the same salary. Thus, younger employees are favored with money purchase plans because they will have more years of employer contributions and plan asset growth than older employees.

The primary disadvantage of the plan is its lack of contribution flexibility. For example, in the event of declining employer cash flow, plan contributions still must be made. In addition, money purchase pension plans severely limit the ability to use plan contributions to buy employer stock. Generally, the employer securities held by the plan cannot exceed 10% of the fair market value (FMV) of plan assets at the time the employer securities are purchased. In other words, for a pension plan, the value of the employer securities cannot be more than 10% of the contribution each time.

Money purchase pension plans were popular in employer-sponsored retirement planning before the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) legislation that increased the deductible employer contributions

permitted in profit-sharing plans and simplified employee pension (SEP) plans to 25%. Still, when an employer wants to install a qualified retirement plan that is relatively simple to administer, has a younger workforce or is self-employed, and can assume the burden of mandatory funding, a money purchase pension plan may be appropriate.

TEST TIP

Many students do not feel confident of their knowledge of money purchase pension plans. However, the key is that the contribution is fixed (at least for the year) and must be made each year. While the contribution rate can be changed in subsequent years (but not zeroed out) by amending the plan document, this is not the normal intent. Also, the worker cannot contribute to a straight money purchase pension plan. The contribution must come from the firm. However, employees may make after-tax contributions to the plan (if the plan document permits). Remember that forfeitures from money purchase pension plans can be used to offset plan expenses, fund future employer contributions, or be reallocated among the remaining plan participants.

Reading: Target Benefit Pension Plans

LO 2.3.2: Examine target benefit pension plans and how they benefit participants.

A **target benefit pension plan** is a qualified defined contribution pension plan in which employer contributions are made for each participant in an actuarially determined amount to reach a targeted benefit at the specified normal retirement age for the plan. In a target benefit plan, the plan designer chooses actuarial assumptions (in the first year of plan operation only) to determine how much must be contributed for participants entering the plan at various ages. Thus, in the first year of plan operation, the services of an actuary are required. Subsequent to that year, however, there are no periodic actuarial valuations and the plan is funded like a money purchase pension plan—that is, using the percentage of compensation approach. In addition, like any other defined contribution plan, there is no guarantee to the employee of the ultimate account balance that will be accumulated in each employee's individual account. Unlike a traditional defined benefit pension plan, annual contributions are not adjusted to guarantee the final benefit.

Target benefit pension plans share the following similarities with defined benefit pension plans:

- The plans favor older participants (generally an employee age 50 or older). Favoring an older employee means the contribution for an older employee who is a new plan participant is larger than for a younger employee who is also a new plan participant and who otherwise makes the same income. This is because the older employee has less time to fund the amount necessary to produce the targeted income stream.
- The plans (initially) require an actuary.

- The plans are a type of pension plan. A pension plan, in this sense, means the annual retirement plan contribution is mandatory. This is contrasted with a profit-sharing plan in which the annual contributions are not mandatory each year but must be substantial and recurring. There are only four important pension plans: (1) traditional defined benefit plans, (2) money purchase plans, (3) cash balance plans, and (4) target benefit plans. The mnemonic device for the mandatory annual plans is *be my cash target* (be = *benefit* in defined benefit plans; my = money purchase plans; cash = cash balance plans; target = target benefit plans). When selecting a retirement plan for an employer, if the employer wants total flexibility in annual contributions, the *be my cash target* plans are all eliminated. If the employer wants the discipline of mandatory annual contributions, then the answer must be one of these *be my cash target* pension plans, or one of these plans needs to be a portion of the answer. It is critical to know which plans call for mandatory annual contributions and which plans allow flexible annual contributions because this is a major issue for employers when selecting a type of retirement plan.
- Mandatory minimum funding standards apply.

Target benefit pension plans share the following similarities with defined contribution plans:

- The employee bears the risk of plan investment performance.
- Each employee has a separate (individual) account.
- PBGC insurance is not available.
- The final actual dollar benefit is not guaranteed.
- The maximum deductible employer contribution is limited to 25% of includible payroll with the maximum compensation for an individual limited to $330,000 (2023).
- The most an individual may receive in his account is limited to the lesser of 100% of compensation or $66,000 (2023). This is in contrast to a DB plan that is not limited by a set contribution percentage or annual dollar amount. Therefore, the DB plan will usually provide a greater tax deduction if an age-weighted plan works best.

A good candidate for a target benefit pension plan is a business that has stable cash flows but does not have enough resources for a defined benefit plan. The business should also have an employee census showing older owners who are around 50 or older and younger rank-and-file employees. Like money purchase pension plans, target benefit pension plans require mandatory annual funding. Accordingly, target benefit pension plans have also been declining in popularity since the EGTRRA of 2001 and the liberalization of the 25% deduction limit for profit-sharing plan contributions. Before 2002, target and money purchase pension plans were sometimes paired with profit-sharing plans to produce what are called tandem plans. A **tandem plan** obtains a greater tax deduction at the cost of two plan administration expenses as well as a partial mandatory employer contribution. For example, employer contributions could consist of a mandatory 10% money purchase pension plan contribution and a maximum discretionary 15% contribution to a profit-sharing plan. This is no longer necessary since the EGTRRA of 2001 because deductible contributions to a profit-sharing plan may now be as high as 25%

of includible compensation on a discretionary basis. Finally, a target benefit pension plan permits a low contribution level for younger, lower-paid employees and an extremely high contribution level for older employees. This is possible by using a permitted concept known as cross-testing to meet qualified plan nondiscrimination rules. Cross-testing will be discussed in greater detail in the next module in discussing age-weighted profit-sharing plans, which are also cross tested. Also, amending a defined benefit plan into a target benefit plan will result in termination of the defined benefit plan.

Forfeitures

In any qualified plan, **forfeitures** are created when nonvested or partially vested employees terminate their service with the sponsoring employer. As a result, this nonvested portion reverts back to the plan.

In defined benefit pension plans (traditional or cash balance), these forfeitures may only be used toward plan expenses or future employer contributions. In defined benefit pension plans, there is no mechanism to reallocate the forfeitures on a pro rata basis among the remaining participants.

This is not the case in defined contribution plans, including the money purchase pension plan. In a defined contribution plan, forfeitures may be

- used to offset plan expenses or future employer contributions; or
- reallocated among the remaining plan participants, increasing their potential individual account balances. The actual reallocation amounts may be according to relative salary, relative account balances, or a combination of both. Notice that all means of reallocating forfeitures favor those with large salaries, especially over time.

Reallocation of plan forfeitures must be on a nondiscriminatory basis, typically using a pro rata formula based on a participant's compensation relative to the other remaining plan participants' compensations. Reallocated plan forfeitures are included in the application of the annual additions limit.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

7. Which of these statements regarding a target benefit plan is CORRECT?
   I. The employee's benefit is not guaranteed by the employer.
   II. The plan requires actuarial assumptions.
   III. The maximum deductible employer contribution is 25% of includible payroll.
   IV. The participant's maximum annual addition is the lesser of 100% of compensation or $66,000 (2023).
   A. IV only
   B. I and IV
   C. II and III
   D. I, II, III, and IV

MODULE 2 ANSWER KEY FOR PRACTICE QUESTIONS

1. **B** The equation is $60,000 × 0.023 × 18 ÷ 12 = $2,070 per month.

2. **D** The only incorrect statement is Statement I. Defined benefit pension plans have mandatory contribution formulas, require the services of an actuary on an annual basis, and require the payment of PBGC insurance premiums. Such plans also tend to favor older participants. *Favoring older employees* means that a larger annual contribution is required for an older employee, even if the younger employee makes the same annual salary. Notice that the answer for this question is not dependent on the scenario. For questions with long set-ups, it can help to skip the scenario and go straight to the actual question, which will be the last sentence. Read the actual question and then look at the answers. First, you will be able to eliminate some of the answers, second, you will be more focused when processing the scenario.

3. **D** Defined benefit pension plan contributions would increase due to the circumstances described in these statements. Benefits are expected to be cost-of-living adjusted; this would not increase the employer's annual contributions.

4. **B** Connor is very early in the financial planning process—and to help Gina achieve her goals, he should request all the documentation and information available about her financial situation, including her anticipated retirement plan benefits, before he can start evaluating her situation. Connor is not at the recommendation stage at this time. The plan administrator for Gina's defined benefit pension plan will not be able to give Connor information over the telephone.

5. **B** The employer directs the plan's investments while guaranteeing a minimum rate of return to the employee. Unlike the traditional defined benefit pension plan, the cash balance pension plan favors younger plan entrants because they have longer for the plan assets to grow. Like the traditional defined benefit pension plan, a cash balance pension plan is subject to the minimum funding standards included in Section 412 of the Internal Revenue Code.

6. **B** If a loan is made from the policy (usually to the businessowner), the plan loses its fully insured status and the minimum funding standards apply.

7. **D** All of these statements are correct. With a target benefit plan, actuaries are required initially to determine the contribution for a new plan entrant. However, actuaries are not needed on an annual basis for the entire plan (like a defined benefit plan).

MODULE 3

Profit-Sharing and Other Defined Contribution Plans

INTRODUCTION

There are two types of defined contribution plans (money purchase and target benefit pension plans) that use mandatory annual contributions to help fund retirement. However, when most planners speak of a defined contribution type of qualified plan, they are referring to some form of discretionary profit-sharing plan established by the employer for the benefit of its employees. In addition to providing a retirement planning vehicle, a profit-sharing plan can also serve as a performance incentive for employees. For example, if a certain specified net income (profit) for the company is not achieved, a profit-sharing contribution by the employer may not be made.

There are several types of profit-sharing plans, but the most prevalent today is a traditional profit-sharing plan with a Section 401(k) feature. A Section 401(k) plan is an arrangement within a qualified profit-sharing or stock bonus plan that allows an eligible employee to make pretax elective deferrals into it. This module will consider Section 401(k) plans from a variety of perspectives.

Also considered in this module are cross-tested plans that have become increasingly popular. Such plans are a means of legally discriminating in favor of older, more experienced employees, who are generally also highly compensated employees (HCEs).

TOPICS, LEARNING OBJECTIVES, AND READINGS

The topics covered in this module are:

- Topic 3.1: Traditional Profit-Sharing Plans
- Topic 3.2: Other Types of Profit-Sharing Plans and Employee Stock Ownership Plans (ESOPs)
- Topic 3.3: Section 401(k) Plans

Throughout this module you will see learning objectives (LOs) that emphasize the knowledge and application skills you will gain from this module. These specific statements, based on the 2021 CFP Board's Principal Knowledge Topics List (the blueprint for the current CFP Board exam), advise you regarding what you should know and be able to do at the completion of this module. In the following table is a list of module topics, learning objectives, and readings.

To enable you to meet the goal of this module, material is structured around the following learning objectives.

Learning Objective		Readings
Topic 3.1: Traditional Profit-Sharing Plans		
3.1.1	Describe the characteristics and benefits of traditional profit-sharing plans.	Traditional Profit-Sharing Plans
Topic 3.2: Other Types of Profit-Sharing Plans and Employee Stock Ownership Plans (ESOPs)		
3.2.1	Distinguish the advantages and disadvantages of age-based profit-sharing plans and new comparability plans.	Age-Based Profit-Sharing Plans and New Comparability Plans
3.2.2	Analyze the benefits of employee stock ownership plans (ESOPs) as they relate to profit-sharing plans.	Employee Stock Ownership Plans (ESOPs)
Topic 3.3: Section 401(k) Plans		
3.3.1	Recognize the characteristics and tax benefits of traditional 401(k) plans.	Traditional 401(k) Plans
3.3.2	Calculate actual deferral percentages and/or actual contribution percentages to determine if a 401(k) plan meets ADP/ACP tests.	ADP and ACP Testing
3.3.3	Analyze the features, advantages, and disadvantages of SIMPLE 401(k), Roth 401(k), and Solo 401(k) plans.	Other Types of 401(k) Plans

KEY TERMS

actual contribution percentage (ACP) test
actual deferral percentage (ADP) test
age-based profit-sharing plan
automatic enrollment notice
cash or deferred arrangement (CODA)
cross-tested plan
defined contribution plan
elective deferral
employee stock ownership plan (ESOP)
financial needs test
hardship withdrawal
in-service distribution
Keogh plan
leveraged ESOP (LESOP)
negative election
net unrealized appreciation (NUA)
new comparability plan (NCP)
profit-sharing plan
qualified automatic contribution arrangement (QACA)
qualified default investment notice
qualified matching contributions (QMACs)
qualified nonelective contributions (QNECs)
resources test
Roth 401(k) plan
safe harbor Section 401(k) plan
savings/thrift plan
SIMPLE 401(k)
stock bonus plan
substantial and recurring
traditional Section 401(k) plan

TOPIC 3.1: TRADITIONAL PROFIT-SHARING PLANS

Reading: Traditional Profit-Sharing Plans

LO 3.1.1: Describe the characteristics and benefits of traditional profit-sharing plans.

A traditional **profit-sharing plan** is a qualified **defined contribution plan** featuring a flexible, discretionary employer contribution provision. Accordingly, the employer's contribution to the plan each year may be purely discretionary or based on some kind of formula related to the employer's profits. Discretionary contributions are not strictly tied to profits. The employer can choose to make profit-sharing contributions even if there were no profits that year. In this case, the contributions would come from retained earnings or current cash flow. Also, the employer is not required by law to make profit-sharing contributions for any individual profitable year. Regardless, as a qualified plan, contributions must still be made in a nondiscriminatory manner so as not to violate the coverage rules discussed in Module 1. In addition, for a profit-sharing plan to remain qualified, Treasury Regulations require that contributions be made on a **substantial and recurring** basis. This is usually interpreted to mean that a contribution must be made in three of every five years. Annual contributions to a participant's account are limited to the lesser of 100% of employee compensation or $66,000 (2023) with only the first $330,000 (2023) of employee compensation taken into account. The most common formula for profit-sharing contributions provides for contributions to be allocated to individual participant accounts on a pro rata basis determined by a given participant's includible compensation in relation to the aggregate includible compensation of all participants. The deduction for employer contributions is limited to 25% of aggregate includible compensation.

Similar to individual retirement accounts, a nonrefundable income tax credit is available for employee elective contributions made to a 401(k) plan, 403(b) plan, 457 plan, SIMPLE, or SARSEP. It is called the retirement savings contribution

Module 3

credit (saver's credit). The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit is available to individuals who are age 18 or over, other than full-time students and individuals claimed as dependents by another taxpayer. The maximum annual contribution eligible for the credit is up to $2,000, depending on the taxpayer's adjusted gross income and filing status for the tax year. The amount of the contribution eligible for the credit is reduced by taxable distributions from 401(k) plans, 403(b) plans, 457 plans, SIMPLEs, SARSEPs, traditional IRAs, or Roth IRAs.

A major advantage of any profit-sharing plan (including one with a Section 401(k) feature) is the option of **in-service distributions**, or the ability of the participant to access the individual account balance prior to retirement. This option for certain in-service distributions is not a federal mandate. The employer makes the decision whether or not to include in-service withdrawals when the plan document is accepted. Most profit-sharing plans only allow in-service withdrawals for hardship withdrawals or after age 59½. Also, hardship withdrawals can always be permitted for employee elective deferrals. Since 2019, QNEC, QMAC, and safe harbor employer contributions can also be made available for hardship withdrawals if the plan document allows. QNECs and QMACs were briefly discussed in Module 1. Another major change that started in 2019 is that the earnings on these sources (including elective deferrals) are also allowed for hardship withdrawals. Next, prior to 2020, a retirement plan that allowed hardship withdrawals could force the participant to take a retirement plan loan before allowing a hardship withdrawal. Under the TCJA, this restriction is no longer required. Also, the plan could prevent the worker from contributing for the next six months. This is no longer allowed. Now, a worker who receives a hardship withdrawal can continue contributing into the retirement plan.

A **hardship withdrawal** must meet the following tests:

- **Financial needs test:** the hardship must be due to an immediate and heavy financial need of the participant-employee.
- **Resources test:** the participant must not have other financial sources sufficient to satisfy the need.

In addition to meeting these tests, the money may only be withdrawn for the following reasons:

- Payment of unreimbursed medical expenses or funeral costs (not just those above 7.5% of AGI limit that are deductible)
- Disasters that have been declared by the federal government
- Purchase of a primary residence
- Payment of higher education expenses for the participant, the participant's spouse, dependent children, or beneficiaries
- Payment necessary to prevent foreclosure on the participant's primary residence

PROFESSOR'S NOTE

You can remember the potentially eligible hardship withdrawal expenses by the saying, "**My disastrously faulty emergency fund.**" "My" is for medical and funeral expenses (unreimbursed).

"Disastrously" is for federally declared disasters. "Faulty" is for buying a "first home" in the sense of a primary residence. This is NOT the same definition as a first-time homebuyer for exceptions to the 10% early withdrawal penalty for IRAs. Also, hardship withdrawals can only be used for a primary residence—never a second home. "Emergency" is for education (higher education) expenses. "Fund" is for foreclosure of the primary home.

Hardship withdrawals can be thought of as "**my disastrously faulty emergency fund**" because they should not be thought of as the emergency fund at all. However, hardship withdrawals are often used when a true emergency fund has not been established. Hardship withdrawals are not a proper emergency fund because they are taxed and penalized. Worse still, the principal and the forgone earnings will not be available for retirement.

Next, unreimbursed medical expenses are not exactly the same as deductible medical expenses. Hardship withdrawals are available for unreimbursed medical expenses whether or not they rise to the amount relative to AGI that allows some of the expenses to be deducted. On the other hand, the requirement that a financial need be "immediate and heavy" means low-level, routine unreimbursed medical expenses do not qualify.

Hardship withdrawals are actually a plan document issue. Retirement plans are not required by law to offer hardship withdrawals. In fact, if hardship withdrawals are allowed, the plan has the ability to include or exclude any of the four reasons. These four reasons are simply withdrawal methods the IRS has permitted in the past and therefore should be thought as similar to a safe harbor provision for hardship withdrawals.

Finally, if a hardship withdrawal is approved and made, the distribution is taxable and a 10% early withdrawal penalty will apply for all distributions except for deductible unreimbursed medical expenses—those medical expenses exceeding 7.5% of the person's AGI, and qualified disaster withdrawals. Also, hardship withdrawals attributed to Roth contributions are neither taxed nor penalized.

PROFESSOR'S NOTE

Notice that hardship withdrawals for higher education expenses are subject to the 10% early distribution penalty. This is different from IRA withdrawals for qualified higher education expenses. Traditional and Roth IRA withdrawals used for qualified higher education expenses are exempt from the 10% early distribution penalty.

The exception to the 10% early withdrawal penalty for unreimbursed medical expenses only applies to amounts over 7.5 of AGI. For example, Sally, age 45, has an AGI of $100,000. She took a hardship withdrawal distribution from her employer retirement account of $17,500 for unreimbursed medical expenses. She is income taxed on the entire $17,500. She owes the 10% penalty on $7,500, but not on the $10,000 that is above 7.5% of her AGI. These results would also apply if she would have taken the $17,500 from her traditional IRA. The exception for medical expenses used to vary annually between 7.5%

and 10% of AGI. In 2020, Congress made 7.5% of AGI the permanent percentage for the exception to the 10% penalty for medical expenses.

Profit-sharing plans have no legal limit on the percentage of contributions that can be invested in the employer's securities. In this sense, they are not subject to the ERISA diversification requirements relative to employer securities that apply to pension plans—nor are profit-sharing plans subject to the minimum funding requirements. Finally, since they are not a defined benefit plan, they are not covered by the PBGC.

When to Use a Profit-Sharing Plan

A traditional profit-sharing plan may be appropriate when

- an employer's profits, or cash flow, fluctuate from year to year;
- an employer wishes to implement a qualified plan with an incentive feature by which an employee's account balance increases with employer profits;
- the majority of employees are young (under age 50) and have substantial time to accumulate retirement savings; or
- the employees are willing to accept a degree of investment risk in their individual accounts.

> **EXAMPLE: Profit-sharing plan**
>
> Joe, age 40, owns a business with sporadic income. Sometimes he does well, but in other years the company loses money. Joe knows he needs to be saving for his own retirement and he would like to help his employees with their retirements if possible. Should Joe implement a pension plan or a profit-sharing plan? Pension plans and profit-sharing plans have several industry definitions. In this case the question is asking if the retirement plan should have a mandatory annual contribution or flexible annual contributions. Clearly, with sporadic earnings, Joe's best choice would be some retirement plan from the profit-sharing category. While there are several types of plans in this category, clearly the entire pension plan category is inappropriate. Thus, all the "Be my cash target plans" (benefit in defined benefit, money purchase, cash balance, and target benefit plans) should be eliminated.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

1. Which statement about a traditional profit-sharing plan is FALSE?
   - A. Profit-sharing plans are qualified defined contribution plans.
   - B. Profit-sharing plans are suitable for companies that have unstable cash flows.
   - C. A company that adopts a profit-sharing plan is required to make contributions each year.
   - D. Company profits are not a prerequisite for employer contributions.

TOPIC 3.2: OTHER TYPES OF PROFIT-SHARING PLANS AND EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

Reading: Age-Based Profit-Sharing Plans and New Comparability Plans

LO 3.2.1: Distinguish the advantages and disadvantages of age-based profit-sharing plans and new comparability plans.

Age-Based Profit-Sharing Plan

An **age-based profit-sharing plan** is a profit-sharing plan in which allocations to participants are made in proportion to the participant's age-adjusted compensation. It is an example of a **cross-tested plan** where compliance with the nondiscrimination rules is tested in accordance with benefits rather than contributions. Under such a plan, each participant's compensation is weighted by an age factor. The employer contribution is then allocated to create an actuarially equivalent benefit at the normal retirement age under the plan for each participant (typically, when the participant reaches age 65). A participant's compensation is age-adjusted by multiplying the participant's actual compensation by a discount factor based on the participant's age and the interest rate elected by the plan sponsor. As a result, older employees (the business owner is usually among them) receive the greatest allocation.

An age-based profit-sharing plan is most appropriate when the business owner is significantly older than most of the employees and wishes to skew the annual contribution on his behalf without violating the nondiscrimination rules. When a profit-sharing plan is age-weighted, however, the business owner is still limited to a dollar contribution of the lesser of $66,000 (2023) or 100% of compensation with no more than $330,000 (2023) of annual compensation taken into account for plan contribution purposes.

New Comparability Plan

A **new comparability plan** is a type of cross-tested profit-sharing retirement plan in which the employee-participants are divided into groups or classes. Common group classifications used include job category, age, or years of service. Each group or class typically receives a different level of employer contribution as a percentage of compensation. The plan works particularly well when there is more than one owner of a business, with the owners having substantially different ages, thus precluding the age-based profit-sharing approach.

Because the new comparability plan is a form of a cross-tested plan, it may also be tested for nondiscrimination on the basis of benefits rather than contributions, thus permitting considerable flexibility in plan design. The goal of a new comparability plan is often to skew plan contributions in favor of highly compensated, key employees, management, and owners.

The new comparability plan will only satisfy the nondiscrimination rules if the plan design satisfies one of two minimum gateways:

1. Each eligible non-HCE must receive an allocation of at least 5% of compensation.
2. If the plan provides an allocation rate of less than 5%, the minimum allocation rate for non-HCEs is one-third of the highest allocation rate under the plan. For instance, if the top allocation rate is 12%, the minimum allocation rate for non-HCEs would be 4% (12% divided by 3).

EXAMPLE: New comparability plan

Peter is a young technical genius. He is 27 and produces top video games. However, Peter is consumed with his technical work and would be terrible as the CEO of his company. Beth is 50 and an incredible business person. She knows how to run a business, but she does not know how to invent the products. These two owners need each other, but their different ages are a challenge for traditional retirement plans. An age-weighted profit-sharing plan would contribute far more to Beth's retirement each year than Peter's. A straight profit-sharing plan would not contribute enough for Beth. A deferred compensation plan would work for Peter and Beth, but the company needs a retirement plan to attract quality workers. This is the classic scenario for a new comparability plan. Peter and Beth can both receive large contributions to their retirement accounts as long as the total plan meets one of the gateway tests. The rank-and-file workers win with a 5% contribution or at least a third of the plan's largest contribution. These contributions are better for the workers than the owners having a deferred compensation plan and the workers not having any retirement plan or a very low match in a 401(k) plan.

PROFESSOR'S NOTE

Essentially, the new comparability plan is a trade-off. The nondiscriminatory rules are relaxed in exchange for a presumably higher contribution rate for the rank-and-file workers.

Cross testing means using defined benefit mechanisms for determining the contributions to a defined contribution plan. The hope is that the higher contributions for older workers will be offset by the younger workers having more time for their benefits to accrue to roughly the same level.

Reading: Stock Bonus Plans and Employee Stock Ownership Plans (ESOPs)

LO 3.2.2: Analyze the benefits of employee stock ownership plans (ESOPs) as they relate to profit-sharing plans.

Stock Bonus Plan

A **stock bonus plan** is a type of profit-sharing plan with one major difference from a traditional profit-sharing plan: the employer contributions and benefits distributed

from the plan are generally made in the form of employer stock, not in cash. In a stock bonus plan, the employer contributes either cash or employer securities to the individual participants' accounts in accordance with normal defined contribution rules and limitations. A stock bonus plan is appropriate for an employer with unstable cash flow who does not wish to deplete needed cash and, instead, wishes to make contributions in the form of listed or closely held stock.

A major employee tax advantage of participating in a stock bonus plan is the ability to defer **net unrealized appreciation (NUA)** on employer securities if the distribution of the stock is in a lump sum. To receive NUA treatment, the departing worker must elect to receive the stock in shares instead of cash. This election is made by the worker with the plan administrator in the distribution paperwork. The shares received cannot be rolled over while cash received from the stock bonus plan can be rolled over to allow continued deferral of income tax. Under the NUA tax benefit, participant retirees are not taxed on the full FMV of employer stock when it is distributed. Instead, the NUA is taxed as long-term capital gain when the participant or beneficiary subsequently sells the stock. At the time of distribution, the participant recognizes as ordinary income an amount equal to the value of the stock at the time of contribution. This ordinary income recognition when the stock is irrevocably distributed outside of any possible retirement account establishes a tax basis in the employer stock for the employee-participant that is recovered tax free as a return of basis upon sale of the stock from the person's normal brokerage account (as opposed to an IRA or other type of retirement account). Any further appreciation of the stock subsequent to the time of the lump-sum distribution is then subject to short-term or long-term capital gain tax treatment, depending on the holding period after the lump-sum distribution. If the stock is held longer than a year, then the gain since the distribution is treated as a long-term capital gain. If the person sells the stock within a year or less from the date of distribution from the plan, any gain since the distribution will be treated as a short-term capital gain. The NUA portion of the lump-sum distribution will always be treated as long-term capital gain, regardless of the holding period after the lump-sum distribution. Finally, any losses after the date of distribution will be be taken out of the NUA amount and the person will not have as large a long-term capital gain when the shares are sold.

There are disadvantages associated with investing so much of a retirement plan's assets in employer stock. A primary disadvantage is the participant now has a largely undiversified, or concentrated, portfolio. This disadvantage is especially important if the company goes bankrupt. Another disadvantage is the dilution of existing ownership that occurs under both a stock bonus and employee stock ownership plan.

Employers that sponsor qualified plans in which a portion of the plan accounts are invested in the employer's publicly traded stock must permit participants to immediately divest themselves of the stock and diversify the proceeds into other plan investments. This diversification rule is not applicable to employee stock ownership plans that do not hold employee contributions. However, if the employer's securities are not readily tradable on an established market, a participant who separates from service must be provided a put option that will be available for at least 60 days after distribution of the stock. The option must be redeemed by the employer (not the retirement plan) and the value of the stock must be determined fairly.

EXAMPLE: Stock bonus plan

When he retired, Kurt had $1.5 million in his company retirement account. $1 million was from his 10,000 shares in company stock and $500,000 was in various mutual funds inside the company retirement plan. He had made elections as allowed over the years to diversify his retirement account. He completed the paperwork to transfer the $500,000 of mutual funds directly into an IRA. He also made the NUA election on the plan's paperwork to distribute the 10,000 shares of company stock worth $1 million directly into his non-retirement brokerage account with his Series 7 financial planner. The fair market value of the stock contributed over the years was $250,000. This was tracked by the retirement plan and reported to Kurt when the shares were distributed.

In this example, $750,000 is treated as NUA and is not taxed upon distribution. In the year of the lump-sum distribution, $250,000 will be taxable as ordinary income.

Because $250,000 was treated as ordinary income at the time of distribution, Kurt's adjusted taxable basis in the 10,000 shares equals $250,000. If Kurt sells shares of stock, his adjusted basis for tax purposes will equal $25 per share and any gain over the $75 per share that is NUA will be subject to capital gains tax, short or long term, depending on Kurt's holding period since the distribution to his brokerage account. On the other hand, if Kurt eventually sells the stock for less than $100 per share, his NUA amount would be decreased by the loss.

For example, Kurt immediately sells some of his shares for $101 per share soon after the shares arrived in his brokerage account. He will not be taxed on $25 per share from the sale of the shares because he was already income taxed as ordinary income on $25 per share on all 10,000 of his shares when the shares were originally distributed. He has a long-term capital gain on $75 per share due to this being the NUA amount/share. He also has a short-term capital gain on $1 per share.

More than a year after the shares were distributed, Kurt sold some of his shares for $110. He is not taxed on $25 per share. The NUA of $75 per share is always considered long-term gain by definition. His final $10 per share is also considered a long-term capital gain because he waited a year and a day or longer to sell these shares.

If Kurt sold shares at any time for less than $100 per share, it would reduce his NUA amount. For example, Kurt sold shares at $90 per share. His basis was $25 per share, so his long-term capital gain from NUA is $65 per share.

Since NUA amounts are already tax advantaged, they do not receive a stepped-up basis if he dies holding the shares. Finally, if Kurt separated from service after attaining age 55, then he is not subject to the 10% EWP on NUA distributions. For example, if Kurt was 52 when he separated from service and made the NUA election, he would not only owe ordinary income tax on the $250,000, he would would also owe $25,000 due to the 10% EWP. If he was 55 or older, when he separated from service, then he would not owe the 10% EWP.

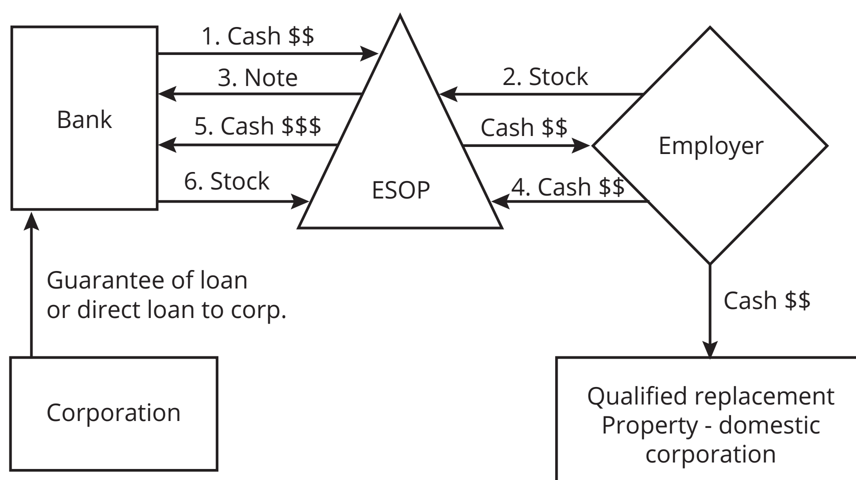
TEST TIP

A test question can signal the NUA election either by stating that the person made the NUA election or by the fact that shares were distributed out of the company retirement account. The only way shares (instead of cash) can be distributed is by the former plan participant making the NUA election at the initial withdrawal.

Employee Stock Ownership Plan (ESOP)

An **employee stock ownership plan (ESOP)** is a type of stock bonus plan in which individual participant accounts are invested primarily in employer stock. It has a unique advantage over every other type of qualified plan in that the ESOP may borrow money in the name of the plan without violating the prohibited transaction rules against a retirement plan borrowing money. If the ESOP does borrow money in the plan's name, it is commonly referred to as a **leveraged ESOP (LESOP)** and engages in a series of transactions, shown in the following diagram.

Figure 3.1: Leveraged ESOP Transactions



1. The plan trustee secures a bank loan.
2. The plan trustee purchases employer stock with loan proceeds.
3. The stock is pledged as loan collateral.
4. With the cash from the stock sale, the employer makes a contribution to the ESOP.
5. The employer's cash contribution is used to pay off the loan.
6. The bank releases the stock to the ESOP.

Important observations regarding the previous diagram include the following:

- The employer stock is pledged as collateral for the loan secured in the name of the ESOP; thus, an ESOP is only appropriate for an incorporated business (a C or S corporation).
- With the cash from the sale of the stock, the employer makes a cash contribution to the ESOP; thus, in selling the stock to the employees of the business, the employer is now making them owners of the business.
- A market is created for employer stock that helps improve the marketability of the stock for existing shareholders; thus, an ESOP is appropriate for creating a market for stock (particularly for closely held stock). A normal ESOP can also increase the marketability of the employer stock. However, a LESOP can be

used to sell a larger quantity of the employer stock upfront. Thus, a LESOP can be especially helpful if owners are nearing retirement and want to sell a major portion of their stock quickly.

When plan participants take distributions from the ESOP, participants have the right to demand that the distribution be in the form of the employer stock. If the stock is not publicly tradable, participants may require the employer to repurchase the employer stock using an actuarially determined formula to determine the fair market value. The forced sale is referred to as a put option or a repurchase option in the ESOP. The repurchase or put option must be available for the 60-day period immediately following the stock distribution and for 60 days in the following plan year.

Like the stock bonus plan, an ESOP provides the tax advantages of NUA for employer stock distributed in a lump sum to employee shareholders.

A LESOP is the only defined contribution plan that can fund more than 25% of the employees' includible compensation. The normal contributions to a LESOP have the 25% limitation. However, interest on the plan loan can mean the total contribution to the LESOP is more than 25% of employee compensation.

A shareholder can obtain tax benefits by selling stock to an ESOP plan.

- The shareholder who reinvests the proceeds received from the ESOP sale in domestic securities pays no current capital gains. This allows the shareholder to create a diversified retirement portfolio from a previously nondiversified investment without tax consequences.
- Nonrecognition of capital gains on the sale of stock by a shareholder to an ESOP occurs if all of the following three requirements are met.
    a. The ESOP must own at least 30% of the stock (either of each class or of the total value).
    b. The owner must have held the stock for at least three years before the sale.
    c. Qualified replacement property must be purchased within one year after the sale (or three months before the sale).

These conditions pertain to publicly traded domestic stock as well as privately owned stock.

An ESOP is a rather complex retirement plan and is most appropriate when

- the employer wishes to make the employees owners of the business through a tax-advantaged means and at a relatively low cost. While an ESOP has the advantage of using stock instead of cash as the contribution to the ESOP, other features like the put option and valuing the stock can be costly and administratively complex;
- the employer wishes to provide an advantageous vehicle for the company to borrow money for business needs such as an expansion, and so on; and
- the owner of the business wants to engage in estate and financial planning that creates a market for the stock (at the expense of having additional shareholders).

A disadvantage of an ESOP is that the employer stock may be a very speculative investment. The inherent risk can create employee ill-will because either the plan is not considered valuable by employees or employees expect too much from the plan.

As mentioned in Module 1, an ESOP may not be integrated with Social Security. That is because Congress determined that ESOPs already had enough advantages for the owners.

PROFESSOR'S NOTE

A LESOP works especially well for a closely held company where the major owner needs cash out of the company for his impending retirement because the closely held company owner can sell a lot of shares all at once to the ESOP. These shares are collateral for the original loan. Over time, the company contributes cash to the LESOP to fund the workers' retirement. The LESOP uses the cash to repay the loan. The loan payments gradually free the individual retirement accounts of this lien.

TEST TIP

All situation questions on the CFP Final are written with the intended answer in mind. Then the scenario is written in such a manner as to work for the answer and also to eliminate all other answers. All individual answers live in a "one strike and you are out" world. For example, if the answer to a scenario question is going to be a LESOP and the other choices were an ESOP, a cash balance plan, and a money purchase plan, the scenario would be written to eliminate all the answers except the LESOP. For example, the question saying the owner wanted to integrate the plan with Social Security would eliminate the ESOP. If the owner also wanted to avoid mandatory annual contributions (could also be stated as needing funding flexibility) the cash balance plan and the money purchase plan would be eliminated. The final answer will be whatever is not eliminated. In a sense, a situation question always asks you to circle the survivor more than pick the winner.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

2. Which of the following are examples of cross-tested plans?
   I. An age-based profit-sharing plan
   II. A traditional profit-sharing plan
   III. A new comparability profit-sharing plan
   IV. A profit-sharing plan with a Section 401(k) feature
   A. I and II
   B. I and III
   C. II and III
   D. II and IV

3. Santana Corp. is considering establishing a qualified plan and has the following objectives:
   - Simplicity
   - Ability of the plan to be integrated with Social Security
   - Funding flexibility
   - Ability to invest in company stock in an unrestricted manner
   - Employees can make in-service withdrawals

- Distributions of the plan retirement benefits in cash if the company chooses
- Immediate tax deduction for the value of the stock contributed to the plan

Which one of the following types of qualified plans would meet Santana's objectives?

A. ESOP
B. Stock bonus plan
C. Money purchase pension plan
D. Cash balance pension plan

TOPIC 3.3: SECTION 401(K) PLANS

Reading: Traditional 401(k) Plans

LO 3.3.1: Recognize the characteristics and tax benefits of traditional 401(k) plans.

The plural of the Section 401(k) heading is used here because there are actually four types of **Section 401(k)** plans. They are the

- **traditional Section 401(k) plan**;
- **safe harbor Section 401(k) plan**;
- SIMPLE 401(k); and
- Roth 401(k).

Traditional Section 401(k) Plan

A **traditional Section 401(k) plan** is also known as a qualified **cash or deferred arrangement (CODA)**. It is a qualified profit-sharing or stock bonus plan under which plan participants have an option to contribute money to the plan on a pretax basis, known as an **elective deferral**, or receive taxable cash compensation. Although elective deferrals are not subject to current income taxation, they are subject to FICA and FUTA taxes. FICA is how Social Security benefits are funded. FUTA funds federal contributions to unemployment benefits. 401(k) plans are allowed for all types of employers except for state and local governments. Since 1986, state and local governments have not been allowed to establish a 401(k). However, plans established before 1986 were grandfathered and thus allowed to continue.

As in all qualified plans, the employee is immediately 100% vested in all elective deferrals and the earnings on the worker's deferrals. On the other hand, the employer's contributions can be subject to the normal defined contribution vesting schedules (three-year cliff vesting and two-to-six-year graded vesting). Because the participant has the right to receive cash compensation, a Section 401(k) plan is an exception to the constructive receipt rules of income taxation. Amounts contributed to the Section 401(k) plan are not taxable until withdrawn by the participant. However, the worker must elect to contribute the money into the plan before it is

earned. In other words, workers can only defer money into the plan that they have not yet been paid; the election applies to future earnings. This allows employees a degree of choice in the amount they wish to save.

Employers can deduct 401(k) profit-sharing plan contributions of up to 25% of the participating employees' payroll. "Payroll" includes the elective deferrals and catch-up contributions of those employees. For purposes of calculating the 25% deduction limit, employer contributions are defined as nonelective contributions, matching contributions, and discretionary profit sharing contributions only. Employee elective deferrals and catch-up contributions are not considered to be employer contributions for this purpose. This is an advantage for an employer that wants to maximize deductible contributions to a 401(k) plan. Plus, it works in favor of employee-participants who want to maximize their plan contributions.

Employer contributions are limited by the maximum annual addition rules. Thus, the total contribution for an individual employee is usually limited to the lesser of 100% of compensation or $66,000 in 2023 according to Section 415 of the Tax Code. The maximum annual addition is made up of employer contributions, employee contributions, and reallocated forfeitures. The only type of contribution that is not included in the $66,000 for 2023 is the age 50 catch-up amount of $7,500. Thus, the actual dollar limit for 2023 is $73,500 for people age 50 and older. However, if asked about the limit on a test, the answer is $66,000 for 2023 unless the question specifically addresses the catch-up amount because Section 415 does not include the age 50 catch-up.

The maximum amount that may be contributed to the Section 401(k) plan by the participant on a pretax basis is specified by law and is indexed for inflation. The maximum elective deferral is $22,500 (2023). Participants at least age 50 by the end of the year can make additional catch-up contributions of $7,500 (2023). As discussed earlier, an employer can make additional contributions to the participant's account in the form of matching contributions or profit-sharing contributions. An employer can also commit itself to contribute a set amount even if the worker does not contribute to the 401(k). For example, an employer can contribute 3% to all eligible worker's 401(k) amount regardless of whether or not the worker defers money into the plan or not. Naturally, the firm can raise, lower, or even eliminate this commitment each year.

Employer-matching contributions are typically a dollar-for-dollar match or $0.50 match for each dollar the participant defers, up to a specified limit.

As a type of profit-sharing plan, a 401(k) can offer in-service and hardship withdrawals as described in LO 3.1.1. Plan loans are also available with 401(k) and 403(b) plans if the plan document chooses to allow loans. Retirement plan loan information is found in LO 6.3.2.

A traditional Section 401(k) plan is appropriate when

- an employer wants to provide a qualified retirement plan for employees but can afford only minimal expense beyond existing salary costs [such a plan can be funded entirely from employee salary reductions, except for installation and administration (testing) costs];
- employees are relatively young and have substantial time to accumulate retirement savings; and

- employers want to encourage employees to save for their own retirement. Some of this is the company being socially responsible, but it also helps the employer guard against older employees who stay too long because they cannot afford to retire. Retirement plan contributions are also an important recruitment and retention tool.

Pension Protection Act of 2006 (PPA) Automatic Enrollment in Traditional Section 401(k) Plans

The PPA provides several incentives for sponsoring employers to adopt automatic enrollment in their Section 401(k) plans. Automatic enrollment, also known as a **negative election**, allows an employer to enroll employees in the Section 401(k) plan without the employees' consent, as long as the employees have the right to opt out of contributing. The PPA includes safe harbor rules that would relieve a **qualified automatic contribution arrangement (QACA)** from special nondiscrimination testing, with lower required employer contributions than under the current safe harbor Section 401(k) plan rules. Such an arrangement will automatically qualify with Section 401(k) nondiscrimination testing if it

- provides for an automatic deferral percentage between 3% and 15% of employee compensation (if the automatic deferral percentage under the plan is less than 6%, a participant's automatic deferral percentage must be increased each year by 1% until reaching at least 6% of compensation);
- provides an employer contribution to non-HCEs of either an employer match of 100% of the first 1% deferred plus 50% of the next 5% or a 3% profit-sharing contribution in lieu of the matching contribution;
- provides that the employer contributions become 100% vested after the employee has completed no more than two years of service; and
- requires that, within 30 days prior to enrollment (and annually thereafter), eligible employees must be given a written **automatic enrollment notice** and a **qualified default investment notice** and allow the employees not to make any contributions, if they so choose.

In addition, under the PPA, non-safe harbor automatic enrollment arrangements will have additional time to test for discrimination testing (under the ADP or ACP tests) and, if needed, make corrective distributions (six months after the end of the plan year rather than the normal 2.5 months).

PROFESSOR'S NOTE

Automatic enrollment is an important topic in the real world because it is very successful in getting workers enrolled in the firm's retirement plan.

Safe Harbor Section 401(k) Plan

Employers can avoid having to comply with special nondiscrimination testing (ADP and ACP tests) that apply to traditional Section 401(k) plans if the plan meets one of the safe harbor provisions under IRC Section 401(k)(12) and the Treasury Regulations. The **safe harbor Section 401(k) plan** permits a high level of elective

deferrals by employees without annual discrimination testing. In addition, the safe harbor alternative is not subject to the top-heavy plan provisions. Safe harbor 401(k) plans are subject to the general nondiscrimination tests described in Module 1 (the percentage test, ratio test, and average benefit percentage test). However, a mandatory minimum employer contribution is required in the safe harbor plan in which the employee must be 100% vested immediately. The two mandatory minimum employer contribution methods are

- a nonelective contribution of 3% of compensation for all eligible employees (regardless of whether these employees are deferring salary into the Section 401(k) plan or not); or
- an employer-matching contribution of 100% on the first 3% of non-HCE compensation plus a 50% match on the next 2% of non-HCE compensation (a total of 4%) for those non-HCEs who are actually deferring salary into the 401(k) plan. This is called the safe harbor 401(k) basic matching formula. The rate of matching for highly compensated employees must not exceed the rate of matching for nonhighly compensated employees. In tabular form, these matching contributions may be shown as follows.

Figure 3.2: Safe Harbor Basic Matching Formula

Employee Contribution as a % of Compensation	Employer-Matching Contribution as a % of Compensation
0%	0%
1%	1%
2%	2%
3%	3%
4%	3.5%
5% or greater	4%

Some safe harbor 401(k) plans use an enhanced matching formula. An enhanced matching formula must be at least as generous as the basic matching formula. The most common enhanced matching formula is a 100% match of the first 4% of compensation.

Notice which employer contribution plan is best for an employee's retirement preparation. With a nonelective contribution, all eligible employees get a 3% contribution and many will not contribute to the plan. With the enhanced match, many will stop at 4%, so they will be saving 8%. With the basic match, the employee must save 5% to get the full match. Thus, a total of 9% will be saved for retirement. This is three times the nonelective contribution rate. In all, a matching formula is highly motivational for employees. Many people who think they "cannot afford to save for retirement" will save if there is a match.

Many small businesses that wish to adopt a Section 401(k) plan will opt for the safe harbor arrangement because it is less expensive to operate and does not need to be tested annually. The plan permits a high level of salary deferrals by employees without annual discrimination testing. In addition, similar to any profit-sharing plan, hardship withdrawals and loans are permitted in the safe harbor Section 401(k), a characteristic that is important to a small business owner and employee participants. Another aspect of safe harbor 401(k)s is that they must provide certain

notices to eligible employees concerning their rights and obligations under the plan. The timing requirement is deemed to be satisfied if the notice is provided at least 30 days (and not more than 90 days) before the beginning of each plan year. Like all 401(k) plans, a safe harbor 401(k) only allows a maximum waiting period of one year to be eligible for the plan and only nongovernmental employers can offer a safe harbor 401(k). Finally, nongovernmental employers of any size may choose to offer a safe harbor 401(k). There is no limit on the number of employees.

PROFESSOR'S NOTE

Safe harbor 401(k)s reflect a change in the philosophy of regulation. Traditional 401(k) nondiscrimination tests were established first and are highly technical and bureaucratic. The goal of the tests are to force the company decision makers to increase plan contributions for non-HCE participants. However, an abundance of rules requires costly administration. The practical result can be that many employers, especially small and non-bureaucratic firms, skip having a retirement plan at all. Currently, approximately 40% of American workers do not have a retirement plan offered by their employer. Safe harbor regulations and other types of employer retirement accounts like SIMPLE plans are an attempt to streamline employer retirement accounts by setting employer contributions at a reasonable level for workers and not fussing over the relative contributions of HCEs to non-HCEs.

EXAMPLE: Safe harbor

The DAL Corporation has a safe harbor 401(k). Steve makes $100,000 working for them and defers at least 5% in the plan. What are the minimum and maximum required contributions the DAL Corporation could make to Steve's safe harbor 401(k)?

Minimum: The 3% nonelective contribution would be $3,000.

Maximum: The basic matching formula is 100% for the first 3% ($3,000) plus 50% of the next 2% ($1,000). The enhanced matching formula would also require a match of $4,000 when Steve contributes 4% or more.

Thus, either matching plan would cost the company $4,000 for Steve, but other workers might not contribute, so the normal matching plan would probably cost less than 4%.

Note that the basic matching plan would mean a worker contributing 5% would actually have a total savings of 9%. On the other hand, the minimum any eligible worker would have would be 3% if the employer chose the 3% nonelective formula.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

4. Elizabeth, age 54, has an annual salary of $120,000 and participates in a traditional Section 401(k) plan sponsored by her employer. The plan provides for a 50% company match on the first 6% of an employee's salary deferred. If Elizabeth makes the maximum elective deferral for 2023 (including catch-up contributions), what additional amount can her employer contribute on her behalf without exceeding the annual additions limit?
   A. $30,400
   B. $32,400
   C. $37,900
   D. $39,900

5. Allen Equipment Co. has just implemented a safe harbor Section 401(k) plan. Which of the following can be avoided with the safe harbor arrangement?
   I. ADP test
   II. ACP test
   III. Top-heavy rules
   IV. General nondiscrimination tests (coverage rules)
   A. I and II
   B. III and IV
   C. I, II, and III
   D. I, II, and IV

Reading: ADP and ACP Testing

LO 3.3.2: Calculate actual deferral percentages and/or actual contribution percentages to determine if a 401(k) plan meets ADP/ACP tests.

A Section 401(k) plan must not only satisfy the general nondiscrimination tests from Module 1 (percentage test, ratio test, or average benefits percentage test) but must also satisfy special nondiscrimination tests known as the **actual deferral percentage (ADP) test** and **actual contribution percentage (ACP) test**. Because of these tests, a traditional 401(k) plan can be relatively costly and complex to administer. In the ADP test, the employer must compare the average percentage of eligible HCEs' pretax elective deferrals and Roth elective deferrals to the average percentage of the eligible non-HCEs' pretax or Roth elective deferrals. (HCE means highly compensated employee as defined by more than 5% ownership or compensation above $135,000 in 2022 or $150,000 in 2023 as covered in Module 1.) In other words, the ADP test only counts what employees are actually deferring into the plan on their own. The ADP test does not count what the employer is putting into the plan directly or by matching. Catch-up elective deferrals are not considered in the ADP calculation. Using catch-up contributions would not be fair because employees cannot control when they were born. Also, not counting catch-up contributions is usually favorable to owners and upper management because they tend to be older and earn more. Thus, they are in a better position to make larger contributions. The point of the ADP test is to pressure the major decision makers to encourage the rank-and-file to save for their own futures as well. For example, the 45-year-old

owner and only HCE of a small company wants to save 9% into his 401(k). Under the individual contribution test, he would be allowed to contribute up to $22,500 into the plan by salary deferral in 2023. That is his individual limit. However, 401(k) plans have more than one test, especially as regards to HCE contribution levels relative to non-HCE contribution levels. The ability for HCEs to contribute are also subject to the ADP and ACP nondiscrimination tests. In this circumstance the HCE is not allowed to contribute 9% unless the rank-and-file is averaging 7.2% (according to the following ADP tests) or the plan will fail the ADP nondiscrimination test. Thus, the owner might establish a match of 50% for the first 8% to encourage the other workers to contribute to the plan. What the non-HCEs actually average deferring will limit the ability for the HCE to contribute.

The ACP test follows the same procedure but uses employer-matching contributions and employee after-tax contributions in the calculations.

To satisfy the ADP test, a traditional 401(k) plan must meet one of the following two tests:

- The ADP for eligible HCEs must not be more than the ADP of all other eligible employees multiplied by 1.25.
- The ADP for eligible HCEs must not exceed the ADP for other eligible employees by more than 200%, but this test is limited to a maximum of 2%.

Figure 3.3: Summary of ADP Rules

If ADP for non-HCE:	Maximum ADP for HCE is:
≤ 2%	2 × ADP of non-HCE
> 2%, but ≤ 8%	2% + ADP of non-HCE
> 8%	1.25 × ADP of non-HCE

EXAMPLE: ADP test

At Company A, the non-HCEs average 1.5% deferrals. Thus the HCEs for Company A can only average deferring 3%. This will incentivize the HCEs to make deferring into the 401(k) more attractive to the non-HCEs by providing matching funds, etc.

At Company B, the non-HCEs average deferring 4%. This allows the HCEs to average deferring 6%.

At Company C, the non-HCEs average deferring 9%. This allows the HCEs to average deferring 11.25%. (9% x 1.25).

If the ADP test fails, the employer has two options.

- A corrective distribution can be made that will decrease the ADP of the HCEs, converting pretax dollars of the HCEs to taxable dollars.
- An additional qualified matching or qualified nonelective contribution may be made for the non-HCEs by the employer. The point of **qualified matching contributions** and **qualified nonelective contributions** is to boost the contributions of the nonhighly compensated employees so the contributions of the highly compensated employees do not have to be withdrawn from the retirement plan.

Qualified matching contributions (QMACs) and **qualified nonelective contributions (QNECs)** count in the application of the annual additions limit ($66,000 in 2023). Employer QMACs and QNECs must be immediately 100% vested to the employee. Corrective distributions have no effect on the non-HCEs. In other words, QMAC or QNEC contributions are made by the firm, but counted as if the employee deferred the money into the plan. Since these contributions are counted as being worker contributions, they are immediately vested along with any earnings tied to the QMAC or QNEC contributions. As covered in LO 3.1.1, these two types of employer contributions and their earnings are now available for hardship withdrawals.

PROFESSOR'S NOTE

Emphasize the difference between QMAC and QNEC contributions versus employer-matching or voluntary employer contributions. For example, an employer puts 2% into all eligible worker's 401(k) accounts and matches 3%. These contributions and their earnings can be subject to the vesting schedule. The feel for QMACs and QNECs is that the 401(k) is about to fail or has failed nondiscrimination testing and is being corrected. However, QMACs and QNECs are very deep for the CFP Final and should not be overemphasized.

The ACP test applies to voluntary employer contributions, employer-matching, and employee after-tax contributions (not pretax contributions or Roth elective deferrals). Compliance with the ACP test is only a concern if the employer allows after-tax contributions, automatically contributes to all eligible plan participants, or matches the employee elective deferrals. If the employer does not do any of these things, only the ADP test must be satisfied. Because most employers do match employee elective deferrals, satisfaction of the ACP is also relevant for most employers sponsoring a traditional Section 401(k). The ACP test has the exact same percentage rules as the ADP test.

Figure 3.4: Summary of ACP Rules

If ACP for non-HCE:	Maximum ACP for HCE is:
≤ 2%	2 × ACP of non-HCE
> 2%, but ≤ 8%	2% + ACP of non-HCE
> 8%	1.25 × ACP of non-HCE

403(b) plans that provide employer-matching contributions are also subject to the ACP test. In other words, if a 403(b) plan does not have an employer match, it is not subject to the ACP test.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

6. In a traditional Section 401(k) plan, which of the following must be considered in complying with the maximum annual additions limit?
   I. Employee elective deferrals
   II. Catch-up contributions for an employee age 50 or older
   III. Qualified nonelective contributions
   IV. Qualified matching contributions

A. I and II
B. III and IV
C. I, II, and IV
D. I, III, and IV

Reading: Other Types of 401(k) Plans

LO 3.3.3: Analyze the features, advantages, and disadvantages of SIMPLE 401(k), Roth 401(k), and Solo 401(k) plans.

SIMPLE 401(k)

There are two forms of the savings incentive match plan for employees (SIMPLE): a SIMPLE IRA and a **SIMPLE 401(k)**. The more prevalent of the two is the SIMPLE IRA, which will be discussed in the next module. However, a Section 401(k) may also be structured as a SIMPLE for some employers. Employers with 100 or fewer employees earning $5,000 (or more) during the preceding year may adopt a SIMPLE 401(k). In fact, there is a two-year grace period for SIMPLEs when the employer grows beyond 100 workers. The employer usually may not maintain any other qualified or employer-sponsored retirement plan. There are two exceptions. First, if eligible, the employer can maintain a Section 457 plan (discussed in the next module) for the benefit of its employees. Second, the employer may maintain a union plan subject to good faith bargaining. However, these two exceptions should only be taken into account on a test if specifically mentioned. In general, it is true that an employer with a SIMPLE cannot also have another open retirement plan for its workers. The SIMPLE 401(k), like the safe harbor option, is exempt from the special nondiscrimination ACP/ADP tests that apply to the traditional Section 401(k) plan. Also, all SIMPLEs are exempt from top heavy testing and requirements.

Employees who participate in a SIMPLE 401(k) may make elective deferrals similar to the traditional Section 401(k) plan. However, the maximum deferral limits are less than those permitted under a traditional Section 401(k) plan. For example, in 2023, employee elective deferrals to the SIMPLE 401(k) are limited to $15,500 with a catch-up contribution for those employees age 50 or older of $3,500. The employer-sponsor of the plan is strictly limited to two choices for employer contributions. First, it can offer a 3% match. This is the only matching option for a SIMPLE 401(k). However, like all matches, if a worker contributed less than 3%, then the exact amount of the worker contribution would be matched. For example, if a worker making $100,000 defers $1,500 into the SIMPLE 401(k), then the company would also contribute $1,500. The second employer contribution option is to make a flat (nonelective) contribution of 2% of compensation for all eligible employees, even those who choose not to make elective deferrals. Unlike traditional Section 401(k) employer contributions for which vesting schedules are permissible, a worker is always 100% vested in the contributions made to a SIMPLE 401(k) by the employer. One advantage of a SIMPLE 401(k) over a SIMPLE IRA is that a SIMPLE 401(k) can offer retirement plan loans. A SIMPLE 401(k) can also offer the normal 401(k) hardship withdrawals. A SIMPLE IRA never limits withdrawals at any time, so it does not need hardship withdrawal provisions. Finally, SIMPLE 401(k)s are subject to the mandatory 20% withholding for rollovers, like any qualified plan. As usual, a direct transfer escapes the 20% mandatory withholding rules. These rules are covered in LO 6.1.2.

Roth 401(k) Plan

A **Roth 401(k) plan** is a type of Section 401(k) plan in which elective deferral contributions are permitted on an after-tax basis. A separate account is created for the Roth contributions and related earnings. The maximum contribution to such a plan is the same as in the traditional Section 401(k), $22,500 (2023). Participants age 50 or older may contribute an additional $7,500 (for 2023) of after-tax dollars.

If the employee also defers salary to a traditional Section 401(k) account, the total amount deferred under both the Roth and traditional Section 401(k) plans combined is limited to $22,500 and $7,500 catch-up (2023). Unlike the Roth IRA (to be discussed in Module 5), the ability to make contributions to a Roth 401(k) is not phased out based on the taxpayer's AGI. Thus, high-income wage earners may find the Roth 401(k) option a very attractive retirement savings vehicle. Also, more than 40% of American workers do not owe income tax. That means a Roth elective deferral would be more appropriate than a tax sheltered deferral that did not actually reduce their current taxation. Employer Roth accounts would also be less heavily taxed if the worker is forced to take a hardship withdrawal. A hardship withdrawal from a Roth 401(k) would be income taxed and subject to the 10% EWP ratably. That means the withdrawn amount that comes from Roth contributions is not taxed or penalized. This is better than being income taxed and penalized on the entire amount. Also qualified distributions from Roth elective deferrals would be income tax free as described below. That might help lower the amount of Social Security retirement benefits that are subject to income taxes as described in Module 7.

The major difference between the traditional Section 401(k) plan and the Roth 401(k) plan is the tax treatment of the contributions and distributions. Only the employer-matching contributions (if any) and the related earnings associated with any employer contributions with a Roth 401(k) are taxable when withdrawn. The employer contributions are made to a traditional Section 401(k) account on behalf of the employee. Worker contributions to the Roth 401(k), and earnings on such contributions, are tax free if made as a qualified distribution. The distribution of earnings from a Roth 401(k) are a qualified distribution and thus tax free if both of the following tests are met:

- The distribution is made after a five-year period beginning on the first day of the taxable year of the first regular contribution or in plan conversion to the Roth 401(k) plan. If money is moved into the plan from a former employer's Roth 401(k), then the time frame from the first plan is attributed to the new employer Roth 401(k). On the other hand, note that employer Roth accounts have a separate five-year clock from Roth IRAs.
- The distribution is made after the date on which the participant has attained age 59½ or becomes disabled, or it is made to a beneficiary of a deceased participant. The three reasons for a qualified distribution from a Roth 401(k) can be remembered with the acronym "DAD" (Death, Age 59½, and Disability).

Minimum distribution rules that apply to traditional Section 401(k) plans also apply to Roth 401(k) accounts.

The following table is a comparison of the major characteristics of regular and Roth 401(k) plans.

Figure 3.5: Comparison of Traditional and Roth 401(k) Plans

Attribute	Traditional Section 401(k)	Roth 401(k)
Employee funding	Pretax	After-tax
Employer-matching	Pretax	Pretax [identical to traditional Section 401(k) account]
Allowable employee contributions	$22,500 plus $7,500 catch-up (2023)	$22,500 plus $7,500 catch-up (2023) [less any contributions to traditional Section 401(k) plan]
Qualified distributions subject to tax	Yes, all amounts, because qualified distributions are not a term that applies to a traditional 401(k)	Only employer-matching contributions and earnings are taxed. Qualified distributions from an employer Roth are tax-free.
Minimum distribution requirement	Yes, starting at age 72 or date of retirement (unless >5% owner)	Yes, starting at age 72 or date of retirement (unless >5% owner)
Rollover options	Tax free rollover to traditional IRA	Tax free rollover to another Roth 401(k) or Roth IRA [but a Roth IRA can never be rolled into a Roth 401(k)]

Section 401(k) plans that permit Roth contributions may allow participants to convert pretax amounts into Roth accounts within the same plan. The converted amount is subject to income tax, but not the 10% EWP. The mandatory 20% withholding from a qualified plan distribution does not apply to the conversion amount. The conversion amount is still taxable, but the taxpayer may pay the income tax from other funds.

One-Participant (Solo) 401(k)

A solo 401(k) is a traditional 401(k) plan covering a business owner with no employees, or that person and their spouse. These plans have the same rules and requirements as any other Section 401(k) plan. In a solo 401(k) plan, the business owner can make contributions to the plan both as a participant and as an employer, subject to qualified plan limits for elective deferrals and annual additions. Thus, a solo 401(k) enables the unincorporated business to contribute up to 20% into the plan for the owner, and the owner can also personally defer up to $22,500 in 2023 (plus an additional $7,500 if age 50 or older). The limit is 20% (not 25%) for an incorporated employer due to the owner being self-employed as described below for Keogh plans.

Savings/Thrift Plan

A **savings/thrift plan** is a qualified defined contribution plan similar to a traditional profit-sharing plan except that it provides for and encourages after-tax employee contributions to the plan. The typical thrift plan provides for after-tax employee contributions with matching employer contributions. Pure thrift plans, featuring only after-tax employee contributions, have generally been replaced with the Section 401(k) type of plan, especially the Roth 401(k).

Special Rules for Self-Employed Plans (Keogh Plans)

A **Keogh (self-employed) plan** is an employer-sponsored retirement plan that covers one or more self-employed individuals, such as a sole proprietor or a partner. It

can be set up as any type of defined benefit pension, defined contribution, or tax-advantaged retirement plan. However, the three most common types of **Keogh plans** are profit-sharing, money purchase pension, and target benefit pension plans, all of which are defined contribution plans.

Member-owners of LLCs taxed as a sole proprietor or partnership are considered self-employed individuals for this purpose. However, if the LLC elects to be taxed as a C corporation, then there are no self-employed owners, and the LLC cannot establish a Keogh retirement plan. Limited liability partnerships (LLPs) can also offer Keogh plans. However, no S corporation can offer a Keogh plan because S corporations owners are not considered self-employed. A Keogh plan is fundamentally like any other qualified or tax-advantaged plan (it must comply with the same technical requirements) except for two differences:

- Self-employed individuals must calculate their retirement plan contribution based on earned income, or net earnings from self-employment, instead of W-2 income.
- Self-employed individuals must use a net contribution rate in determining their allowable contribution to a Keogh defined contribution plan (for example, a profit-sharing plan). This rate is calculated by dividing the plan contribution percentage by (1 + the contribution percentage). For example, the maximum contribution for a self-employed participant in a plan with a 25% contribution formula is 20% [0.25 divided by (1 + 0.25)].

Earned income takes the place of compensation (W-2) income in applying the special rules applicable to Keogh plans. In calculating earned income of a self-employed individual, self-employment tax must be calculated, and a deduction of one-half of the self-employment tax must be taken before determining the Keogh deduction. This creates a circular calculation because the amount of self-employment tax (SE tax) deduction is not known before the calculation of earned income, and the amount of earned income cannot be derived without knowing the self-employment tax deduction. Following are the steps in determining the Keogh deduction:

1. Determine the net income of the business from Schedule C, IRS Form 1040, or the Schedule K-1 provided to the partner or the LLC member-partner.
2. Subtract the deductible amount of SE tax applicable from that income.
3. Multiply the result by the net contribution rate.

EXAMPLE: Keogh deduction

Ken, a sole proprietor, earns $70,000 of Schedule C income. Ken's business maintains a profit-sharing plan with a 25% contribution on behalf of all employees. Ken's deductible contribution as an owner-employee of the business is calculated as follows:

Schedule C income:	$70,000	
Less deductible amount of SE tax paid:	(4,945)	[($70,000 × 0.9235 × 0.0765)]
Equals:	$65,055	
Multiply by net contribution rate:	× 0.20	
Maximum deductible contribution:	$13,011	

> **Note:** The deductible amount of SE tax on Schedule C income at or below the Social Security taxable wage base may be calculated using this shortcut method: (The initial amount of self-employment income/profit x 0.9235 x 0.0765 = The amount to subtract from self-employment income) In Ken's case: ($70,000 × 0.9235 × 0.0765) = $4,945.
>
> The point of these adjustments are to give the self-employed owner the same contribution rate as a worker. Observe that Ken's compensation after half the SECA and the contribution to the profit-sharing plan is $52,044 ($70,000 - $4,945 - $13,011 = $52,044). If this number is multiplied times the 25% contribution rate the regular employees get, the result is $13,011. Thus, when comparing apples to apples employees and self-employed owners are getting the same contribution rate. See the FP514: Tax Planning course to learn how to make this calculation when Schedule C income exceeds the taxable wage base.

Important concepts with respect to this contribution include the following:

- The net contribution rate of 20% is determined by dividing 0.25 by (1 + 0.25). If the plan contribution percentage was 15%, divide 0.15 by (1 + 0.15) for a net contribution rate of 13.04%.
- This calculation applies only to the owner-employee of the business (the self-employed individual); those individuals who work for the owner-employee (or the rank-and-file employee) are entitled to a full or unadjusted deductible contribution.
- The deductible contribution for the owner-employee is an above-the-line deduction on IRS Form 1040.

Keoghs vs. Other Qualified and Tax-Advantaged Plans

Keogh plans cover self-employed individuals who are not considered normal employees. The most important special rule for Keoghs is the definition of earned income. Earned income takes the place of compensation in applying the plan rules for Keoghs and is defined as the self-employed individual's net business income after all deductions, including the deduction for Keogh plan contributions. In addition, the IRS has ruled that the SE tax must be calculated, and a deduction of one-half of the SE tax must be taken before determining the Keogh deduction.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

7. Robert's Restoration Company is a small business with 20 employees. The business has adopted a SIMPLE 401(k). It now wishes to implement another plan on their behalf. Which one of the following plans, if any, may Robert's Restoration adopt immediately?
    A. A simplified employee pension (SEP) plan
    B. A traditional profit-sharing plan
    C. A cash balance pension plan
    D. None of these

8. All of the following with respect to a Roth 401(k) are correct EXCEPT
   A. the maximum elective deferral (younger than age 50 participant) to a Roth 401(k) is $22,500 for 2023.
   B. individuals age 50 or older may contribute an additional $7,500 to a Roth 401(k) for 2023.
   C. elective deferral contributions and catch-up contributions are made with after-tax dollars.
   D. the ability to make contributions to a Roth 401(k) is phased out based on the taxpayer's AGI.
9. The deductible contribution to a money purchase pension plan on behalf of a self-employed individual whose income from self-employment is $20,000 and whose deductible SE tax is $1,413 is limited to
   A. $3,000.
   B. $3,717.
   C. $4,714.
   D. $5,000.
10. Landon is a CFP® professional and his sister, Jessica introduced him to Kevin today. Jessica works at the bank that has Kevin's business and personal accounts. When she refers a client to Landon, he gives her a small finder's fee. Kevin is the sole shareholder of a closely held corporation and is considering various profit-sharing plan alternatives for providing a qualified retirement plan to his employees and saving for his own retirement. He feels he needs the advice of a financial planning professional and likes what he has learned of Landon's services. What is Landon's next step in helping Kevin choose the best profit-sharing plan alternative?
    A. Landon asks for all the documentation about Kevin's personal financial status and gets detailed information on the company's finances, employee census, and more details on what Kevin wants to accomplish with the retirement plan.
    B. Landon recommends a profit-sharing plan with a Section 401(k) feature to allow employees to contribute to their own retirement.
    C. Landon discusses the financial planning process with Kevin and explains the scope of services he will provide; he also discloses in writing his relationship to Jessica and her finder's fee and issues a client engagement letter to Kevin.
    D. Because Kevin wants to choose a retirement plan for his corporation, Landon must decline to provide any services, as he can provide financial planning services only to individuals and not entities.

MODULE 3 ANSWER KEY FOR PRACTICE QUESTIONS

1. **C** Profit-sharing plans are not required to make annual contributions. As a discretionary plan, profit-sharing plans are suitable for companies that have unstable cash flows. Finally, a firm has the option, but not the requirement, to contribute to a profit-sharing plan even in years without a profit. The company would have to take the money from retained earnings or current cash flow if it chose to fund the profit-sharing plan in a year without a profit.

2. **B** An age-based profit-sharing plan and a new comparability profit-sharing plan are examples of defined contribution plans that may be tested for nondiscrimination on the basis of projected benefits—in other words, cross-tested plans.

3. **B** An ESOP cannot be integrated with Social Security. Money purchase pension plans and cash balance pension plans cannot invest in company stock in an unrestricted manner. As pension plans, they are restricted to 10% of the contribution being employer securities. The two pension plans (cash balance and money purchase plans) also lack contribution (funding) flexibility.

4. **D** The company can contribute an additional $39,900 in 2023 on behalf of Elizabeth, calculated as follows:

Maximum limit:	$66,000	
Less regular elective deferral:	–$22,500	
Less employer match:	–$3,600	($120,000 × 0.06 × 0.50)
Additional amount:	$39,900	

   Elizabeth's catch-up contributions of $7,500 in 2023 do not count against the annual additions limit.

5. **C** Safe harbor 401(k) plans are not required to comply with ADP, ACP, or top-heavy rules. However, as a qualified plan, it still must comply with the general nondiscrimination tests or coverage rules.

6. **D** All of these are counted against the annual additions limit except catch-up contributions for an employee age 50 or older. Such contributions are not taken into account for the annual additions limit or for purposes of ADP special nondiscrimination testing.

7. **D** Because it has already established a SIMPLE 401(k) plan, Robert's Restoration Company may not have any other type of employer-sponsored retirement plan. Some employers may also be eligible to have a Section 457 plan, but Robert's Restoration Company does not meet the criteria for establishing a Section 457 plan.

8. **D** Unlike a Roth IRA, the ability to make contributions to a Roth 401(k) is not phased out based on the participant's AGI.

9. **B** The maximum deductible contribution on behalf of the self-employed individual is $3,717, calculated as follows:

Schedule C income:	$20,000.00	
Less: deductible self-employment tax (half):	($1,413.00)	
Equals:	$18,587.00	
Multiply by net contribution rate:	× 0.20	(0.25 divided by 1.25)
Maximum deductible contribution:	$3,717.40	

10. **C** Landon is still in the first step of the financial planning process and must make all regulatory and other disclosures and provide an engagement letter with the scope of services he intends to provide to Kevin.

Module 3

MODULE 4

Tax-Advantaged Plans and Nonqualified Plans

INTRODUCTION

This is the last of three modules discussing employer-sponsored retirement plans. The plans addressed in this module are best categorized as tax-advantaged plans rather than qualified plans. The term *tax-advantaged* means the plans have very similar requirements to qualified retirement plans, but the provisions of each plan are addressed in a Tax Code section other than Section 401, which applies to qualified plans.

Several of the plans addressed in this module are essentially IRAs sponsored by a participant's employer. Among these plans are the simplified employee pension IRA (SEP IRA) and the savings incentive match plan for employees IRA (SIMPLE IRA). In addition, this module considers plans that may be established by public or private tax-exempt employers, such as the tax-sheltered annuity (known as a TSA or a Section 403(b) plan). Also discussed are nonqualified deferred compensation Section 457 plans that may be established for either municipal (state and local) government employees or nongovernmental employees. The CFP® exam program addresses governmental 457 plans only.

TOPICS, LEARNING OBJECTIVES, AND READINGS

The topics covered in this module are as follows:

- Topic 4.1: Tax-Advantaged Plans
- Topic 4.2: Savings Incentive Match Plans for Employees (SIMPLEs) and Simplified Employee Pensions (SEPs)
- Topic 4.3: Tax-Sheltered Annuities (TSAs)/Section 403(b) Plans and Section 457 Plans
- Topic 4.4: Multiple Plan Limits

Throughout this module, you will see learning objectives (LOs) that emphasize the knowledge and application skills you will gain from this module. These specific statements, based on the 2021 CFP Board's Principal Knowledge Topics List (the blueprint for the current CFP® exam), advise you regarding what you should know and be able to do at the completion of this module.

In the following table is a list of module topics, LOs, and readings.

Learning Objective		Readings
Topic 4.1: Tax-Advantaged Plans		
4.1.1	Compare tax-advantaged plans and qualified plans.	Tax-Advantaged Plans
Topic 4.2: Savings Incentive Match Plans for Employees (SIMPLEs) and Simplified Employee Pensions (SEPs)		
4.2.1	Analyze employer attributes to determine SIMPLE plan eligibility.	Savings Incentive Match Plans for Employees (SIMPLEs)
4.2.2	Determine the plan requirements for a simplified employee pension (SEP).	Simplified Employee Pensions (SEPs)
Topic 4.3: Tax-Sheltered Annuities (TSAs)/Section 403(b) Plans and Section 457 Plans		
4.3.1	Examine the characteristics of tax-sheltered annuities (TSAs)/Section 403(b) plans to determine employer/employee attributes that would best be served by these retirement plans.	Tax-Sheltered Annuities (TSAs)/Section 403(b) Plans
4.3.2	Analyze the benefits and taxation of Section 457 plans.	Section 457 Plans
Topic 4.4: Multiple Plan Limits		
4.4.1	Determine the maximum amount of elective deferrals that may be made to multiple plans on behalf of an employee.	Multiple Plan Limits

KEY TERMS

salary reduction SEP (SARSEP)
savings incentive match plan for employees (SIMPLE) IRA
Section 403(b) plan
Section 457 plan
simplified employee pension (SEP) plan
tax-advantaged
tax-sheltered annuity (TSA)
top-hat plan

TOPIC 4.1: TAX-ADVANTAGED PLANS

Reading: Tax-Advantaged Plans

LO 4.1.1: Compare tax-advantaged plans and qualified plans.

Tax-advantaged plans have nondiscrimination rules that differ from those that apply to qualified plans, although tax-advantaged plans generally avoid the issue entirely by requiring almost universal coverage. Nevertheless, tax-advantaged plans are more like qualified plans than other nonqualified plans and should not

be confused with the nonqualified deferred compensation plans discussed in the *FP512: Risk Management, Insurance, and Employee Benefits Planning* course. Neither the 10-year forward averaging, special pre-1974 participation capital gain treatment nor the special net unrealized appreciation (NUA) treatment for employer stock distributions is available for nonqualified plans, including the tax-advantaged plans discussed in this module. Also, IRA-funded employer-sponsored tax-advantaged plans (SEP, SARSEP, and SIMPLE IRA) may not incorporate loan provisions.

The following tax-advantaged plans have many similarities to qualified plans, especially regarding tax treatment:

- Simplified employee pension (SEP) plans
- Traditional individual retirement accounts (traditional IRAs)
- Roth IRAs
- Savings incentive match plans for employees (SIMPLEs)
- Section 403(b) plans, also known as TSAs

Each plan makes the same promise to the plan participant—to pay the balance of the individual account at retirement. The distribution rules are essentially the same as those for qualified plans. Qualified plans and tax-advantaged plans all provide for deferred compensation, and plan sponsors of these plans make contributions to either a trust, an insurance contract, or an individual retirement account depending on the type of plan.

Nonqualified deferred compensation plans do not benefit from all the tax advantages that apply to qualified plans or other tax-advantaged plans. These plans are generally discriminatory in favor of highly compensated employees. Nonqualified plans may supplement qualified plans, particularly in exceeding Section 415 limitations, and may defer taxes for the employee participants; they are commonly referred to as **top-hat plans** because they are often used to retain upper-level management.

TOPIC 4.2: SAVINGS INCENTIVE MATCH PLANS FOR EMPLOYEES (SIMPLEs) AND SIMPLIFIED EMPLOYEE PENSIONS (SEPs)

Reading: Savings Incentive Match Plans for Employees (SIMPLEs)

LO 4.2.1: Analyze employer attributes to determine SIMPLE plan eligibility.

Characteristics

There are two types of SIMPLEs: SIMPLE IRAs and SIMPLE 401(k)s (discussed in Module 3). SIMPLE IRAs are not generally subject to the nondiscrimination and top-heavy rules applicable to qualified plans.

Employer contributions are deductible if made by the due date of the employer's tax return, including extensions, and are not subject to payroll (FICA) taxes. Contributions made by employees are excludable from the employee's gross income for income tax purposes but are still subject to payroll taxes.

Plan assets for SIMPLEs cannot be rolled over into another plan (other than another SIMPLE) within two years of initial participation. Also, only deductible contributions are allowed. Therefore, Roth and after-tax contributions are not available.

Eligibility for SIMPLEs

An employer is eligible to establish a SIMPLE if it

- has 100 or fewer employees on any day during the year who earned at least $5,000 during the preceding year (there is a two-year grace period for continuing a plan if the number of employees subsequently exceeds 100); and
- does not maintain another employer-sponsored retirement plan, SEP plan, SARSEP plan, or Section 403(b) plan. An employer may, however, maintain a Section 457 plan and also have a SIMPLE plan if eligibility requirements are met for both plans.

Self-employed individuals can also establish SIMPLEs.

Employees who earned $5,000 or more during any two preceding years and are reasonably expected to receive at least $5,000 during the current year must be allowed to participate. There are only two types of workers who can be excluded from SIMPLE plans: those covered by a collective bargaining agreement that is subject to good faith bargaining and nonresident aliens who receive no U.S. source earned income.

SIMPLE IRA

The **savings incentive match plan for employees (SIMPLE) IRA** is the second form of an employer-sponsored SIMPLE retirement arrangement. A SIMPLE IRA is easy to adopt by using IRS Form 5304-SIMPLE or Form 5305-SIMPLE and is less expensive to administer than a qualified plan. Also, this plan is easy to understand and explain to employees.

As with a SIMPLE 401(k), an employer that adopts a SIMPLE IRA plan may not also maintain another active qualified plan, Section 403(b) plan, or SEP plan at the same time. There are only two exceptions to this rule against having another open retirement plan. The first is for collective bargaining agreements negotiated in good faith. The second is an eligible 457 plan. These exceptions are not to be dealt with in a testing situation unless the question specifically brings it up. In general, it is true that an employer with a SIMPLE may not have another active employer retirement plan. Previous retirement plans do not have to be terminated, but they can no longer accept new contributions tied to current compensation from either the worker or the employer. Rollovers and transfers to these closed retirement plans would be allowed. The plan must be effective January 1 of any year for which contributions are made, unless it is the first year of adoption, in which case the effective date

may be any date between January 1 and October 1 of the applicable year. Also, the employer must notify participants that they have a 60-day election period just before the calendar year end to make a salary deferral election or modify a previous election for the following year. Finally, all SIMPLE plans must be calendar year plans. In other words no SIMPLE can be based on a different fiscal year.

Employees may make an elective deferral into the plan as a percentage of compensation up to $15,500 (2023). In addition, individuals who have attained age 50 may make additional catch-up contributions of $3,500 (2023). As always, salary reduction contributions (elective deferrals) are subject to FICA and FUTA withholding, but employer contributions are not.

The employee is 100% vested in both elective deferrals and employer contributions, and the plan is not subject to nondiscrimination rules generally applicable to qualified plans like ADP and ACP testing. Finally, SIMPLEs are not subject to the top-heavy rules.

Employers make contributions to the SIMPLE IRA using one of the following two formulas:

- An employer match of up to 3% of the employee's compensation—the employer can match as little as 1% of the employee's compensation in no more than two out of five years. For example, the employer could match only 2% or 1.5%, etc., for up to two years. However, the most common change would be to drop the normal 3% match to 1% when needed.
- A 2%-of-compensation nonelective contribution for each eligible employee

There is, however, an operational oddity as these contribution rules are applied to a SIMPLE IRA. If the employer elects the 3% match, the includible compensation limit of $330,000 applicable to qualified plans in 2023 does not apply. Instead, the 3% employer match will max out at the salary that causes the maximum annual employee contribution to reach the annual limit of $15,500 in 2023. This can be found by dividing the maximum annual employee contribution of $15,500 (2023) by the employer match of 3% ($15,500/0.03). Thus, $516,667 is the maximum salary that will be included in the employer SIMPLE IRA 3% match.

In the application of the compensation limit to all tax-advantaged plans, this is the only exception to the $330,000 limit. If the sponsoring employer of a SIMPLE IRA uses the nonelective 2% option, the includible compensation limit does apply, and no more than $330,000 of compensation may be taken into account in 2023.

Unlike the SIMPLE 401(k), a 25% premature withdrawal penalty applies to distributions made from a SIMPLE IRA during the first two years of plan participation if the participant is under age 59½. Also, as a form of IRA, the SIMPLE IRA may not purchase life insurance as a funding vehicle and participant loans are unavailable. Employees bear the investment risk. Finally, SIMPLE IRAs are subject to the same general exceptions, withdrawal rules, and penalties as traditional IRAs (other than the additional early withdrawal penalty of 25% for the first two years).

Reading: Simplified Employee Pensions (SEPs)

LO 4.2.2: Determine the plan requirements for a simplified employee pension (SEP).

Simplified Employee Pensions (SEPs)

A **simplified employee pension (SEP) plan** is an employer-sponsored IRA in which the employer agrees to contribute retirement monies on behalf of employees on a nondiscriminatory and fully vested basis (this avoids nondiscrimination testing). Such a plan is used most frequently by self-employed individuals, including sole proprietors, but may be established by any form of business entity. SEPs can also be integrated with Social Security.

Advantages

The major advantage of a SEP plan is its simplicity. It may be adopted by completing a single IRS form—IRS Form 5305-SEP. However, if an employer wishes to adopt a model SEP using Form 5305-SEP, it may not currently maintain another qualified plan. The SEP used to have a unique advantage in that it may be adopted and funded as late as the due date of the sponsoring employer's tax return, including extensions. This rule now applies to all employer retirement plans.

SEP plans can be described as an employer's agreement to contribute on a nondiscriminatory basis to IRAs opened and maintained by employees. All contributions are made by the employer; there are never any employee elective deferrals. Even when owners decide to contribute money into their own accounts, the contribution is treated as an employer contribution, not as a worker contribution. This is especially helpful for people with a side business. For example, Brian, age 44, contributes the maximum allowable $22,500 in 2023 to the 401(k) where he works. He also has his own business on the side. For his side business, he would not be allowed to make any employee contributions to a retirement plan for that business this year because he is already making the maximum employee contribution of $22,500. However, he would be allowed to make employer contributions to a SEP he established for his own business.

The account established for the participants is totally portable, meaning it can be easily rolled to another IRA or qualified plan (presuming the receiving plan document allows for it). It is appropriate when the employer wants an alternative to a qualified plan because contributions are discretionary, and overall, the plan is less expensive to operate. Thus, a SEP is like a poor man's profit sharing plan. The participant may self-direct the investments in the IRA.

The major SEP plan requirements include the following:

- The plan must cover all employees who are at least 21 years of age and who have worked for the employer for three out of the preceding five years. Part-time service counts for purposes of this requirement.
- Contributions must be made on behalf of any employee whose compensation is at least $750 (2023) for the tax year for which the contribution is being made and who otherwise meets eligibility requirements.

- SEP contributions can only be made by the employer. A worker can never make salary deferrals into a SEP. (This is different from a grandfathered SARSEP. With a SARSEP, both the employer and the worker are allowed to make contributions.) Also, the contribution percentage is the same for all participants in the plan. For example, if the owner sets the SEP contribution at 5% for employees, the owner's contribution can only be 5% as well. However, if the owner is self-employed (meaning the business is not incorporated and the owner also works there), the owner's contribution is adjusted twice. First, half the self-employment tax is deducted from the initial self-employment income. For example, a business with $150,000 of revenue and $50,000 of expenses has an initial self-employment income of $100,000. Then, the contribution rate is adjusted by dividing the contribution rate in decimals by 1 plus the contribution rate in decimals. For example, if the contribution rate is 4% for the workers, the self-employed owner's contribution rate would be 3.85% (0.04/1.04 = 0.0385 = 3.85%).

Also note the low amount of income required to make an employee eligible for a SEP contribution from the owner compared to the $5,000 annual salary required for SIMPLE plans. When selecting a retirement plan for an employer with many low-paid workers, these limits are important. A SEP will require contributions for workers making over $750 per year in 2023, but workers making less than $5,000 will not automatically require a contribution with a SIMPLE. Thus, all other things being equal, a SIMPLE would be preferred over a SEP by an owner in this situation. On the other hand, a SEP usually allows a higher contribution for the owner's account (the lesser of 25% of compensation up to $66,000 in 2023) than a SIMPLE. However, for an owner with lower amounts of compensation, you would have to apply the rules for both plans to determine which retirement plan allows the owner to save more in a given year.

The plan may exclude nonresident alien employees who have received no U.S. wages or compensation and employees who are members of unions (or any other collective bargaining unit) if they have their own retirement plan and the retirement benefits have been the subject of good-faith bargaining. Notice that these categories of workers have the same rules as apply to a SIMPLE.

The limits for SEP plan contributions are higher than those of traditional IRAs and are similar to those of the qualified plans. Specifically, SEP plan contributions are limited to the lesser of

- 25% of the employee's compensation (limited to the includible compensation amount of $330,000 [2023]), or
- $66,000 (2023).

Top-Heavy Rules

SEPs, like profit-sharing plans, are subject to controlled group rules and nondiscrimination requirements. As such, SEP plans are treated as defined contribution plans when applying the top-heavy rules if, at the determination date (the last day of the preceding plan year), the sum of the account balances for key employees exceeds 60% of the total of all account balances in the SEP plan. There is a special rule for the 60% test for SEP plans: when calculating the 60% test, the total of all employer contributions made to the SEP plan for the plan participants may be used instead of the participant account balances.

If the SEP plan is determined to be top heavy, then the employer must make a minimum contribution of 3% of the employee's compensation for each non-key employee plan participant each year that the plan remains top heavy unless the key employees are getting less than a 3% contribution. In that case, everyone gets the same percentage contributed.

Disadvantages

The following are some potential disadvantages of SEP plans:

- Employees cannot rely on a SEP plan alone to provide adequate retirement benefits because the benefits are not significant unless the employer makes substantial, regular contributions to the SEP plan, but the employer has no obligation to do so.
- The employee bears the investment risk under the plan.
- If an employer maintains a SEP plan and a qualified plan, contributions to the SEP plan reduce the amount that may be deducted for contributions to the qualified plan.
- The special rule for calculating deductible contributions on behalf of an owner-employee also applies to a SEP plan, as noted in the discussion of Keogh plans.
- Only the employer is allowed to make contributions to a SEP. This means that the workers are not allowed to save for their retirement at work using the SEP. On the other hand, as an employer contribution, amounts going into a SEP are not subject to FICA or FUTA.
- A SEP cannot receive a Roth contribution. The only employer plans that allow Roth accounts are 401(k) plans, 403(b) plans, and governmental 457 plans.
- Contributions for the year must be made for eligible employees even if they die or separate from service.

Tax Implications

An employer may deduct contributions to a SEP plan up to the contribution limit. Distributions to employees from the plan are treated as distributions from an IRA. As with an IRA, investments in collectibles and life insurance are not allowed. A 10% excise tax may be assessed to the employer on excess contributions. For the employee, an excess IRA contribution may be subject to a 6% excise tax. Also, employees can roll money that is distributed from a SEP plan into a different IRA within 60 days without withholding or penalty as long as it is not a required minimum distribution.

Participation in a SEP plan counts as active participant status for purposes of determining the deductibility of separate IRA contributions. There is a difference between impacting IRA deductibility and changing the ability to contribute to a traditional IRA. Being an active participant in a SEP or any other employer retirement plan (except for a 457 plan) may lower or eliminate IRA contribution deductibility, but it does not change the fact that anyone with earned income or whose spouse has sufficient earned income can make nondeductible contributions to a traditional IRA. When an IRA contribution will be nondeductible, it is best to check if it can be made to a Roth IRA instead of a nondeductible IRA.

Salary Reduction SEP (SARSEP)

As of January 1, 1997, employers can no longer establish a **salary reduction SEP (SARSEP)** plan. Some employees, however, still participate in active SARSEP plans. Also, a new employee who joins a firm with a grandfathered SARSEP may open an account with that SARSEP.

The SARSEP plan contribution limit for employees is $22,500 (2023). Individuals who have attained age 50 may make a catch-up contribution of $7,500 (2023). Elective deferrals (salary reduction contributions) are subject to Social Security (FICA) and federal unemployment (FUTA) taxes. A SARSEP can only operate when an employer has 25 or fewer employees. Finally, at least 50% of the eligible employees must participate.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

1. Celine, age 38, earns $350,000 annually as an employee for Rotolo Enterprises, Inc. Her employer sponsors a SIMPLE IRA plan and matches employee contributions to the plan 100% up to 3% of compensation. What is the maximum contribution (combined employee and employer) that can be made to Celine's SIMPLE IRA plan in 2023?
   A. $10,500
   B. $15,500
   C. $25,400
   D. $26,000
2. Which of the following plans is NOT permitted to invest in life insurance?
   A. A SIMPLE 401(k)
   B. A traditional profit-sharing plan
   C. A SIMPLE IRA
   D. An ESOP
3. For 2023, what is the maximum amount possible that may be contributed to a SEP plan on behalf of an individual participant?
   A. $15,500
   B. $22,500
   C. $30,000
   D. $66,000
4. Which of the following statements with respect to SEP contributions made by an employer is CORRECT?
   A. Contributions are subject to FICA and FUTA.
   B. Contributions are currently excludible from the employee's gross income.
   C. Contributions are subject to income tax withholding.
   D. Contributions are capped at $22,500 (2023).

TOPIC 4.3: TAX-SHELTERED ANNUITIES (TSAs)/ SECTION 403(B) PLANS AND SECTION 457 PLANS

Reading: Tax-Sheltered Annuities (TSAs)/Section 403(b) Plans

LO 4.3.1: Examine the characteristics of tax-sheltered annuities (TSAs)/ Section 403(b) plans to determine employer/employee attributes that would best be served by these retirement plans.

A **tax-sheltered annuity (TSA)**, also known as a **Section 403(b) plan**, is a tax-deferred retirement plan that may only be adopted by certain private, tax-exempt, and Section 501(c)(3) organizations.

The employer organization must be one of the following:

a. A tax-exempt employer described in Section 501(c)(3) of the IRC
   1. The employer must be organized and operated exclusively for religious, charitable, scientific, public safety testing, literary, or educational purposes; to foster national or international amateur sport competition; or for the prevention of cruelty to children or animals.
   2. The organization must benefit the public rather than a private shareholder or individual.
   3. The organization must refrain from excessive political campaigning or propaganda intended to influence legislation.

b. A public or private educational organization with both of the following:
   1. a regular faculty and curriculum
   2. a resident student body operated by a state or municipal agency

An employee who participates in a Section 403(b) plan is considered an active participant for purposes of determining the deductibility of traditional IRA contributions. Plan contributions are not currently taxable to the employees, and income taxes are deferred until the funds are distributed to the employees by the plan. Contributions can be pretax, after-tax, or Roth contributions, and there may or may not be employer participation (employee elective deferrals are 100% immediately vested). Discrimination testing is more limited than with a 401(k) plan, and until several years ago, Form 5500 federal reporting was not mandatory.

Because a 403(b) is an employer retirement plan, distributions are generally limited to separation from service, disability, death, eligible hardship withdrawals (similar to 401(k) plan hardship withdrawal rules), and participant attainment of age 59½. In other words, like other employer retirement plans, distributions are much less available than with an IRA. However, Section 403(b) plans may provide plan loans (loan provisions are the same as qualified plans) and in-service withdrawals to participants. Also, if an employer establishes a TSA plan, it must be available to all eligible employees. This is called *universal availability*.

TSA funding is limited either to annuity contracts or mutual funds. The annuities can be either group or individual contracts and can be either fixed or variable. The

annuity contracts give participants some degree of choice as to investment strategy. Custodial accounts invested in mutual funds are another type of permitted investment in a Section 403(b) plan. Many plans allow for both mutual funds and annuities. Employees have individual accounts to which employers contribute (or employees contribute through salary reductions).

Section 403(b) plans must now comply with many of the same reporting and auditing requirements that apply to Section 401(k) plans. Several years ago, the IRS introduced major changes that have transformed Section 403(b) plans from employee-controlled, tax-sheltered accounts to fully integrated plans that give Section 501(c)(3) organizations responsibility for plan development, investment provider choices, plan administration, and regulatory compliance.

Section 403(b) plans may be established similar to Section 401(k) plans—that is, on the basis of employee salary reduction contributions only or with accompanying employer matching. Salary reductions, but not employer-matching contributions, are subject to FICA and FUTA payroll taxes. Two limitations apply:

- If the employer contributes, the qualified plan defined contribution limit of the lesser of 100% of the employee's compensation (up to $330,000 in 2023) or $66,000 (2023) applies.
- Maximum elective deferrals by employees are limited to $22,500 (2023).

There are two catch-up provisions that apply to a Section 403(b) plan participant:

- The regular catch-up provision of $7,500 (2023) is for individuals having attained age 50.
- A special catch-up provision allows a participant who has worked for the same qualifying employer ("HER" employers: healthcare, education, and religion/church—all these employers must be not for profit) for at least 15 years to increase their annual contribution limit by an amount equal to the lesser of
  - $3,000,
  - $15,000 reduced by amounts previously deferred under the special catch-up, or
  - $5,000 multiplied by the employee's years of service with the employer, less the sum of all prior salary deferrals.

If an employee is eligible for both the age 50+ catch-up and the special catch-up, catch-up deferrals will first be considered special catch-up deferrals (until the lifetime maximum is exhausted) before being applied as age 50+ catch-up deferrals. For example, if an eligible participant wishes to make a $5,000 catch-up contribution and has not yet exhausted the $15,000 lifetime special catch-up amount, $3,000 of the contribution will be classified as special catch-up and $2,000 will be classified as age 50+ catch-up.

It is possible that a Section 403(b) participant age 50 or older with 15 years of service (for the same sponsoring 501(c)(3) employer) can contribute $33,000 in 2023 ($22,500 as the basic elective deferral; $3,000 under the special catch-up rule; and $7,500 as a regular age 50+ catch-up). In fact, this is the order the IRS applies the special catch-up. Thus, if a teacher who was age 52 with 15 or more years of service, contributed $24,500 in 2023, the IRS would consider the first $22,500 as the basic contribution amount. The remaining $2,000 would be counted as coming

from the $15,000 special catch-up and none of the contribution would be an age 50 or older catch-up. This is an example of how Congress writes loosely phrased laws and the IRS interprets the law in the least tax-payer friendly manner.

Section 403(b) plans that permit Roth contributions may also allow participants to convert pretax amounts that qualify as eligible rollover distributions into Roth accounts within the plan. The 10% early distribution penalty does not apply for this in-plan conversion. The mandatory 20% withholding rules that apply to distributions do not apply to in-plan Roth conversions. The conversion amount is taxable, but the taxpayer may pay the income tax from other funds.

Distributions of basis (contributions) from a Roth 403(b) plan are received income tax free. Distributions of earnings from a Roth 403(b) plan also will be income tax free, provided that both of the following tests are met:

a. The distribution must be made after a taxable five-year period, which begins January 1 of the taxable year for which the first regular contribution or in-plan Roth conversion is made to the Roth 403(b) plan.
b. The distribution must satisfy one of the following requirements:
    - Made on or after the date on which the individual attains age 59½
    - Attributable to the disabled individual
    - Made to a beneficiary or estate of the individual on or after the date of the individual's death

Required minimum distribution rules do apply to Roth 403(b) plan distributions, usually when the individual attains age 72. Nonqualified distributions from a Roth 403(b) plan will be treated as both a distribution of contributions (excludable from income) and a distribution of taxable accumulated earnings (on a pro rata basis). Note that this is different from the way nonqualified Roth IRA distributions are taxed. In addition, the 10% EWP may apply, depending on the disqualifying event.

Advantages

A common misconception is that a Section 501(c)(3) employer (as a tax-exempt organization) cannot establish a Section 401(k) plan. In fact, it can choose to establish a Section 401(k) or Section 403(b) plan (or, infrequently, both). However, a Section 403(b) plan has certain advantages over a Section 401(k) plan. Among them are the following:

- A Section 403(b) plan is not generally subject to special (ADP and ACP) nondiscrimination testing (it is, however, subject to ACP testing if employer-matching or after-tax employee contributions are permitted). Any time nondiscrimination testing is involved, retirement plans can become relatively costly and complex to administer.
- A Section 403(b) plan sponsored by a governmental or church organization is not subject to ERISA reporting and disclosure requirements.
- A Section 403(b) plan sponsored by a Section 501(c)(3) employer without substantial employer involvement (i.e., the plan is only a salary deferral plan, there is no employer contribution, and actual employer involvement is minimal under ERISA rules) may not be subject to ERISA reporting and disclosure requirements (the DOL will analyze the plan on a case-by-case basis for the exemption).

- There is a required 20% withholding on any eligible distribution that is not transfered or directly rolled over to another plan or IRA.
- The special catch-up limit on salary reduction contributions applies to employees who have completed 15 years of service with the same qualifying employer.

PROFESSOR'S NOTE

A 403(b) plan that only allows for an employee salary reduction (i.e., there are no employer contributions being made to the employee's account) is not treated as an employer-maintained plan and, therefore, is not subject to ERISA; hence, there is no annual Form 5500 reporting requirement. Also, Section 403(b) plans are eligible for rollover treatment to IRAs.

Disadvantages

While Section 403(b) plans are a great source of retirement savings, they do have some disadvantages. For example, account balances at retirement age may be insufficient to provide adequate retirement amounts for employees who entered the plan at later ages. Although the ADP test does not apply, Section 403(b) plans must comply with the ACP test for matching contributions. Employees bear the risk for investments in their individual accounts, and individual stocks and bonds are not permitted as investments in Section 403(b) plans. Employer contributions are optional, while minimum distributions (RMDs) are mandatory.

In summary, a TSA/Section 403(b) plan is most appropriate when:

- the employee works for a public or private tax-exempt employer,
- the employer wants to provide a tax-deferred retirement plan for employees with minimum administrative expenses,
- employees are willing to accept the investment risk and investment responsibility associated with the plan, and
- a plan similar to a Section 401(k) plan is desired by a nonprofit employer for the benefit of its employees.

Reading: Section 457 Plans

LO 4.3.2: Analyze the benefits and taxation of Section 457 plans.

A **Section 457 plan** is a nonqualified deferred compensation plan established by a private tax-exempt employer (other than a church) or municipal (state or local) government for the benefit of its employees. Because a 457 plan is not a qualified plan, it does not offer certain favorable tax treatment for distributions (e.g., 10-year forward averaging or capital gains treatment on pre-1974 contributions). Also, because the employer does not have stock, 457 plan distributions are never eligible for NUA tax treatment. Amounts inside the plan grow income tax free until the time of distribution. All 457 plans are subject to some degree of bankruptcy risk because, like all nonqualified deferred compensation plans, they are essentially considered an asset of the employer if the employer files for bankruptcy.

Section 457 plans generally cannot allow the plan participants to take money from the plan until age 59½ unless they separate from service or there is an unforeseeable emergency (similar to the hardship withdrawals for 401(k) plans). However, a 457 participant that has been in the plan for at least two years may make a one-time in-service withdrawal of a limited amount set by law. In this case, the plan participant would only be income taxed on the withdrawn amount, not the entire account. Also, because 457 plans are technically deferred compensation plans instead of traditional retirement plans, there is usually no 10% penalty if the distribution is made before 59½. Employer contributions are optional, while required minimum distributions (RMDs) are mandatory.

Under Section 457 of the Tax Code, plans that include limits on the amounts deferred are subject to favorable income tax treatment; these are generally referred to as eligible Section 457 plans (457(b). Plans providing greater deferral, generally designed for corporate executives (hence, the discriminatory nonqualified nature of the plan), are referred to as ineligible plans (457(f)). For purposes of this course, we need be concerned only with eligible Section 457(b) plans.

Section 457 plans sponsored by state and local governments are permitted to have Roth accounts.

Employee elections to defer compensation under Section 457 must be made under an agreement entered into before earning the compensation. If done, the amount deferred annually cannot exceed the lesser of the elective deferral limit of $22,500 (2023) or 100% of the employee's compensation includable in gross income. In addition, employees who have attained age 50 in a 457 plan may make additional catch-up contributions of $7,500 for 2023 as long as—for governmental 457 plans only—they have not also elected the three-year catch-up provision for plan participants (to be discussed shortly). With 457 plans, any employer contributions count toward the contribution limit ($22,500 in 2023).

To properly apply the provisions of Section 457, we need to differentiate between governmental (state and local government) Section 457 plans and nongovernmental (non-church-controlled, private tax-exempt employer) Section 457 plans. For example, the regular catch-up provision for individuals age 50 and older is only available for participants in a governmental plan. Employees (or their beneficiaries) include Section 457 governmental plan distributions in income when they are paid; employees (or their beneficiaries) in private tax-exempt plans must include these distributions when there is no longer a substantial risk of forfeiture on their receipt (which may be earlier than when they are actually paid). These distributions are not subject to an early withdrawal penalty.

The special catch-up provision that applies to only a governmental 457 plan is unique. During the participant's last three years of employment before the plan's normal retirement age, the limit on elective deferrals is increased to the lesser of

- twice the amount of the regular elective deferral limit ($45,000 in 2023), or
- the sum of the otherwise applicable limit for the year plus the amount by which the applicable limit in the preceding years exceeded the participant's actual deferral for those years. In other words, this catch-up is limited to unused deferrals in prior years.

Thus, during the last three years before the plan's normal retirement age, a governmental 457 plan participant may defer the greater of

- the elective deferral limit plus the regular catch-up amount, or
- the elective deferral limit plus the amount permitted under the three-year catch-up provision.

EXAMPLE: 457 plan contributions

Suzanne, age 58, is a State of Kansas employee earning $60,000 per year. She participates in the Kansas governmental 457 plan and is within three years of the plan's normal retirement age of 60. Thus, for 2023 (and ignoring the summation limit), Suzanne can contribute a maximum of $45,000 to the plan ($22,500 of regular elective deferrals and $22,500 of special catch-up). Suzanne cannot use the age 50 and older catch-up amount of $7,500 in the same tax year she uses the special catch-up rule.

Taxation of Benefits

Section 457 plans are sponsored by tax-exempt entities, so contribution deductibility is not an issue for the employer. Assets in a Section 457 plan grow tax deferred until they are withdrawn by the employee. Employees must include distributions from a Section 457 plan in their gross income when a distribution occurs. Distributions from a 457 plan are usually not subject to an early withdrawal penalty. This is because a Section 457 plan is not a qualified retirement plan or even a normal type of tax-advantaged plan.

Additionally, since 2001 (EGTRRA), governmental 457 plans may be rolled into IRAs upon separation from service and even comingled with rollouts from qualified plans. Nongovernmental 457 plans may not be rolled out to IRAs; participants may transfer to another nongovernmental 457 or begin distributions from this particular nongovernmental 457 plan.

PROFESSOR'S NOTE

Money rolled into a 457 plan from a retirement account that was subject to the early withdrawal penalty remains subject to the early withdrawal penalty.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

5. What is the maximum employee contribution limit (elective deferral) for a TSA in 2023, assuming no catch-up provisions apply?
   A. $3,500
   B. $15,500
   C. $22,500
   D. $66,000

6. Which of the following are permitted investments in a Section 403(b) plan?
   I. Variable annuity contract from an insurance company
   II. Growth stock mutual fund (open-end investment company)
   III. A self-directed brokerage account invested in individual stocks
   IV. Whole life insurance
   A. I and II
   B. I and IV
   C. II and III
   D. III and IV
7. Which of the following statements regarding a Section 457 plan is FALSE?
   A. In 2023, an individual who is age 50 or older may generally make additional catch-up contributions of up to $7,500.
   B. It is a qualified plan of governmental units or agencies and non-church-controlled, tax-exempt organizations.
   C. The participant contribution limit in a governmental 457 plan may be doubled in the last three years (limited to unused deferrals in prior years) before the plan's normal retirement age.
   D. The time of taxable distribution depends on the type of plan and the eligible participant.

TOPIC 4.4: MULTIPLE PLAN LIMITS

Reading: Multiple Plan Limits

LO 4.4.1: Determine the maximum amount of elective deferrals that may be made to multiple plans on behalf of an employee.

In most instances, employers are not limited to just one type of qualified or tax-advantaged plan. For example, as mentioned, a Section 501(c)(3) employer may establish both Section 401(k) and Section 403(b) plans. However, with one exception, elective deferrals that may be made to multiple plans are limited by employee rather than by plan. Thus, the employee-participant must aggregate all elective deferrals from:

- traditional and Roth Section 401(k) plans;
- SIMPLE IRAs and SIMPLE 401(k)s (Note: SIMPLEs are subject to a lower deferral amount;
- SARSEP plans; and
- Section 403(b) plans.

> **EXAMPLE: Elective deferral limits with multiple plans**
>
> Marissa, age 44, works for two employers in 2023, both of which maintain Section 401(k) plans. If Marissa contributes $9,000 to Employer A's plan, she may then contribute only $13,500 to Employer B's plan (a total of $22,500).

PROFESSOR'S NOTE

The one exception to this aggregation rule is when the individual participates in one of the aforementioned plans and a Section 457 plan. When an individual participates in a Section 457 plan (governmental or nongovernmental) and any other type of qualified or tax-advantaged plan, the Section 457 participant may contribute an additional or second elective deferral amount up to $22,500 (2023). Also, participation in any form of a Section 457 plan is not considered active participation for purposes of the IRA deductibility rules (to be discussed in the next module).

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

8. Leon, age 48, works for two private, tax-exempt employers. One has a Section 403(b) plan and one maintains a nongovernmental Section 457 plan. If Leon defers $10,000 into the Section 403(b) plan in 2023, how much can he separately defer into the Section 457 plan? (Assume he has sufficient compensation to fund both plans to the maximum.)
   A. $9,000
   B. $12,500
   C. $22,500
   D. $30,000
9. Nadia, age 51, has been working with Rebecca, a CFP® professional, in developing a plan for optimizing how she is saving for her retirement. Rebecca developed a plan she feels will accomplish Nadia's goals and gave it to her in a written document. Nadia reviewed it and has returned to Rebecca's office to tell her she has accepted all of the recommendations. The plan has several parts, including changing her contributions to the Section 403(b) plan at her place of employment and taking better advantage of the Section 457 plan that is also available to her. What is Rebecca's next step in assisting Nadia in her retirement planning?
   A. Rebecca should tell Nadia how much she should defer each pay period in both the Section 403(b) and Section 457 plans.
   B. Rebecca should call the plan administrator for the plans at Nadia's employer and get the forms for Nadia to fill out.
   C. It is up to Nadia to put Rebecca's recommendations in place now that she has a good plan from a financial planning professional.
   D. Rebecca should create a prioritized timeline for implementation of the recommendations and explain how monitoring the implemented recommendations will be accomplished and by whom.

MODULE 4 ANSWER KEY FOR PRACTICE QUESTIONS

1. **D** The maximum contribution that may be made on Celine's behalf is $26,000 ($15,500 of employee elective deferrals and $10,500 of employer contributions). Rotolo Enterprises, Inc., has chosen to make a matching contribution up to 3% of compensation (the SIMPLE maximum). Thus, the includible compensation limit of $330,000 does not apply, and it can be matched based on Celine's total salary ($350,000 × 0.03 = $10,500).

2. **C** A SIMPLE IRA is a form of IRA and, therefore, cannot invest in life insurance (in the plan's name). All the other types of plans are qualified plans and are, within limits, permitted to invest in life insurance.

3. **D** For 2023, the maximum contribution to a SEP plan is the lesser of 25% of employee includible compensation or $66,000.

4. **B** This is the only correct response. Contributions to a SEP plan are not subject to FICA, FUTA, or income tax withholding and are excluded from the employee's current income. The SEP plan contribution limit is the lesser of 25% of the employee's compensation or $66,000 (2023), not the elective deferral limit of $22,500 (2023).

5. **C** The employee elective deferral limit for 2023 to a TSA is $22,500.

6. **A** Section 403(b) plan accounts must be invested in either annuity contracts (fixed or variable) or mutual funds (open-end investment companies). Such accounts may not be invested in individual stocks or whole life insurance.

7. **B** "It is a qualified plan of governmental units or agencies and non-church-controlled, tax-exempt organizations" is a false statement. A 457 plan is not a qualified plan. Rather, it is a nonqualified deferred compensation plan of governmental units or agencies and non-church-controlled tax-exempt organizations. In only a governmental 457 plan, the participant contribution limit may be doubled in the last three years (limited to unused deferrals in prior years) before the plan's normal retirement age. This provision is unique to a governmental 457 plan.

8. **C** Leon can separately defer the maximum of $22,500 into the Section 457 plan in 2023 because Section 457 plan limits are not aggregated with the Section 403(b) plan limits.

9. **D** Nadia and Rebecca are in the implementation phase of the financial planning process.

MODULE 5

Traditional and Roth IRAs

INTRODUCTION

Most financial planners and consumers have a general understanding of the role played by traditional and Roth IRAs in retirement planning. However, what may not be so widely understood are the limitations on the tax deductibility of contributions to a traditional IRA and the rules regarding conversions of a traditional IRA to a Roth IRA. This module addresses both of these issues, as well as characteristics of both of these exceedingly important retirement planning vehicles.

While the term traditional IRA refers to either a personal IRA or a SEP IRA (discussed in Module 4 of this course), the discussion of this module will be confined to the personal type of IRA first created by the Employee Retirement Income Security Act of 1974 (ERISA).

Contributions made to a Roth IRA on a nondeductible basis within certain statutory limits result in 100% tax-free withdrawals if certain requirements are met. The compounding of these tax-free dollars over the years may be substantial, and a comparison should be made as to whether it is better to contribute to a traditional IRA or a Roth IRA. Even though the taxpayer-client may receive an income tax deduction for contributions made to the traditional IRA, this is not always the best alternative.

TOPICS, LEARNING OBJECTIVES, AND READINGS

The topics covered in this module are:

- Topic 5.1: Traditional IRAs
- Topic 5.2: Rollover, Inherited, and Stretch IRAs
- Topic 5.3: Tax Implications of Traditional IRA Distributions
- Topic 5.4: Roth IRAs

Throughout this module, you will see learning objectives (LOs) that emphasize the knowledge and application skills you will gain from this module. These specific statements, based on the 2021 CFP Board's Principal Knowledge Topics List (the blueprint for the current CFP Board exam), advise you regarding what you should know and be able to do at the completion of this module.

The following table shows a list of module topics, learning objectives, and readings.

Learning Objective		Readings
Topic 5.1: Traditional IRAs		
5.1.1	Describe the basic attributes of traditional IRAs.	Traditional IRA Contributions and Deductibility Rules
5.1.2	Calculate the deductible amount of an IRA contribution.	Traditional IRA Contributions and Deductibility Rules
Topic 5.2: Rollover, Inherited, and Stretch IRAs		
5.2.1	Compare rollover, inherited, and stretch IRAs.	Rollover, Inherited, and Stretch IRAs
Topic 5.3: Tax Implications of Traditional IRA Distributions		
5.3.1	Analyze a situation to determine the tax implications of a traditional IRA distribution.	Early Distribution Penalties and Penalty Exceptions
Topic 5.4: Roth IRAs		
5.4.1	Identify the basic characteristics of Roth IRAs.	Characteristics of Roth IRAs
5.4.2	Analyze the tax consequences of Roth IRA distributions and conversions.	Roth IRA Distributions and Conversions
5.4.3	Distinguish Roth IRAs, designated Roth 401(k)s, and pretax 401(k)s.	Roth IRAs, Designated Employer Roth Accounts, and Pre-Tax 401(k)s

KEY TERMS

amortization method
annuity method
backdoor Roth IRA
early distribution penalty
first-time homebuyer
individual retirement accounts
individual retirement annuities
inherited IRA
life expectancy method
ordering rules
prohibited transaction
rollover IRA
Roth IRAs
spousal IRA
stretch IRA
traditional IRAs

TOPIC 5.1: TRADITIONAL IRAs

Reading: Traditional IRA Contributions and Deductibility Rules

LO 5.1.1: Describe the basic attributes of traditional IRAs.

LO 5.1.2: Calculate the deductible amount of an IRA contribution.

Traditional IRAs have been a common form of retirement savings by individuals since 1974. However, as the availability and popularity of Section 401(k) plans grew, IRAs became somewhat less popular for those with employer retirement plans. But only around 60% of American workers have an employer retirement plan. Also, as workers retire, billions of dollars will be moved into IRAs each year from employer retirement plans.

An individual of any age who has compensation or whose spouse, if married filing jointly, has compensation may open and fund a traditional IRA. For the most part, compensation for IRA eligibility purposes is compensation earned from employment. Compensation includes wages, salaries, commissions, tips, professional fees, bonuses, and other amounts received for providing personal services. For IRA purposes, compensation also includes any taxable alimony and separate maintenance payments received under a decree of divorce or separate maintenance that was settled prior to 2019. For divorces finalized in 2019 and afterwards, alimony is not taxable income and thus is not considered earned income for IRA contribution purposes. Earned income for IRA purposes does not include rental income; investment income; interest or dividend income; pension, annuity, or deferred compensation income; housing costs that are excluded from income; or foreign earned income.

There are two types of **traditional IRAs**:

- **Individual retirement accounts** (usually funded with securities or investment products)
- **Individual retirement annuities** (funded with insurance products)

Both types of IRAs are subject to the following contribution limits for 2023:

Taxable Year	Maximum Regular Contribution*	Maximum Catch-Up**
2023	$6,500	$1,000

*Lesser of 100% of earned income or this amount. There is a 6% penalty for excess contributions.

**Individuals age 50 and older

Investment income earned on the assets held within either type of traditional IRA is not subject to federal income tax until withdrawn from the account. Minimum distribution rules for traditional IRAs require withdrawals to begin when the IRA owner attains age 72. All distributions are taxable as ordinary income even though investment-type (capital) assets may be used to fund the account.

Spousal IRA contributions of up to $6,500/year (or $7,500 if spouse is age 50 or older) are permitted in 2023 if the compensation limit is met even by only one spouse. In effect, the spouse without earned income borrows compensation from the spouse with earned income to fully fund a traditional IRA or Roth IRA.

Appropriate Application

Traditional IRAs are used when an individual wants to defer taxes on personal retirement investment income and shelter current compensation or earned income from taxation. They are also appropriate when long-term accumulation is an important financial objective, especially for retirement purposes. Traditional IRAs are an important supplement or alternative to a qualified pension or profit-sharing plan for workers with these plans.

Advantages

For 2023, eligible individuals may contribute up to $6,500 to an IRA and possibly deduct this amount from their current taxable income (see "Deductibility Rules for a Traditional IRA," as follows). Individuals who have attained age 50 may make additional catch-up contributions. The additional catch-up amount for 2023 is $1,000 for each person age 50 or older. An income tax credit is allowed for certain taxpayers with respect to contributions to a traditional or Roth IRA. Investment income earned on the assets held in an IRA is not subject to federal income tax until it is withdrawn from the account. Finally, an IRA owner is always 100% immediately vested in the IRA.

Disadvantages

IRA withdrawals may be subject to a 10% early withdrawal penalty. Distributions are not eligible for 10-year forward averaging, pre-1974 participation capital gains treatment, or net unrealized appreciation (NUA) that applies to certain lump-sum distributions from qualified plans. A traditional IRA can receive contributions regardless of age as long as the individual has earned income. A traditional IRA can also accept a rollover at any age. Roth IRAs can also continue to accept new contributions at any age as long as the person has earned income. Also, a new IRA account can be opened with a rollover from a previous IRA or employer retirement plan at any age. Finally, withdrawals from a traditional IRA are required by April 1 of the year following the year the individual attains age 72. Roth IRAs are never required begin distributions while the original owner is alive. Distributions from inherited Roth IRAs will be covered later. All distributions from IRAs are ordinary income to the extent taxable.

Deductibility Rules for a Traditional IRA

There are three basic rules associated with the deductibility of contributions made to a traditional IRA.

- If neither married filing jointly (MFJ) spouse is an active participant in an employer-sponsored retirement plan or if a single person is not an active

participant, then contributions to a traditional IRA are deductible without regard to the participant's modified adjusted gross income (MAGI).

- Active participation in a defined benefit pension plan is when an employee is eligible to accrue benefits. That means the employer is required to contribute to the defined benefit plan for the worker that year. A worker is not an active participant in a defined benefit plan if they are not eligible for the plan or if they are excluded from participation.
- Active participation in a defined contribution plan as well as a SIMPLE IRA, SEP IRA, or Section 403(b) plan is considered when an employer contribution or forfeiture is allocated to the participant's account or if the participant contributes an elective deferral. A taxpayer who participates in a Section 457 plan is not considered an active participant for purposes of determining deductibility of IRA contributions. Also, vesting is never considered when determining if anyone is an active participant in any type of employer plan (defined benefit or defined contribution).

- If both MFJ spouses are active participants (or if a single person is an active participant) in an employer-sponsored retirement plan, then deductibility of contributions is phased out based on the following MAGI ranges for 2023:
  - Single filing status: $73,000–$83,000
  - Married filing jointly status: $116,000–$136,000
  - Married filing separately status: $0–$10,000
- When one spouse is an active participant and one spouse is not an active participant, two separate phaseout thresholds are applicable. The phaseout for the active participant in 2023 is combined MAGI of $116,000–$136,000. The phaseout for the nonactive participant is combined MAGI of $218,000–$228,000.

EXAMPLE: IRA deductibility

Shawn and Anna (both age 44) are married (married filing jointly) and have a combined MAGI of $165,000 in tax year 2023. Anna is an active participant in her company's Section 401(k) plan. Shawn works for the state of Maine and participates in its Section 457 plan. Both Shawn and Anna want to make a deductible contribution of $6,500 to their own traditional IRAs. Because Shawn is not considered an active participant in an employer-sponsored plan (participation in a 457 plan does not count when determining active participant status), his deduction will not begin to be phased out until the couple's MAGI reaches $218,000. As Shawn and Anna's combined MAGI is $165,000 for 2023, Shawn is entitled to a full $6,500 deductible contribution. However, because Anna is an active participant, and their combined MAGI exceeds $136,000, none of her contribution will be deductible. Anna may still contribute to her traditional IRA, but she could not deduct any of the $6,500 contribution for 2023. However, why would she make a nondeductible IRA contribution when she has the option of making a Roth IRA contribution? In this case, Anna should contribute to a Roth IRA and Shawn could contribute to a traditional, deductible IRA.

If a taxpayer's MAGI is between the beginning of the phaseout range and the maximum phaseout amount, the allowable deductible amount is partially phased

out. A phaseout percentage of the maximum allowed contribution is applied. This is the amount of MAGI in excess of the applicable beginning phaseout range in relation to the total amount of phaseout range. For example, if a MFJ taxpayer (age 45, with MAGI of $121,000, who is also an active participant in an employer-sponsored plan) wishes to contribute to a traditional IRA, 25% of the deductible amount is phased out [$5,000 (excess MAGI) ÷ $20,000 (total phaseout range of $116,000–$136,000 in 2023) = 25%]. The initial maximum deductible contribution becomes $4,875 (1 – 25% × $6,500). This is "bumped up" (as will be described below) to $4,880. The taxpayer may still contribute $6,500 to the IRA, but the deduction is limited to $4,880. On the other hand, the remaining $1,620 could be contributed to a Roth IRA instead of a nondeductible IRA.

A second way to determine the maximum deductible contribution for a year is to start with the highest number on upper range of the deduction phaseout. For example, an active participant married filing jointly taxpayer's phaseout range in 2023 is $116,000–$136,000. Thus, the top of the phaseout range is $136,000. Therefore the maximum deductible amount for the 45-year-old above with a MAGI of $121,000 is calculated as ($136,000 – $121,000) ÷ $20,000 × $6,500 = $4,875. This is then bumped up to $4,880.

Note that either procedure divides the MAGI differential by the total phaseout range to determine the percentage of the maximum allowed contribution that is either phased out or allowed to be deducted. For MFJ, the phaseout range for an active participant is $20,000. For married filing separately, the range is $10,000 (always $0–$10,000, this number is not indexed). For single taxpayers contributing to a traditional IRA, the phaseout range is $10,000 ($73,000–$83,000).

There is a final adjustment when determining the deductible amount for a traditional IRA. The final answer is "bumped up" (not rounded up) to the next tens digit. For example, if the phaseout calculation determines the deductible amount would be $2,461.10, the final correct answer would be $2,470 because you always go up to the next tens digit.

For a married couple this calculation is done separately for each spouse.

TEST TIP

Note that the formula for calculating the deductible amount uses the *maximum legal contribution* for the person (not the actual contribution). The calculation is measuring how far a person is into the phaseout range and thus the maximum they could deduct.

PROFESSOR'S NOTE

Remember that there are two phase-out ranges for a married couple filing jointly, one for the case when both MFJ spouses are active participants in employer-sponsored retirement plans, and another for MFJ spouses where only one spouse is an active participant.

TEST TIP

One thing to notice is the higher IRA deductibility phaseout range for a married person who is not an active participant is that the numbers are the same as the Roth IRA phaseout numbers.

PROFESSOR'S NOTE

Because the final deductible number for a traditional IRA contribution is bumped up a correct answer must have a zero in the ones place. For example, $3,240 could be an answer, but $3,234 cannot be a correct answer. If the formula gave you $3,234, the correct answer would be $3,240.

Prohibited Transactions

Generally, a **prohibited transaction** is the improper use of an IRA account or annuity by the individual or any disqualified person. The account fiduciary and members of the individual's family (spouse, ancestor, lineal descendant, and spouse of a lineal descendant) are examples of disqualified persons.

Prohibited transactions with an IRA include the following:

- Borrowing money from the IRA
- Selling property to the IRA
- Receiving unreasonable compensation for managing the IRA
- Using the IRA as security for a loan
- Buying property for personal use (present or future) with IRA funds.

The owner cannot purchase assets from the IRA and subsequently move them out of the IRA. For example, if Ted's IRA included American Eagle gold coins, Ted could not buy them from the IRA and thus remove them from the IRA. This would be a prohibited transaction.

Generally, if an individual or the individual's beneficiary engages in a prohibited transaction with the individual's IRA account at any time during the year, the account will be treated as a withdrawal of the IRA as of the first day of the year. The individual (or beneficiary) must include the fair market value of all (or part, in certain cases) of the IRA assets in gross income for that year.

The fair market value is the price at which the IRA assets would change hands between a willing buyer and a willing seller, when neither party has any need to buy or sell, and who both have reasonable knowledge of the relevant facts. The individual must use the fair market value of the assets as of the first day of the year he is engaged in the prohibited transaction. The individual also may have to pay the 10% tax on premature distributions.

If an individual borrows money against an IRA annuity contract, the individual must include the fair market value of the annuity contract as of the first day of the tax year in gross income. The individual may have to pay the 10% additional tax on premature distributions. Also, if an individual uses a part of his IRA account as security for a loan, that part is treated as a distribution and is included in gross income. The individual may have to pay the 10% additional tax on premature distributions. Thus, borrowing against an IRA annuity is catastrophic for the entire account. Borrowing against an IRA account, however, would only be a distribution of the collateralized amount. These rules are why institutions have safeguards prohibiting the use of IRA assets as collateral for a loan.

Allowable Investments in a Traditional IRA

Traditional IRA funds can generally be invested in any type of asset, with three specific exceptions:

- Collectibles, such as stamps, coins, or antiques; however, certain types of U.S.-issued coins such as the American Eagle gold coin, are permissible. If an IRA owner invests in an unacceptable collectible, the amount of the purchase is treated as a distribution and subject to income tax and the 10% early withdrawal rules.
- Life insurance policies
- Any form of participant note or obligation; an IRA cannot make loans to an IRA participant

Also, an IRA cannot own S corporation stock as it is not a permissible shareholder under the S corporation rules.

An IRA owner cannot contribute more than his earned income for the year, except in the case of a spousal IRA. The total amount that may be contributed for 2023 to all IRAs, traditional or Roth, deductible or nondeductible, is $6,500 per person, plus applicable age 50 and older catch-ups.

PRACTICE QUESTIONS

Choose the best answer for each of the questions below. The answer can be found at the end of this module.

1. Juan and Emily (both 38) and are married filing jointly. Their MAGI for 2023 is $131,925. Juan is self-employed. Emily is a nurse. She contributes $4,000/year to her 403(b). How much can Emily make in deductible IRA contributions for 2023?
   A. $1,320
   B. $1,324
   C. $1,330
   D. $6,500

TEST TIP

The question only states Juan was self-employed. It did not mention him having a retirement plan at work. Thus, he is assumed not to have a retirement plan through his work.

2. David and Amy are 52 and 50. They are married filing jointly. Their MAGI for 2023 is $219,000. David is a doctor and Amy is a homemaker. David's practice has a 401(k). This year neither David nor the practice contributed to his 401(k), but his account received $13 of forfeitures. How much can David and Amy combined contribute to a deductible IRA?
   A. $750
   B. $6,750
   C. $7,500
   D. $15,000

3. Jon and Mary, both age 33, are married and file a joint income tax return. Jon is self employed and does not maintain a retirement plan through his business. He earned $126,000 of Schedule C income, and pays $17,804 in total self-employment taxes. Mary is a full-time homemaker. What is the maximum combined deductible IRA contribution Jon and Mary can make, if any, for 2023?
   A. $0
   B. $6,500
   C. $9,750
   D. $13,000
4. Which of the following is a permissible investment in a traditional IRA?
   I. An investment-grade work of art
   II. An international stock mutual fund
   III. Gold coins minted by the U.S. Treasury
   IV. A mutual fund that invests exclusively in gold mining stock
   A. II only
   B. I and III
   C. II and IV
   D. II, III, and IV
5. Which of the following individuals may make at least some amount of deductible contributions to a traditional IRA in 2023?

	Person	Filing Status	Modified Adjusted Gross Income (MAGI)	Covered by Employer Plan
I.	Jane	Single	$ 77,000	Yes
II.	Joe	Married	$119,000	No
III.	Betty	Single	$ 45,000	Yes
IV.	Sue	Married	$ 90,000	Yes

   A. I and II
   B. III and IV
   C. II, III, and IV
   D. I, II, III, and IV

TOPIC 5.2: ROLLOVER, INHERITED, AND STRETCH IRAs

Reading: Rollover, Back, and Stretch IRAs

LO 5.2.1: Compare rollover, inherited, and stretch IRAs.

The traditional IRA is a very popular retirement planning vehicle. In addition to holding personal contributions, a traditional IRA may be used to receive and distribute funds from a qualified plan (a rollover IRA). An inherited IRA is a specially titled account for which a spouse or nonspouse IRA beneficiary may use to defer taxation (outside of RMDs) when inheriting IRA funds. You can tell an inherited IRA by how it is titled. For example, an inherited IRA would be held as "Thomas B Harris, III (deceased July 28, 2018) FBO Michael A Harris." FBO means "for the benefit of." A stretch IRA is an inherited IRA that extends the tax deferral

of earnings within the IRA beyond the life of the person who originally established the IRA. According to the IRS, only about 20% of beneficiaries limit their annual withdrawals to the required minimum distribution (RMD). The concept of stretching an IRA was materially modified by the SECURE Act for deaths in 2020 and later. The details of stretch IRAs after the SECURE Act will be covered in Module 6.

Rollover IRA

A rollover is a distribution of cash or other assets from one retirement plan to another retirement account. Such a distribution is income tax free as long as the entire rollover contribution is made by the 60th day after the participant receives a distribution. Any amount not rolled over exceeding basis is treated for income tax purposes as a distribution and is taxable as ordinary income in the year distributed and may also be subject to a 10% premature distribution penalty rules.

A rollover may occur between a qualified or tax-advantaged plan and an IRA. Unlike an initially established traditional IRA, there is no dollar limit on the amount of contributions that may be made to a **rollover IRA** (an IRA established and funded solely with money coming from an employer retirement account). In addition, under the Bankruptcy Act of 2005, all amounts in a rollover IRA are protected from the participant's creditors while within the confines of the rollover IRA (that is, not distributed to the participant). This is like the unlimited asset protection an employer enjoyed by employer retirement accounts. On the other hand, the Bankruptcy Act of 2005 limits creditor protection for all IRAs that are not rollover IRAs to an amount specified in April every three years. Currently, the amount of creditor protection for these IRAs is $1,512,350. This amount will be updated again on April 1, 2025. The specific amount is not testable, but the general parameters of creditor protection for IRA accounts are. Thus, IRAs have a lot of creditor protection, but not as much as an employer retirement account. In fact, SIMPLE IRAs and SEPs are treated as an employer retirement account for creditor protection purposes. Rollover IRAs that only have money from an employer retirement plan also have unlimited creditor protection. Next, any IRA rollover must be reported on the participant's tax return for the year that the distribution is made. However, the rollover is coded on the Form 1040 in a way that shows the IRS the amount that is not taxable in the rollover year. Tax-free rollovers between traditional IRA accounts are also allowed. Finally, one-time IRA distributions are allowed to fund an HSA up to the contribution limit for the HSA for the year of the rollover.

Inherited IRA

An **inherited IRA** is created when an IRA owner dies and leaves IRA funds to another person. A nonspouse beneficiary (such as an adult child) may transfer the decedent's balance from a qualified plan, Section 403(b) plan, governmental Section 457 plan, or IRA to an inherited IRA, which is a specially titled IRA account, via a trustee-to-trustee transfer. No other contributions from earned income may be made to the inherited IRA, and no additional rollovers of someone's own IRAs may be made from or into the inherited IRA. In other words, a nonspouse can never combine inherited IRA money with money that was contributed based on her own earnings. All distributions in excess of basis, if any, from the inherited IRA are includable as income in the tax year it is received.

Prior to 2007, the opportunity to roll over a deceased IRA owner's account balance was available only to a surviving spouse. Since then there has been a significant broadening of the inherited IRA opportunity, but the nonspouse beneficiary must still generally begin distributions from the inherited IRA in the year following the year of death of the owner. A surviving spouse beneficiary has more options. Essentially, a surviving spouse can move the inherited money into a retirement account in her own name (including commingling the inherited money with her other retirement accounts). This is not treated as an inherited account and she can defer withdrawals until she is 72. Alternatively, she can move her deceased husband's retirement account into an inherited IRA titled "John Darling (deceased January 3, 2022) FBO Susan B Darling." This is an inherited IRA. Then, she may continue to defer distributions until the deceased spouse would have turned 72. In other words, a spouse beneficiary of an IRA has the option of either rolling over the decedent's IRA balance to a personally owned IRA and being treated as an original owner or electing to be treated as the beneficiary rather than the owner. One advantage of being treated as an original owner is that the spouse can defer withdrawals until she turns 72 if desired. On the other hand, any withdrawals from a directly owned IRA will be subject to the 10% early withdrawal penalty rules and a distribution from this directly owned IRA will not benefit from the exception for early withdrawals due to death.

If the spouse chooses an inherited IRA, the distributions must begin when the deceased spouse would have turned 72. However, any distributions from an inherited IRA will qualify for the exception from the 10% early withdrawal penalty due to death.

EXAMPLE: Inherited IRA

John Darling dies at 55. His wife Susan is 50 and the beneficiary of all his retirement accounts and IRAs. She has the following choices:

- She can roll John's employer retirement accounts and IRAs into her own IRA. Now all money in this IRA is treated as if she contributed the assets directly. She can defer withdrawals until she is 72. If she withdraws money from this IRA prior to 59½, she will be subject to the 10% early withdrawal penalty (EWP) system and the withdrawals from this IRA will not qualify for the exception from the 10% penalty due to a death. They might qualify for another exception like certain higher education expenses, but they will not be able to use the exception for distributions due to death.
- Alternatively, she can move John's retirement accounts and IRAs into an inherited IRA. She will be required to start RMD distributions five years earlier than her own RMD distributions because she must start RMDs when John would have turned 72 and he was five years older. However, she will never be subject to the 10% EWP from this IRA because it is treated as an inherited IRA; and thus all distributions from this IRA meet the exception to the 10% EWP.
- She can do a combination of the first two options. She could move some of his retirement money into an inherited account and some could be moved under her own name. She could also have all the money in an inherited account until she reaches 59½. Then, she could move the money under her name.

RMD rules will be covered more thoroughly in Module 6.

Stretch IRA

A **stretch IRA** extends or stretches the period of tax-deferred earnings within an IRA beyond the lifetime of the owner who originally established it. Such an IRA allows the IRA owner's beneficiaries to name their own beneficiary at the owner's death, which may provide an even longer stretch for any money remaining in the account when the initial beneficiary died. It is critical that the stretch IRA be established correctly before beginning distributions to optimize continued tax deferral.

New stretch IRAs were drastically modified by the SECURE Act. If an IRA owner dies after December 31, 2019, distribution rules under the SECURE Act rules apply. These rules will be covered in more detail in Module 6. However, a major rule under the SECURE Act is that the deceased's healthy adult child is under the "10 year rule." That means the only requirement would be that the inherited account must be fully distributed by December 31 of the year containing the 10th anniversary of the original owner's death.

> **EXAMPLE: Stretch IRA**
>
> Linda has a $1 million traditional IRA and names her 45-year-old son, Scott, as the primary beneficiary. Linda's grandson, Jim, is named as the contingent beneficiary. When Linda dies, Scott may elect to distribute Linda's IRA funds over the next 10 years.

Note: According to the IRS, only about 20% of those who inherit an IRA or retirement account limit their withdrawals to their RMD.

TOPIC 5.3: TAX IMPLICATIONS OF TRADITIONAL IRA DISTRIBUTIONS

Reading: Early Distribution Penalties and Penalty Exceptions

LO 5.3.1: Analyze a situation to determine the tax implications of a traditional IRA distribution.

Generally, distributions taken from a traditional IRA before the owner attains age 59½ are subject to an **early distribution penalty** (early withdrawal penalty or EWP) of 10% of the taxable amount taken (in addition to income tax on the same). Distributions from a traditional IRA that include nondeductible contributions are subject to tax on a pro rata basis according to the following formula:

$$\text{Nontaxable portion} = \left[\frac{\left(\begin{array}{c}\text{nondeductible contributions prior to current year} + \\ \text{all contributions for current year}\end{array}\right)}{\left(\begin{array}{c}\text{balances at end of current year} + \\ \text{distributions received in current year}\end{array}\right)}\right] \times \text{total distributions in current year}$$

However, there are notable exceptions to the imposition of this 10% penalty. If any of the following circumstances are associated with the distribution from the IRA, the penalty will not be imposed:

- Attainment of age 59½
- Total and permanent disability
- Death
- For unreimbursed medical expenses >7.5% of AGI (whether actually deducted or not)
- To pay qualified higher education costs for the taxpayer, spouse, child, or grandchild
- To pay acquisition costs of a "first-time home buyer" for the participant, spouse, child, or grandchild of the participant or the participant's spouse, up to a $10,000 lifetime maximum. A "first-time home buyer" is not necessarily someone who has never bought a home. IRS Publication 590-B defines a first-time home buyer as, "Generally, you are a first-time home buyer if you had no present interest in a main home during the 2-year period ending on the date of acquisition of the home which the distribution is being used to buy, build, or rebuild. If you are married, your spouse must also meet this no-ownership requirement."
- To pay health insurance premiums if the owner is unemployed (the participant must file for unemployment compensation and have received unemployment compensation for 12 consecutive weeks due to losing their job before this exception applies)
- As a part of substantially equal periodic payments received at least annually over the life expectancy of the owner, or the owner and a designated beneficiary; in addition, these payments, once begun, must continue for the greater of five years or until the owner attains the age of 59½. There are three methods for calculating substantially equal periodic payments:
  - **Life expectancy method**: Distributions are made over remaining life expectancy.
  - **Amortization method**: The participant's account balance amortizes over a period equal to the life expectancy of the participant (or joint life expectancy with beneficiary). The interest rate must be a reasonable rate of interest on the date the payments begin.
  - **Annuity method**: The participant's account can be divided by an annuity factor to determine a payment. A reasonable interest rate and a reasonable mortality table must be used in the calculation of the payment.

The calculations for any of these methods are beyond the scope of this course.

Note: Any of the three methods may be chosen. Thus, it is possible to somewhat tailor the method to the client's goal. For example, choosing the amortization method with only the life expectancy of the participant will give a larger payment than choosing the amortization method with the joint life expectancy of the participant and beneficiary. Thus, if the client requires a larger payment, choose the amortization method with only the participant's life expectancy. If the client needs a smaller payment, use the joint life expectancy of the client and the beneficiary.

PROFESSOR'S NOTE

Substantially equal periodic payments must last until the *greater* of five years or 59½, so five years is really only applicable to those age 54½ or older. Also, if the actual payments end up violating this exception, the client is subject to interest and penalties back to the start of the series of payments. For both these reasons, the substantially equal periodic payments exception is very rarely used.

Transfers Incident to Divorce

If an IRA interest is transferred from a spouse or former spouse (transferor) to an individual (transferee) by reason of divorce or separate maintenance decree, the transfer is tax-free if the transferred assets are deposited into the receiving spouse's IRA or qualified plan. Note that Qualified Domestic Relations Orders (QDROs) only apply to employer plans like 401(k)s, not to IRAs.

PRACTICE QUESTIONS

Choose the best answer for the question below. The answer can be found at the end of this module.

6. The premature distribution (10%) penalty does not apply to IRA distributions
   - I. made after attainment of the age of 55 and separation from service.
   - II. made for the purpose of paying qualified higher education costs for the owner's spouse.
   - III. paid to a beneficiary after the death of the IRA owner who had not begun receiving minimum distributions.

   A. II only
   B. III only
   C. I and II
   D. II and III

TOPIC 5.4: ROTH IRAs

Reading: Characteristics of Roth IRAs

LO 5.4.1: Identify the basic characteristics of Roth IRAs.

Roth IRAs are similar to traditional IRAs in many respects. For example, the list of permitted (and prohibited) investments is the same for both traditional and Roth IRAs. In addition, the definition of earned income is the same for both types of IRAs and the contribution limit is the same, $6,500 (2023) with an age 50+ catch-up of $1,000. It is important to note that a taxpayer may own both a traditional IRA and a Roth IRA, but the maximum contribution is applied aggregately, not $6,500 (2023) for each account.

Roth IRAs permit only after-tax (nondeductible) contributions to be made. If applicable holding period rules are met and a qualified distribution is made, these contributions plus the earnings generated thereon are entirely income tax free to the participant.

Only taxpayers with a modified adjusted gross income (MAGI) below certain levels are permitted to make contributions to a Roth IRA. Notice that only MAGI levels are used to determine eligibility for Roth IRA contributions. Active participant status is used to compute deductibility on contributions. Because Roth IRA contributions are never deductible, there is no need to determine active participant status relative to Roth IRA contributions. For 2023, contributions are phased out for taxpayers with MAGIs as follows:

- Single: $138,000–$153,000 (Note that the phaseout range for Roth IRA contributions for unmarried taxpayers is $15,000.)
- Married filing jointly: $218,000–$228,000
- Married filing separately: $0–$10,000

Contributions to a Roth IRA may be made for years beyond when the owner has attained the age of 72 and has earned income. This has always been true for Roth IRAs. However, traditional IRA contributions may now be made at any age. This change started in 2020 due to the SECURE Act. In addition, required minimum distributions (RMD) do not apply for Roth IRAs the owner's lifetime.

TEST TIP

The phased out contribution amount is always the percentage of the remaining phaseout range times the maximum allowable contribution. Thus, the farther into the phaseout range, the lower the ability to contribute to a Roth IRA. On the other hand, if the taxpayer is barely into the phaseout range, the allowed contribution would be higher.

Some people whose income is too high to contribute directly to a Roth IRA can benefit from what is unofficially called a **backdoor Roth IRA**. Essentially, the taxpayer contributes to a nondeductible IRA and then immediately converts it to a Roth IRA. Since the original contribution was not deducted, only the increase between the contribution and the conversion would be subject to income taxes. If the contribution included a commission, the earnings would have to be more than the commission before any conversion was actually taxed. Thus, a backdoor Roth IRA contribution would seldom be a taxable event. Now, the owner has the opportunity for tax-free growth as long as the eventual withdrawal is a qualified distribution.

This sounds wonderful, but the devil is in the details. A backdoor Roth IRA works best for a person with no other traditional IRA accounts at all. This is because the IRS considers each person as only having one IRA, even if there are multiple traditional IRA accounts with different custodians. If the client does not have any other traditional IRA accounts, contributing to a backdoor Roth IRA is easy. Make a nondeductible IRA contribution and then convert it to a Roth IRA very quickly. It is best to inform the custodian that the client will be contributing to a nondeductible IRA and then converting to a Roth IRA. Anyone with earned income can contribute to a nondeductible IRA regardless of a high income level. Once the nondeductible IRA has been established, convert it to a Roth IRA. A backdoor Roth IRA does not work as well for those with other traditional IRAs; this is because the IRS would account for the conversion as coming from the total amount of all IRAs owned by the client regardless of where the other traditional IRAs were held. For

example, a client has $93,500 in a traditional IRA with the ABC Funds Family. She contributed $6,500 to a nondeductible IRA with the XYZ Funds and she converted the XYZ account the next day. Essentially, the IRS will determine that only 6% of the conversion was tax free. However, if she had a husband without any traditional IRAs, the family could do a backdoor Roth IRA on his side. In all, there are many potential pitfalls with a backdoor Roth IRA, so it is best to consult IRS Publication 590-b before attempting it.

Reading: Roth IRA Distributions and Conversions

LO 5.4.2: Analyze the tax consequences of Roth IRA distributions and conversions.

Distributions

Most people start their analysis of Roth IRA distributions by asking whether or not a withdrawal is a qualified distribution. However, this is the wrong place to start because qualified distributions only addresses earnings.

The right place to start is dividing the Roth IRA into three categories.

- Category 1: Contributions. The first money withdrawn from a Roth IRA is ALWAYS AND WITHOUT EXCEPTION accounted for as coming from contributions. Contribution money was not deductible when contributed. Thus, contribution money cannot be income taxed when withdrawn. Also, because contribution money is not income taxed when withdrawn, it cannot be subject to the 10% early withdrawal penalty (EWP) rules. In other words, withdrawals of contributions are always income tax and early withdrawal penalty free. There is never a time when the withdrawal of contribution money is ever income taxed or penalized. For example, a child is a baby model. Her earned income allowed her to set up a Roth IRA. By the time she was 7, she had contributed $30,000 into her Roth IRA. If she withdrew $25,000 to pay for voice lessons she would not be income taxed on the withdrawal even though she was only 7. Nor was she 10% penalized. Contribution withdrawals are accounted as coming out first and they can never be taxed or penalized.
- Category 2: Conversions. After the contribution category is totally empty, the next money withdrawn is accounted for as coming from the oldest conversion. Because conversions of deductible retirement accounts were income taxed at the conversion, the withdrawal of conversion money is never subject to income tax (again). Usually when a withdrawal is not taxed, it is not penalized. However, to protect against sham conversions, a withdrawal of converted money is subject to the 10% EWP for five years. After five years, the conversion money becomes like contribution money. It is neither taxed nor subject to the 10% EWP system. During the five years, however, a withdrawal of converted money is subject to the 10% EWP. For example, pull the conversion money out within 5 years of the conversion to buy a bass boat at age 50, and you are 10% penalized even though you don't owe income taxes. Pull the money out within five years at age 50 to pay for your daughter's college tuition and you are not 10% penalized because you meet an exception. Finally, in addition to FIFO

ordering, distributions of conversion amounts are further ordered as follows: first, taxable amounts at the time of conversion, then, nontaxable (basis) amounts at the time of conversion.

- Category 3: Earnings. After all contributions and conversions are completely withdrawn, earnings are the final category from which distribution funds are pulled. Within the earnings category, it is important to determine whether the distribution is qualified. See Figure 5.1 for detailed information on qualified distributions.

A qualified distribution (income tax- and penalty-free distribution) is made from a Roth IRA when *both* of the following requirements are met. These two tests could be thought of as a holding period test and a reason for the withdrawal test.

- Holding Period Test: This test is administered first to determine if the distribution is made after a five-year holding period (which begins January 1 of the taxable year for which the first regular contribution is made to the taxpayer's first Roth IRA or, if earlier, January 1 of the taxable year in which the first conversion contribution is made to a converted Roth IRA). For example, if a Roth IRA contribution is made in February 2023 for tax year 2022 the five-year holding period requirement timeline begins January 1, 2022. Note that a separate five-year period applies to each conversion relative to the 10% early withdrawal penalty (not in regards to income taxes). This is different from the treatment of contributions. A separate five year period is not applied for Roth contributions. For example, Pete contributed $500 to his first Roth IRA on March 27, 2022, but the $500 was coded as a 2021 contribution. Thus, Pete's Roth IRA clock started on Jan 1, 2021. It will end on Jan 1, 2026 because his Roth years are 2021, 2022, 2023, 2024, and 2025. Thus, he will have passed the Roth IRA holding period test on Jan 1, 2026.
- Reason for Withdrawal Test: The distribution is made for one of the following reasons:
  - The owner dies, and payment is made to a beneficiary or estate of the owner on or after his death.
  - The owner attains the age of 59½.
  - Payment is made to buy, build, or rebuild a first-time home for the owner, spouse, child, parent, direct ancestor, or grandchild (with a lifetime cap of $10,000 of earnings). Also, anyone related to the spouse in a similar way (child, grandchild, or direct ancestor of the spouse) qualifies for first-time homebuyer withdrawals. A ***first-time homebuyer*** is defined for this IRA distribution by IRS Publication 590-b as someone who has not had "a present interest in a main home during the two-year period ending on the date of acquisition of the home . . . If you are married, your spouse must also meet this no-ownership requirement." Distribution amounts over $10,000 cannot be a qualified distribution under the first-time home buyer rules. For example, if John, age 45, withdrew $15,000 accounted for as coming from earnings from his seven-year-old Roth IRA to purchase his first home, $10,000 would be a qualified distribution and $5,000 would not be a qualified distribution.
  - The owner becomes disabled.

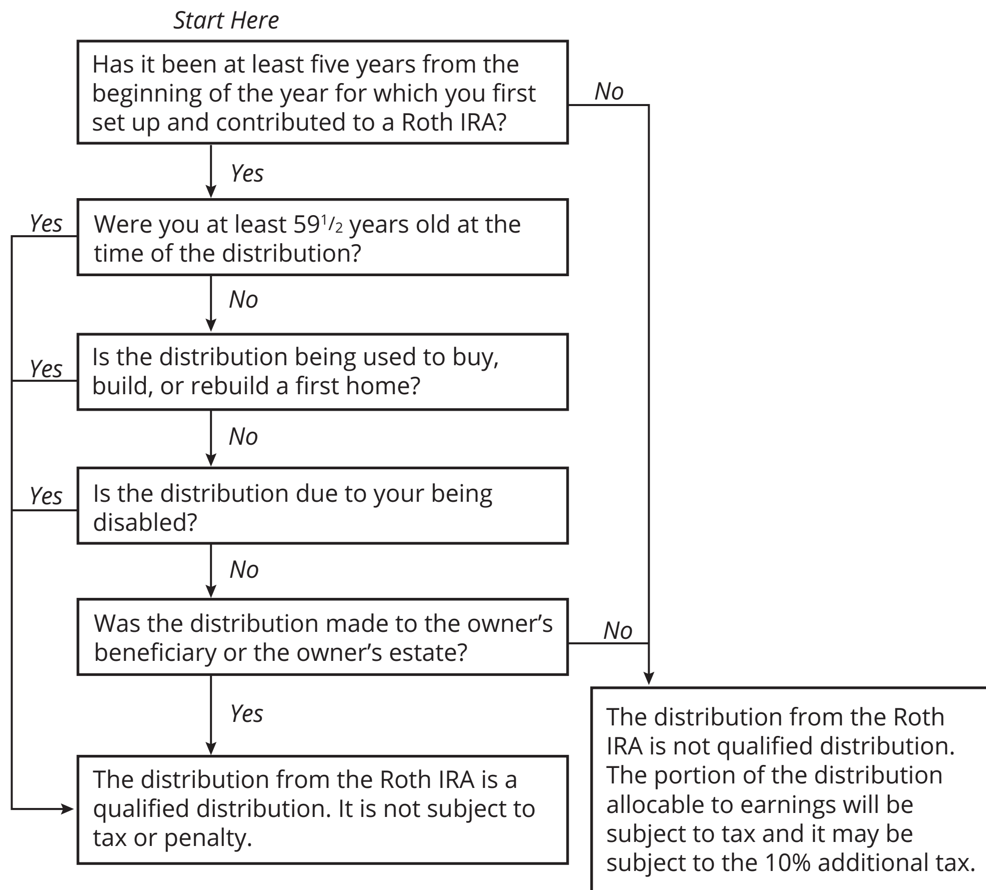
Note the five-year holding period test is an absolute requirement for a qualified distribution. Additionally, one of the other listed requirements must also be met. It is important to recognize that attainment of age 59½ is not an absolute requirement; it is only one of the possible qualifying events. It is possible for a qualified distribution to occur prior to age 59½ if the five-year holding period is satisfied and death, disability, or first-time home purchase is the reason for the distribution.

The four reasons for a qualified Roth IRA distribution can be remembered with the phrase "Denver Area Fire Department." *Denver* is for death. *Area* is for age 59½. *Fire* is for first-time homebuyer. *Department* is for disability. Notice that higher education expenses are not one of the reasons for a qualified distribution. They are an exception to the 10% EWP, but not a reason for a qualified distribution. Who knows why Congress does things like this?

On the other hand, the reasons for a qualified distribution from an employer Roth account (Roth 401(k), etc.) are even easier to remember. Just think of "Dad" (death, age 59½, and disability).

The five-year holding period is not re-determined when the Roth IRA owner dies. Thus, the beneficiary of the Roth IRA only needs to wait until the end of the original five-year period for the distribution to be treated as a qualified distribution.

Figure 5.1: Qualified Roth IRA Distribution Flow Chart



EXAMPLE: IRA distribution

Sherry, age 50, had a Roth IRA worth $50,000 that she started 10 years ago. She had contributed $15,000 and converted another $10,000 three years ago. She will be in the 22% federal tax bracket this year. What will she owe the IRS if she withdraws $30,000 this year to pay for a vacation?

The first $15,000 is neither taxed nor penalized because it came from contributions. The second $10,000 is accounted for as coming from her conversion. It is not taxed because that money was income taxed when she converted it. However, the $10,000 is subject to the 10% EWP because the conversion is less than five years old. But will the conversion withdrawal actually have to pay the 10% EWP? Yes, because withdrawing for a vacation is not an exception to the 10% EWP. Thus, the withdrawn conversion amount owes $1,000 of EWP. The final $5,000 of the withdrawal comes from earnings. Is this a qualified distribution? First, has Sherry had a Roth IRA for five Roth years or more? Yes, so the withdrawal passes the first qualified distribution test. Is the distribution after age 59½, for first-time home buyer expenses, due to Sherry being disabled, of due to Sherry's death? No. The $5,000 withdrawal of Roth IRA earnings is not a qualified distribution and thus is subject to both income taxes and the 10% early withdrawal penalty. Does the withdrawal meet one of the exceptions to the 10% EWP for any IRA? No. That makes the final bill to the IRS $2,600. $1,500 of 10% EWP and $1,100 of income tax. What would her IRS bill be if she would have withdrawn the money to pay her daughter's college tuition? $1,100. The same analysis holds for earnings, but the 10% EWP would not apply because there is an exception to the 10% EWP for qualified higher education expenses.

EXAMPLE: Roth IRA conversion

Tristan, age 45, converts $20,000 to a Roth IRA (#1) in Year 1 and $15,000 to a Roth IRA (#2) in Year 3. No other contributions to either Roth are subsequently made. In Year 7, a $30,000 distribution is made to Tristan to help start a business. As a result, the distribution is taxed under the **ordering rules** as $20,000 from the Year 1 conversion contribution (#1) and $10,000 from the Year 3 conversion contribution (#2). These amounts were includable in gross income when converted. As a result, for Year 7, no amount is includable in Tristan's gross income. However, because $10,000 is allocable to a conversion contribution made within the previous five years (and no exception applies), that amount is subject to the 10% penalty. Thus, Tristan pays a penalty of $1,000 ($10,000 × .10) on the total $30,000 distribution

Roth distributions are a source of confusion for many students. Here are some general principles to consider concerning Roth distributions:

1. There are four types of Roth accounts: Roth IRA, Roth 401(k), Roth 403(b), or Roth Governmental 457. Each type of Roth account has its own five-year Roth clock.
2. Roth IRA money is never allowed to be moved to an employer Roth account, but employer Roth accounts can be moved into each other and also into a Roth IRA. This is a good reason for everyone to establish a Roth IRA no later than age 54½.

3. It is never possible to have a Roth distribution be a qualified distribution until the type of Roth account has met the five-year Roth clock holding period. This even includes Roth distributions where the new owner inherited the account. For example, a dad opened his first Roth IRA account three years ago. He died and left the Roth IRA to his daughter. The daughter cannot have a qualified distribution until the Roth account has another two years on it. In other words, even dying does not supersede the five-year Roth holding period. On the other hand, the person who inherits the Roth IRA does not have to start a new Roth clock for that money. The five-year Roth clock for inherited IRAs begins when the original owner opened the account.
4. Every aspect of a qualified distribution from a Roth account is income tax free and also 10% EWP free. All contributions, conversions, and earnings from a qualified distribution are tax-free. When analyzing a Roth distribution, think of each category separately—contributions, conversions, and earnings. Then handle them in turn: first contributions, then conversions, and, finally, earnings.
5. Just because a Roth distribution fails to be a qualified distribution, it does not mean the distribution will always be taxed or penalized.

To recap the rules stated above:

- Roth distributions are counted against contributions first. Any Roth distributions that are accounted for as coming from contributions are never subject to any income tax or the 10% EWP (early withdrawal penalty). Contributions are legitimate after-tax principal. Legitimate after-tax principal is never income taxed nor is it subject to the 10% EWP.
- After all Roth contributions are withdrawn, the next category is Roth conversions. Conversions are also considered after-tax principal and thus will never be subject to income tax a second time. After five years from each Roth conversion, distributions accounted for as coming from that Roth conversion are also not subject to the 10% EWP. Waiting at least five years after a conversion means the law treats the conversion exactly like it treats contributions—they are legitimate after-tax principal.
- Roth distributions that are treated as coming from a conversion that is less than five years old seem suspicious to the IRS. The IRS is worried that the Roth conversion was intended to dodge the 10% early distribution penalty. Thus, even though a distribution that is accounted for as coming from a Roth conversion is not subject to income taxes (again), it is still subject to the 10% EWP until the conversion is five years old, unless it meets an exception to the 10% EWP.
- Roth earnings that are withdrawn will always be subject to income taxes unless they are part of a qualified distribution.
- Roth earnings that are withdrawn will always be subject to the 10% EWP unless one of the exceptions applies. The exceptions to the 10% EWP for all IRAs (both traditional IRAs and Roth IRAs) can be remembered by the phrase, "4D IRS Child's MEAL at home before 59½." As in, "You don't want to be a 4D IRS Child's MEAL at home before 59½."

Figure 5.2: IRA Exceptions to the 10% Early Withdrawal Penalty

4D IRS MEAL at home before 59½
D – Death
D – Disability
D – Divorce/marital separation
D – Disaster (qualified disaster distributions up to $100,000)
I – Insurance for health care when unemployed
R – Reservist/qualified reservist
S – Substantially equal periodic payments or Section 72(t)
Child's – the birth or adoption of a child under 18
M – Medical expenses over 7.5% of AGI
E – Education expenses for higher education
A – Annuitized distributions
L – Levy by the IRS
Home – Qualified first-time homeowner expenses up to the $10,000 lifetime maximum
59½ – Distributions after 59½

These are also generally the exceptions from the 10% EWP from an employer retirement plan except that employer plans do not allow an exception for higher education expenses, unemployed individuals paying for health insurance premiums, or first-time homebuyer expenses. To make up for this, employer plans allow an exception to the 10% EWP for separation from service in the year someone will be age 55 or older. For example, Joe was laid off by the GST Company on June 3. He turned 55 on December 25 of that year. Because he is 55 in the calendar year of his separation from service, he will not be subject to the 10% EWP on distributions from the GST retirement plan. However, he would be subject to the 10% EWP if he took money out of an IRA or another former employer's retirement plan before he was 59½. Two other exceptions unique to employer retirement plans are for qualified domestic relations orders (QDROs) and ESOP dividend distributions. These will be covered in more detail in the next module.

Conversions

An amount in a traditional IRA may be converted to a Roth IRA. The amount converted must generally be from a traditional IRA that is rolled over to a Roth IRA within 60 days of the distribution. A direct rollover or direct trustee-to-trustee transfer is also allowed.

Any converted amount is treated as a taxable distribution from the traditional IRA and is included in the owner's gross income for the year in which the distribution occurs to the extent the amount exceeds basis, if any, in the traditional IRA. However, the 10% premature withdrawal penalty does not apply, regardless of the owner's age at the time of the conversion. The opposite of a conversion is a "recharacterization." A recharacterization means going from a Roth IRA to a traditional IRA. This used to be available at any time and provided an active tax strategy during market drops. However, today, the only Roth IRA money that can be recharacterized now are Roth IRA contributions. Also, there is a time limit

to recharacterize a Roth IRA contribution. The latest a Roth IRA contribution can be recharacterized to a traditional IRA is Oct 15th of the following year. For example, you contribute $5,000 to a Roth IRA for this year. This money can be recharacterized to a traditional IRA until October 15th next year. Congress would like to never allow recharacterizations. However, this option is required to accommodate people who find out they made too much money to contribute to a Roth IRA. For example, Cindy contributed to a Roth IRA for the current year. However, when she did her income taxes she discovered that her AGI was too high to contribute to a Roth IRA, so she recharacterized her contribution to a traditional IRA before October 15th of next year.

Additionally, a participant in a Section 401(k) plan, Section 403(b) plan, or a governmental Section 457 plan may elect to convert any eligible rollover distribution of non-Roth sums into an individual Roth account within the same plan if the plan offers a Roth account and in-plan Roth conversions. These employer Roth conversions are not subject to the 10% EWP at the time of conversion.

The decision to convert a traditional IRA to a Roth IRA is not an easy one and requires a comprehensive tax and accounting analysis. However, if the tax due initially on conversion will be paid from assets other than the traditional IRA and the converted assets will remain in the Roth IRA for a relatively long period of time before withdrawal, the conversion is generally advisable. A financial planner should assist the client to determine if a conversion should, in fact, be made.

Aggregation Rule

The Internal Revenue Code (IRC) requires that all deductible and nondeductible traditional IRAs be aggregated together and treated as one IRA for the purpose of calculating the basis of a distribution. Even if the nondeductible traditional IRA contributions are segregated in separate IRAs from the deductible traditional IRA contributions, the aggregation rules require that any distribution be treated as a partial return of nontaxable basis and a partial taxable distribution of contributions and earnings.

Also, when calculating the nontaxable portion of the distributions made during a given tax year, all distributions in that year are also aggregated as though there was only one distribution in the year. The purpose of these rules is to prevent a taxpayer from choosing to convert or distribute only the nontaxable portion of a traditional IRA and leaving the taxable contributions and earning untouched. Once the IRAs are combined, the basis in the distribution is allocated as follows:

$$\text{Nontaxable portion} = \left[\frac{\begin{pmatrix}\text{nondeductible contributions prior to current year} + \\ \text{all contributions for current year}\end{pmatrix}}{\begin{pmatrix}\text{balances at end of current year} + \\ \text{distributions received in current year}\end{pmatrix}}\right] \times \text{total distributions in current year}$$

myRA Retirement Savings Account

A new type of Roth IRA was temporarily established by the U.S. Treasury Department. The myRA account was available to employees through employers, allowing contributions via payroll deduction on an after-tax contribution basis. While anyone could have opened an account at a sponsoring employer, the myRA was targeted for low to middle income workers who may not have had access to an employer-sponsored retirement plan. Accounts were established with any payroll deduction amount and were subject to regular Roth IRA contribution limits and rules. The myRA earned interest at the same rate as the Government Securities Investment Fund in the Thrift Savings Plan for federal employees. Participation was subject to income thresholds. Once a participant's account balance reached $15,000, or after 30 years, the account had to be transferred to a regular Roth IRA. The myRA program stopped receiving contributions as of December 4, 2017. The government is encouraging myRA account owners to move the assets to Roth IRAs.

Distributions to Charity

The Consolidated Appropriations Act of 2016 made permanent the ability for a taxpayer to make direct distributions from IRAs to eligible charitable organizations. Known as a **qualified charitable distribution** (QCD), the provision allows IRA owners and beneficiaries age 70½ or older to donate up to $100,000 per year ($200,000 for a married couple) tax-free to eligible charitable organizations. The QCD is not first reported as income with a corresponding charitable deduction. A QCD offers full tax exemption of the amount donated, up to the annual ceiling of $100,000 per taxpayer. This is a key benefit for taxpayers because the distribution is not included in AGI, which impacts various tax and retirement benefits. The charitable distributions from the IRA are required to be paid directly to the organization, with no constructive receipt by the IRA owner or beneficiary. Traditional and Roth IRAs are eligible IRAs for QCD purposes. SEP and SIMPLE IRAs are not eligible unless contributions are no longer being made to the account. QCD amounts may be considered in satisfying a required minimum distribution (RMD) for a given tax year.

The SECURE Act has some important implications for QCDs. First, the age for QCDs was not changed by the SECURE Act. The age for QCDs is still 70½. Second, if a person makes a contribution to a traditional IRA after age 70½, there are implications for QCDs. The implications are beyond the scope of the test, but they should be investigated before advising a client who is making post-70½ contributions to a traditional IRA to make a QCD.

Reading: Roth IRAs, Designated Employer Roth Accounts, and Pre-Tax 401(k)s

LO 5.4.3: Distinguish Roth IRAs, designated Roth 401(k)s, and pretax 401(k)s.

Roth Comparison Chart

	Designated Roth 401(k) or Roth 403(b)*	Roth IRA	Pretax 401(k)
Contributions	Designated Roth employee elective contributions are made with *after-tax dollars*.	Roth IRA contributions are made with *after-tax dollars*.	Traditional, pretax employee elective contributions are made with *before-tax dollars*.
Income Limits	There is no income limitation to participate.	Income limits: 2023—modified AGI married $228,000/ single $153,000	There is no income limitation to participate.
Maximum Elective Contribution	Aggregate** employee elective contributions are limited to $22,500 in 2023 (plus an additional $7,500 for employees age 50 and over).	Contributions are limited to $6,500 plus an additional $1,000 for employees age 50 or over (in 2023).	This has the same aggregate* limit as a Designated Roth 401(k) account.
Taxation of Withdrawals	Withdrawals of contributions and earnings are not taxed, provided it's a *qualified distribution*—the account is held for at least five years and made: ■ on account of disability, ■ on or after death, or ■ on or after attainment of age 59½. Think "Dad."	This is the same as Designated Roth 401(k) account and can have a qualified distribution for a first-time home purchase. Think "Denver Area Fire Department."	Withdrawals of contributions and earnings *are* subject to federal and most state income taxes.
Required Minimum Distributions	Distributions must begin no later than age 72, unless still working and not a 5% owner.	There is no requirement to start taking distributions while the original owner is alive.	This is the same as a Designated Roth 401(k) account.

* Employer Roth rules for Roth 401(k) and Roth 403(b) are the same.

**This limitation is by individual, rather than by plan. You can split your annual elective deferrals between designated Roth contributions and traditional pre-tax contributions, but your combined contributions cannot exceed the deferral limit—$22,500 in 2023 ($30,000 if you're eligible for catch-up contributions for being age 50 and above).

PRACTICE QUESTIONS

Choose the best answer for each of the questions below. The answer can be found at the end of this module.

7. In what ways are Roth IRAs and traditional IRAs the same?
   I. Both must start Required Minimum Distributions when the owner turns 72.
   II. Both share the same exceptions to the early distribution penalty.
   III. Both share the same investment prohibitions.
   IV. Both may be funded regardless of MAGI if the owner is not an active participant.
   A. I and II
   B. I and IV
   C. II and III
   D. III and IV

8. Troy is a 50-year-old single taxpayer with a $140,515 MAGI in 2023. He is also an active participant in his 401(k) at work. How much can he contribute to his Roth IRA in 2023?
   A. $0
   B. $1,250
   C. $6,250
   D. $7,500

9. Ted, age 43, is in the 22% marginal tax bracket, contributed $10,000 to his Roth IRA over the last eight years. Today, the account is worth $15,000. How much would the income taxes be, plus any applicable 10% early withdrawal penalty, for Ted if he withdrew $7,000 to pay his credit cards?
   A. $0
   B. $1,540
   C. $2,240
   D. $2,349

10. James and Jackie are both 34, married, and file a joint tax return. Their MAGI for 2023 is $158,000. Jackie has already made a $6,500 deductible contribution to her traditional IRA and has made a contribution of $2,000 to their daughter's 529 Plan this year. What is the maximum additional amount that may be contributed, if any, to a Roth IRA for James and Jackie for the year 2023 given these facts?
    A. $0
    B. $2,000
    C. $6,500
    D. $13,000

11. Which of the following are exceptions to the early withdrawal penalty that would apply to IRA distributions, but not to a 401(k)?
    I. Qualified higher education expenses.
    II. Separation from service at age 55 or later.
    III. Unreimbursed medical expenses in excess of 7.5% of AGI.
    IV. First-time home buyer expenses
    A. I and II
    B. II and III
    C. III and IV
    D. I and IV

12. Roth IRA distributions are required to be treated as occurring in a specific order. Which of the following sequences correctly states this order?
    A. Contributions, conversions, earnings
    B. Conversions, earnings, contributions
    C. Contributions, earnings, conversions
    D. Earnings, contributions, conversions
13. Andrea, who is age 35, converted a $90,000 traditional IRA to a new Roth IRA in Year 1. She also made a contribution of $4,000 to a Roth IRA in Year 2. If Andrea takes a $4,000 distribution from her Roth IRA during Year 3, to buy furniture, how much total federal tax, if any, including penalties, is due as a result of the distribution? (Assume that Andrea is in a combined 30% marginal tax rate.)
    A. $0
    B. $200
    C. $620
    D. $915
14. Which of the following are characteristics completely shared by a Roth IRA and a Roth 401(k)?
    I. Active participation status is not a consideration when determining if the person is allowed to contribute to the account.
    II. Required Minimum Distributions (RMDs) for retired workers and Roth IRA owners can be delayed past age 72 in some circumstances.
    III. The reasons a withdrawal can be a qualified withdrawal.
    IV. The income limits concerning who can contribute to a Roth 401(k) and a Roth IRA are identical.
    A. I only
    B. I and II
    C. II and III
    D. II and IV

MODULE 5 ANSWER KEY FOR PRACTICE QUESTIONS

1. **C** In 2023, Emily can deduct up to $1,330 calculated as follows. ($136,000 – $131,925) ÷ $20,000 × $6,500 = $1,324.75. This is bumped up to the next tens digit, so the final answer is $1,330 that Emily can deduct of her IRA contributions. Juan, on the other hand can deduct the full $6,500 because their AGI is far below the phaseout range for the nonactive participant MFJ spouse of $218,000–$228,000 for 2023.

2. **B** In 2023, Amy and David can combine to deduct $6,750. David cannot deduct anything. He is an active participant because his 401(k) received the reallocation forfeiture. The phaseout range for MFJ active participants in 2023 is $116,000–$136,000. Thus, David cannot deduct any IRA contributions. Amy, however, is not an active participant. She can deduct up to $6,750 calculated as follows. ($228,000 – $219,000) ÷ $10,000 × $7,500 = $6,750. It seems like a travesty of justice that a reallocated forfeiture of $13 makes David an active participant. However, even $1 coming into his 401(k) from himself, his employer, or as a reallocated forfeiture makes him an active participant by law. A rollover, however, would not make him an active participant. The rollover money would have already been in a retirement account, so it would not be new money coming into his overall retirement situation.

3. **D** Neither Jon nor Mary is an active participant in an employer-sponsored retirement plan. Therefore, they can establish a spousal IRA for Mary using Jon's earned income. They can contribute (and deduct) a total of $13,000 (a maximum of $6,500 each) to a traditional IRA for 2023.

4. **D** Collectibles are generally prohibited as an investment in a traditional IRA. Gold coins minted by the U.S. Treasury are an exception to this general rule. A mutual fund investing in gold mining stock is a permissible investment.

5. **D** All of these people may make some level of deductible contributions to a traditional IRA. Jane's MAGI is in the phaseout range for 2023, thus she cannot deduct the full $6,500, but she could deduct some contribution. Joe's AGI also puts him in the phaseout range for married people filing jointly. However, he is not covered by an employer plan, so he is not an active participant. Also, no information is given about his wife, so her situation is irrelevant to the question. As a review, even if she was an active participant in an employer retirement plan, Joe could still deduct his entire traditional IRA contribution because their MAGI is below the start of the phaseout range for a married person filing jointly without an employer plan when the spouse is an active participant of a retirement plan. In 2023, that phaseout range is $218,000–$228,000. Betty and Sue are active participants but they both have an MAGI below the start of the phaseout range.

6. **D** The first statement is an exception for distributions from qualified plans. The second and third statements are correct exceptions to the imposition of the 10% penalty for early distributions made from an IRA.

7. **C** Roth IRAs are never required to start RMDs as long as the original owner is alive. Also, active participation status is not considered in determining if a person can contribute to a Roth IRA. The only tests for eligibility to contribute to a Roth IRA are earned income and MAGI. While Roth IRAs and traditional IRAs share the same exceptions to the 10% early distribution penalty (because they are both IRAs), this is not true for Roth IRAs and employer Roth accounts (or traditional IRAs and employer retirement plans). While there are many of the commonalities between IRA exceptions to the 10% early withdrawal penalty and employer plan exceptions to the 10% early withdrawal penalty, there are some differences between the exceptions for IRAs and the exceptions for employer plans. These differences are highly testable.

8. **C** Troy is in the Roth contribution phaseout range for single taxpayers of $138,000–$153,000. Thus, he may contribute $5,800 to his Roth IRA in 2023. ($153,000 – $140,515) ÷ $15,000 × $7,500 = $6,242.50. This is bumped up to $6,250. Note that his status as an active participant is a distractor in this question. Active participation status is irrelevant for Roth IRA contributions.

9. **A** Ted would not be income taxed nor would he be 10% penalized because the entire withdrawal would come from his contributions. Now Ted's Roth IRA has $3,000 of contributions and $5,000 of earnings.

10. **C** The maximum combined contribution to traditional and Roth IRAs (for an owner who is younger than age 50) is $6,500 per person annually for 2023. Therefore, James and Jackie have a total of $13,000 to allocate between both forms of IRAs. Jackie has already contributed the maximum amount to an IRA for her benefit; therefore, James can only contribute $6,500 to his own Roth IRA for the current year. Note that the $2,000 529 Plan contribution is not included in either the $6,500 (individual) or $13,000 (combined) limit. Also note that Roth IRAs do not take into account anyone's status as an active participant. Finally, in this case, their MAGI is above the phaseout range for active participants. Because Jackie was able to deduct $6,500, you know that she was not an active participant this year.

11. **D** Qualified higher education expenses and first-time home buyer expenses (up to $10,000 of earnings for Roth IRAs and $10,000 of taxable distributions for traditional IRA) are not exceptions for employer retirement plans but they are for IRAs.

12. **A** Under the ordering rules, regular contributions are distributed first, followed by conversion contributions and, finally, earnings. Distributions made from all Roth IRAs are aggregated for purposes of the rules.

13. **A** Although the distribution is not a qualified distribution, it will not be taxable because it is treated as coming from the regular Roth IRA contributions (here, $4,000 in Year 2). Because the $4,000 is accounted for as coming from contributions it will not be taxed or penalized.

14. **A** Active participation status deals with whether or not a taxpayer is allowed to deduct traditional IRA contributions. Active participation is not one of the tests for Roth IRA contributions. If a person contributed to a Roth 401(k), she would be considered an active participant, but that is not relevant in determining if she would be allowed to contribute to a Roth IRA. Distributions from a Roth IRA are not subject to the required minimum distribution (RMD) rules as long as the original Roth IRA owner is alive. Employees who retire must take RMDs from an employer Roth account. Any employee who is eligible for the employer retirement plan can contribute to the Roth 401(k) regardless of income (even though only $330,000 of compensation is includable in 2023 for contributions to the employer plan). The point remains that an employee earning $1 million can legally defer some income into an employer Roth account even though they could not contribute to a Roth IRA directly. An employer Roth may make a qualified distribution for age 59½, death or disability. The reasons a Roth IRA can make a qualified distribution are the same as an employer Roth account and also for qualified first-time home buyer expenses.

MODULE 6

Plan Distributions

INTRODUCTION

One of the most frequent issues financial planners deal with is how to maximize the effectiveness of distributions from a qualified plan, an IRA, or both. Distributions may be selected to create the cash flow security of an annuity or a lump-sum distribution or rollover. The retiree must choose a proper retirement plan distribution strategy to accommodate lifestyle needs while distributing as little as possible to save on income taxes. IRS regulations have somewhat resolved this issue for people age 72 and older by requiring a minimum amount of payment to be made for tax purposes [known as a *required minimum distribution* (RMD)], although the retiree is permitted to withdraw more. Balanced against these considerations is the anticipated life expectancy of the client and the withdrawal rate to ensure that the client does not outlive his total retirement assets. The risk of running out of money in retirement is called superannuation.

This module will address the various distribution issues for retirement plan assets. Distributions issues while the original owner is alive will be covered first. The second half of the module will cover retirement distribution issues following the death of the retirement plan owner.

TOPICS, LEARNING OBJECTIVES, AND READINGS

The topics covered in this module are as follows:

- Topic 6.1: Lifetime Distribution Options
- Topic 6.2: Required Minimum Distributions
- Topic 6.3: Early Distributions and Loans
- Topic 6.4: Beneficiary Designations and Survivor Benefits
- Topic 6.5: Other Distribution Considerations

Throughout this module, you will see learning objectives (LOs) that emphasize the knowledge and application skills you will gain from this module. These specific statements, based on the 2021 CFP Board's Principal Knowledge Topics List (the blueprint for the current CFP® exam), advise you regarding what you should know and be able to do at the completion of this module.

The following table shows a list of module topics, LOs, and readings.

Learning Objective		Readings
Topic 6.1: Lifetime Distribution Options		
6.1.1	Analyze the options for receiving a preretirement distribution from a qualified retirement plan and the associated tax implications.	Lifetime Distribution Options
6.1.2	Interpret the tax consequences of net unrealized appreciation (NUA).	Net Unrealized Appreciation (NUA)
Topic 6.2: Required Minimum Distributions		
6.2.1	Examine the relationship between the required beginning date for an individual and the required minimum distributions.	Required Beginning Date (RBD) for Required Minimum Distributions (RMDs)
6.2.2	Calculate the required minimum distribution (RMD) for a given situation.	Calculating Required Minimum Distributions (RMDs)
Topic 6.3: Early Distributions and Loans		
6.3.1	Determine the early distribution penalty for qualified plans and Section 403(b) plans as well as exceptions to this penalty.	Early Distribution Penalties and Penalty Exceptions for Qualified Plans and Section 403(b) Plans
6.3.2	Apply the rules and tax implications of loans from qualified plans, Section 403(b) plans, and governmental Section 457 plans.	Loans from Qualified Plans, Section 403(b) Plans, and Governmental Section 457 Plans
Topic 6.4: Beneficiary Designations and Survivor Benefits		
6.4.1	Analyze a retirement plan scenario to determine outcomes with proposed beneficiary designations.	Choice of Beneficiary for Qualified Plans, IRAs, Section 403(b) Plans, or Section 457 Plans
6.4.2	Describe the automatic survivor benefits for plans in which they are required.	Automatic Survivor Benefits (QJSAs and QPSAs)
Topic 6.5: Other Distribution Considerations		
6.5.1	Apply retirement distribution rules when QDROs or the death of an IRA owner is involved.	Qualified Domestic Relations Orders (QDROs) and Roth IRA Postdeath Distributions

KEY TERMS

50% excise tax
annuity
beneficiary
designated beneficiary
direct transfer
early distribution penalty
eligible designated beneficiary (EDB)
five-year rule
lump-sum distribution
net unrealized appreciation (NUA)
nonspouse beneficiary
qualified domestic relations order (QDRO)
qualified joint and survivor annuity (QJSA)
qualified preretirement survivor annuity (QPSA)
qualifying public charity
qualifying trust
remaining life expectancy
required beginning date (RBD)
required minimum distribution (RMD)
rollover
surviving spouse
trigger year
Uniform Lifetime Table/ Table III

TOPIC 6.1: LIFETIME DISTRIBUTION OPTIONS

Reading: Lifetime Distribution Options—Part 1

LO 6.1.1: Analyze the options for receiving a preretirement distribution from a qualified retirement plan and the associated tax implications.

In the case of a qualified retirement plan, there are three basic distribution options that may be available, depending on plan provisions:

- A lump-sum distribution
- An annuity or other form of periodic payment
- A rollover or direct transfer

Lump-Sum Distribution

Generally, distributions from qualified plans are taxed as ordinary income. Special tax treatment may be available when a distribution meets the qualifications for **lump-sum distribution** treatment. The most common of the special tax treatments available is net unrealized appreciation (NUA).

Typically, only defined contribution qualified plans offer a lump-sum payout option. A lump sum distribution is a technical term. It is different than getting a large check from a retirement account. A lump-sum distribution is a distribution from a qualified plan of a participant's entire interest in the plan that occurs within one tax year. Getting a lump-sum distribution is the key to being eligible for special tax treatment (NUA, 10-year forward averaging, or pre-1974 capital gains treatment).

There are three conditions that must be met for a lump-sum distribution to qualify for favorable income tax treatment. These conditions include the following:

- The distribution must represent the entire amount of the employee's benefit in the plan.
- An election must be made by the participant, or in the case of the participant's death, by the estate, within one year of the receipt of the distribution.

- The distribution must be due to one of the following:
  - The employee dies.
  - The employee becomes age 59½.
  - The employee separates from service (this triggering event is not possible in the case of a self-employed individual).
  - The employee becomes disabled.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

1. A lump-sum distribution made from a qualified plan may be eligible for the following favorable tax treatments except
   A. NUA on employer securities portion of distribution.
   B. 5-year forward averaging for individuals born before January 2, 1936.
   C. 10-year forward averaging for individuals born before January 2, 1936.
   D. capital gains treatment on the portion of distribution allocable to pre-1974 contributions.

Reading: Lifetime Distribution Options—Part 2

In-Service Withdrawals

The employer has a fiduciary requirement to run the retirement plan primarily for the participants' retirement needs. However, some plans offer limited amounts of in-service withdrawals. Hardship withdrawals were covered in Module 3 using the sentence "My disastrously faulty emergency fund." (Medical and funeral expenses that are not reimbursed; disaster withdrawals; first home purchase [in the sense of a primary residence only]; education expenses; and foreclosure prevention for a primary residence). Notice that hardship withdrawals for homes are always tied to the primary residence only.

Besides hardship withdrawals, some retirement plans offer in-service withdrawal options. "Pension plans" (the "Be my cash target plans"—benefit as in defined benefit plans; money purchase plans; cash balance plans; and target benefit plans) usually do not allow in-service withdrawals before age 59 ½. Note that these plans do not allow worker contributions, so the employers feel more empowered to limit in-service withdrawals. "Profit sharing plans" as a category may offer earlier in-service withdrawals. One common in-service withdrawal option selected by profit sharing plans is age 59½ as a limited retirement option. The intention is to allow a worker who partially retires or cuts back time at a firm to receive some retirement distributions while still employed.

Pension Annuity or Other Periodic Payment

The second basic option for distributions from qualified retirement plans, most often associated with a traditional (noncash balance) defined benefit plan, is an **annuity** or other periodic payment option. An annuity distribution received from a qualified

plan is taxable as ordinary income to the extent that it exceeds the allocated portion of the employee's basis, if any. If the employee has no basis in the plan created by after-tax contributions, the full amount of each annuity distribution is taxable as ordinary income when received. The most common reason for a defined benefit plan having a basis comes from life insurance purchased inside a retirement plan. These details are covered in Module 8.

A simplified method of taxing annuity distributions payable from a qualified plan is now required by law. Under this method, the participant recovers the basis, if any, as of the annuity starting date in level amounts over the number of anticipated monthly payments. Except in the case of payments that are made for a fixed period (rather than over the life expectancy of the participant or a spouse), the number of anticipated payments is determined under IRS tables. The calculation of exclusion amount of the annuity payment (tax-free portion) is covered in both the *FP512: Risk Management, Insurance and Employee Benefits Planning* and *FP514: Tax Planning* courses. Divide the total amount of after-tax contributions by the expected return of the annuity. The expected return is the monthly benefit multiplied by the assumed number of payments. This establishes the exclusion ratio. The exclusion ratio multiplied by the monthly benefit is the tax-free amount of income from the monthly annuity until the entire after-tax contribution has been received back tax-free. After this, all benefit payments are taxable.

TEST TIP

A common mistake is made when the exam questions ask how much of the benefits are subject to income tax. This is the difference between the monthly annuity benefit and the amount excluded each month. Be certain you are answering the question being asked. It can either be the amount that is taxable or the amount that is excluded.

All pension plans (such as traditional defined benefit, cash balance, money purchase pension plans, and target benefit pension plans) must provide for two forms of survivorship annuities for spouses: the **qualified preretirement survivor annuity (QPSA)** and the **qualified joint and survivor annuity (QJSA)**. These will be discussed in more detail below. Profit-sharing type plans (traditional profit-sharing, Section 401(k) plan, stock bonus plan, and ESOPs) generally are not required to provide these types of annuities, although they can, and often, do.

Direct Transfers and Rollovers

Qualified plan participants and IRA owners may transfer plan assets between plans, without current taxation, through direct transfers and rollovers.

A **direct transfer** (or trustee-to-trustee transfer) occurs when the trustee or other custodian who holds the assets making up the participant's accrued benefits transfers some or all of those assets directly to the trustee or custodian of another retirement plan or IRA. A direct transfer is important because such a transfer is not subject to the 20% mandatory tax withholding that is otherwise applicable to qualified plan distributions. Note that a SIMPLE 401(k) is considered a qualified plan for the 20% mandatory withholding rules.

Any taxable eligible rollover distribution paid from an employer-sponsored retirement plan directly to the plan participant is subject to a mandatory income tax withholding of 20%, even if the participant intends to roll it over later. If the withheld portion of the distribution is subsequently rolled over, the participant must add funds from other sources equal to the amount withheld, or the withheld amount itself is subject to current income taxation and a possible early withdrawal penalty. The 20% mandatory tax withholding is not applicable to IRA, SEP IRA, or SIMPLE IRA distributions.

If the participant adds funds equaling the 20% withholding amount and rolls over the entire original amount distributed from the plan to another retirement plan or IRA, none of the distributed amount is included in the participant's gross income. The income tax withheld is added to any other federal income tax withholding amounts for that tax year and may be refundable to the taxpayer when the IRS Form 1040 is filed for the tax year.

Qualified plan participants and IRA owners may also transfer assets tax free through rollovers. Generally, a **rollover** is a distribution from a qualified plan or IRA that the taxpayer subsequently contributes to another qualified plan or IRA within 60 days of receipt of the distribution. The rollover is free from current taxation if completed within 60 days of receipt of the distribution.

A taxpayer may make only one tax-free IRA-to-IRA or Roth IRA-to-Roth IRA rollover within a 12-month period. This includes the employer IRA plans (SEPs and SIMPLE IRAs). In other words, the limit is one tax-free IRA-to-IRA rollover when the money is not moved by a trustee-to-trustee transfer. This is a significant disadvantage when compared to a direct transfer, as the number of direct transfers that may be made in a 12-month period is not limited. Even if a taxpayer has multiple IRAs, only one rollover is allowed per 12-month period; this rule is intended to eliminate the possibility of perpetual tax deferment via a "chain" of IRAs. This rule was significantly tightened by a 2014 Tax Court case known as *Bobrow v. Commissioner*. Post Bobrow it is critical to understand the following things:

- Avoid all IRA-to-IRA and Roth IRA-to-Roth IRA rollovers. The Bobrow limit applies only to IRA-to-IRA and Roth IRA-to-Roth IRA rollovers. The Bobrow rule does not apply to IRA-to-Roth IRA conversions. It also does not apply to rollovers to or from an employer retirement plan except for SEP and SIMPLE IRA rollovers because these two plans use IRAs. The Bobrow rule applies to all IRA rollovers. That includes rollovers by beneficiaries like spouses who inherit an IRA.
- If your client attempts a second IRA-to-IRA or Roth IRA-to-Roth IRA within 365 days, the best option would be to roll the money into the client's employer retirement plan before the 60 days are completed. This would mean the Bobrow decision would not apply. Then you can transfer the money from the employer plan to an IRA without Bobrow implications. (You would not want to roll the money out of the employer retirement account because that would make it subject to the 20% mandatory withholding rules.) A second option would be to convert the traditional IRA rollover money into a Roth IRA within the 60 days allowed for a rollover. The distribution is still taxable, but at least it stays in a retirement account and can continue growing for retirement. Also, the 10% early withdrawal penalty (EWP) would be avoided. A third option would be to live on the disallowed IRA rollover money in order to fund new contributions

to the client's IRA and/or employer retirement accounts. This option offsets the income tax on the Bobrow distribution but it does not deal with the 10% EWP until all the Bobrow withdrawal is offset. A Bobrow IRA distribution has been called a "fatal error" because this money is no longer retirement money and thus it cannot continue to grow for retirement needs. Also, Bobrow money is completely income taxed and subject to the 10% EWP rules. However, if new money is contributed to the client's employer retirement plan or IRA, those contributions would essentially offset the income tax on the disallowed IRA rollover and could eventually lower the 10% penalty). More importantly, the equivalent of the principal lost would be returned to the client's retirement accounts. For married couples with IRAs and employer retirement accounts that accept salary deferrals who are not already maximizing their contributions, a lot of the Bobrow withdrawal can be offset. For especially large IRA withdrawals, multiple years of large IRA and employer contributions can used to restore the Bobrow principal withdrawn.

EXAMPLE: Bobrow Distribution

Joe, age 45 and married, received a second IRA withdrawal on March 15th of this year for $10,000. He is contributing $2,000/year into his 401(k), but nothing to his IRA. If he lived on some of the $10,000 IRA distribution each month for the rest of this year, he could afford to increase his 401(k) contributions for his year to a total of $12,000. Thus, he would offset all the income taxes he owes on the unintended $10,000 IRA withdrawal. To be clear, he will be income taxed on the $10,000 IRA rollover attempt that was disallowed, but his W-2 will have $10,000 less after he increased his 401(k) contributions for this year BY $10,000. He is still on the hook for the $1,000 EWP, but at least his $10,000 of retirement principal is back working for his retirement. Also, if he made additional deductible IRA contributions for himself or his spouse, they would essentially eat into his $1,000 early withdrawal penalty. For example, if he was in the 22% marginal tax bracket and in addition to deferring a new $10,000 into his 401(k), they contributed $6,000 into a deductible IRA, then their total tax bill would be $320 LESS than before the Bobrow withdrawal. In this case their Form 1040 would show a $1,000 early withdrawal penalty and a $10,000 taxable rollover. However, his W-2 would be $10,000 less than before implementing this plan and then they would have a $6,000 IRA deduction they were not planning on before attempting the disallowed IRA rollover. In this scenario their total tax bill would drop by $320 because the first $4,545 of deductible IRA contributions offset the $1,000 EWP ($1,000 ÷ .22 = $4,545). The remaining $1,455 of deductible IRA contributions lowered their tax bill by $320 ($1,455 × .22 = $320).

Since they have the money on hand from the disallowed rollover attempt, this strategy of living on the principal to fund future contributions to their retirement account does not have to stop after the year of the distribution. What if the disallowed rollover was so large the entire rollover account could not be offset in the year of the distribution? In that case, the client could make the maximum available offsetting contributions for this year and then continue funding large IRA or retirement plan contributions in the next year. In the year of the distribution, they would be subject to the 10% EWP the same as always and they would be effectively taxed on the net

> amount that was not offset. However, their large contributions in the next year would lower their income tax in that year. Eventually, the equivalent of all the Bobrow withdrawal money could be returned to the client's retirement accounts.

The following rules apply to all rollovers and direct transfers:

- Both the transferor and transferee plans must satisfy statutory requirements for treatment as an eligible retirement plan or IRA.
- Required minimum distributions (RMDs), withdrawals from electing out of automatic contribution arrangements, the return of an excess contribution, and hardship withdrawals may not be rolled over.

In addition, a distribution from a qualified plan, a Section 403(b) plan, or a Section 457 plan or IRA cannot be rolled over if it is made by reason of the substantially equal periodic payment exception (IRC Section 72(t)) to the 10% premature distribution penalty rules.

Rollovers and direct rollovers are allowed among all qualified plans, Section 403(b) plans, IRAs, and Section 457 plans. The following chart summarizes allowable rollovers.

Allowable Rollovers*

Type of Distribution	Rollover Allowed To
1. From qualified plan	a qualified plan, Section 403(b), or Section 457 plan or IRA
2. From Section 403(b) Plan (TDA or TSA)	a qualified plan, Section 403(b), or Section 457 plan or IRA
3. From Section 457 Plan (governmental)	a qualified plan, Section 403(b), or Section 457 plan or IRA
4. Pursuant to a qualified domestic relations order (QDRO)	a qualified plan, Section 403(b), or Section 457 plan or IRA
5. From SIMPLE IRA (after two years of participation)	a qualified plan, Section 403(b), or Section 457 plan or IRA
6. From SIMPLE IRA (during first two years of participation)	a SIMPLE IRA only
7. From Section 457 plan (nongovernmental)	a Section 457 plan only
8. From after-tax contributions to a qualified plan or Section 403(b) plan	an IRA, Section 403(b), or a direct transfer to a defined contribution or defined benefit plan (separate account)
9. From after-tax contributions to an IRA	an IRA only

*Note: Since December 18, 2015, eligible distributions from an employer-sponsored plan or an IRA may be rolled over to a SIMPLE if the SIMPLE has existed for two years.

While plans are required to provide participants with the option of rolling over distributions by transferring them directly to another plan or IRA, there is no requirement that the transferee plan must accept the rollover contribution. One reason a retirement plan might not allow a transfer or rollover from another retirement plan is the receiving retirement plan has had documentation issues with

transfers and rollovers from other plans. For example, contributions and earnings in a retirement plan should be coded according to their source (employer contributions vs. employee contribution, etc.). Without this information, the new plan can have problems with issues such as how much is eligible for hardship withdrawals. Some plans handle this uncertainty by not allowing transfers or rollovers. Thus, before assuming that one qualified plan distribution may be rolled to another qualified plan, it is best to check with the new plan administrator.

Participants can make direct transfers of distributions from their qualified plans, Section 403(b) plans, and governmental Section 457 plans to Roth IRAs. Any such transfer is subject to the Roth IRA conversion rules in effect at the time of the transfer. There is no modified adjusted gross income limit for taxpayers making conversion transfers.

Finally, an employee-participant is not required to roll over the entire amount received from a qualified plan or IRA. The participant may roll over only a portion. To the extent of the amount rolled over properly, the distribution is nontaxable and is not counted as a contribution to a recipient plan (annual additions limit) or IRA (annual limit). Alternatively, the taxable portion of any amount not rolled over properly is treated as ordinary income and is subject to the 10% early withdrawal penalty as discussed in Modules 5 and 7.

Which Form of Distribution Should a Client Elect?

The threshold question for any qualified plan participant who has any of the three distribution options—lump-sum, annuity, or rollover—available is "which one do I choose?" There is no one simple answer to this question as it depends on a number of factors, including future income tax rates. But there are some basic questions to be considered:

- How will the benefit be used by the participant? For example, if the plan offers a lump-sum distribution payout, and the participant wants to buy a vacation home with his retirement benefit, the lump-sum distribution may seem like be the best choice, but the tax consequences of doing so should be considered.
- Does the participant need the principal of the retirement benefits or just the income to support her anticipated retirement lifestyle? If choosing the lump-sum distribution or rollover option, the participant assumes the risk of superannuation or the risk of outliving her money. This is not an issue if an annuity or periodic payment is taken, so long as it is not over a fixed period, but rather over the participant's life.
- What is the amount of the retirement distribution? Certainly, from a tax deferral standpoint, either the annuity or rollover is best. If a lump-sum distribution is chosen, taxes need to be paid immediately, which will deplete the retiree's resources sooner.
- What is the anticipated life expectancy of the participant? The amount to which a rollover distribution accumulates is dependent on a longer participant life expectancy. As a general rule, the younger the participant is when separating from service (and generally eligible for a distribution), the more advantageous is the rollover option so as to achieve maximum compounding of tax-deferred dollars.

Retirement Distribution Strategies

Selecting a retirement distribution strategy can be extremely complex. First, the stakes are huge. The number one issue in retirement is always preventing the client

from running out of income. Technically, this is not possible for someone with a Social Security benefit, but Social Security benefits alone will not be enough for most, especially when the surviving spouse is only receiving one Social Security check. Second, the strategy should depend on several factors like the amount of guaranteed income, the person or couple's life expectancy, the ratio of mandatory expenses to discretionary expenses, fear of inflation, expected investment returns, and risk tolerance.

One retirement distribution model starts with a detailed monthly retirement budget with a large miscellaneous category to cover unexpected expenses. Then all guaranteed income sources (Social Security benefits, traditional defined benefit pension amounts, military retirement, and previously annuitized monthly benefits) are subtracted from the budget. This produces the monthly shortfall. To address the monthly shortfall, the planner assumes 100% of retirement benefits are annuitized with the type of annuity the client would select. For example, a married client might decide that *if* they annuitized, they would choose a joint life annuity with a 66% survivor annuity and a 15-year period certain. Then the monthly annuity would be calculated if every retirement asset was annuitized with this payout structure. For a married couple, it is important to run these trials three ways: while both are alive, if the husband dies first, and if the wife dies first. All three scenarios must be positive to say a person is financially prepared for retirement on the assumed budget. The results would suggest the following distribution strategies:

- If the monthly annuity amount was less than the retirement shortfall, then the client would not be financially capable of retiring with the projected monthly budget. The client must either delay retirement, work part-time in retirement to make up the shortfall, or cut the budget. Without these adjustments the client would be in grave danger of running out of money later in retirement.
- If the monthly annuity amount just covers the retirement shortfall, the client is financially able to retire with this level of income if they actually choose to annuitize all their retirement assets. The good news is that their income is locked in for their entire lives. Also, their Social Security benefits would be inflation-adjusted. However, there is also plenty of bad news. They will lose all control of their retirement investments. They will also have a major risk from inflation, and they will not have a financial legacy unless they both pass away before a period certain or refund option has matured. In all, clients who choose to annuitize 100% of their retirement assets face a declining lifestyle over the years as inflation decreases their purchasing power. While this is not an appealing prospect, guaranteeing a certain amount of income over Social Security retirement benefits is far better than running out of all non-Social Security income. A 100% annuity does benefit those whose retirement preparations have shown they are not adequate savers and investors relative to their needs, and an annuitized asset is less susceptible to elder abuse. Despite the benefits, 100% annuitization should be thought of as an emergency level for an unexpected or forced retirement.
- If the monthly annuity amount more than adequately covers the retirement shortfall, the client is financially able to retire with their projected budget without annuitizing 100% of their retirement assets. For example, if the annuitized amount gave them 150% of their retirement shortfall, they could

annuitize two-thirds of their retirement assets with the features they selected and still have a third of their retirement assets as a strategic reserve or as source of discretionary income. The good news is that their basic retirement budget would be covered without losing control of all their retirement assets, and they have a cushion from the remaining assets.

- If the retirement shortfall could be covered by a 4% withdrawal from their retirement assets, then the clients could decide not to annuitize anything and live off some sort of systematic withdrawal or bucket approach. This level of retirement preparedness provides the most options for investment management in retirement and offers the highest legacy possibilities. However, people in this category must vigilantly manage their withdrawals to prevent running out of money.

A second distribution strategy applicable to non-annuitized money is to pay attention to the location of the retirement money. For example, 401(k), traditional IRA, and Roth IRA assets are clearly available to fund retirement expenses. However, there are many other types of assets that can be employed to fund retirement. These include nonqualified annuities, life insurance cash values, non-retirement investment accounts, income from the ownership of a business, and installment payments from the sale of an asset. One simple model for retirement distributions is to spend taxable assets, then tax-deferred assets, then tax-free assets. For example, a widow has money in her brokerage account, a traditional IRA, and a Roth IRA. A simple model would be to spend the brokerage account first until it is totally depleted. Then she would spend the tax-deferred account. Finally, she would take withdrawals from her Roth IRA. Why choose this order? First, the taxable investments are producing taxable income each year. Living off these assets first means they will not produce taxable income in the future. Second, taxable accounts are not taxed on the return of principal, thus, withdrawals from taxable accounts are only income taxed on dividends, interest, and capital gains. Plus qualified dividends and capital gains are taxed at preferential rates. Living off the taxable investments initially gives the tax-deferred and tax-free assets time to grow without current taxation. When the after-tax investments are completely spent, the next withdrawals come from the tax deferred accounts. First, the tax-deferred accounts will have RMDs for retirees starting at age 72. Spending the tax-deferred money before age 72 reduces RMDs. The last source of withdrawals in this model is tax-free, also called *tax-exempt*.

For example, Grandma retired at 65. She only trusts the ABC Fund. In fact, she has $150,000 in the ABC Fund outside of her retirement accounts. These accounts are taxable/after-tax investments. She also has $300,000 in her traditional IRA invested in the ABC Fund and another $400,000 in her Roth IRA in the ABC Fund. By this model she should spend down the $150,000 account until it is completely depleted. This leaves the traditional and Roth IRAs alone to grow for later. She would be forced to start taking RMDs from the traditional IRA when she turns 72, but the model still is essentially spending the taxable/after-tax accounts first, then tax-deferred, then tax-free (tax-exempt).

A final model would be taking distributions from the various types of accounts in an annual manner that is mindful of current taxation and the behavior of the market. This model starts with the traditional after-tax, tax-deferred, then Roth approach but

makes modifications as appropriate. For example, if the market was way down, a qualified distribution from a Roth account would be tax-free and thus would require a smaller withdrawal to fund a certain after-tax spending amount. Thus, a retiree in the 22% MTB would need to withdraw $1,282 from their traditional IRA to have $1,000 after-tax to fund $1,000 of retirement spending. If the fund had a NAV of $10, it would require the sale of 128.2 shares to produce $1,282 of taxable income sufficient to pay the income tax and provide the $1,000 of retirement spending ($282 to pay the tax and $1,000 for spending). However, if the account was a Roth account, it would only require 100 shares to produce the $1,000 after-tax for the retirement spending ($0 for tax and $1,000 for spending). Thus, a Roth account with qualified distributions should last around 25–30% longer than a traditional IRA that produced the same after-tax income for retirement for this retiree. In other words, choosing to take withdrawals from a Roth account when the market is way down can combat sequence of return risk. Why did it take 28.2% more from the traditional IRA, when the client was in the 22% tax bracket? Because the amount required to pay the 22% tax was also taxed. In all, this model says take from the tax-deferred account like usual when the market is up and they can offer the income taxes, but take money from the Roth account (even when there was still money in the tax-deferred account) when the market is down to combat sequence of return risk.

Another technique in this model would be to fill up lower tax brackets, especially in the early years, with Roth conversions. The hope is to reduce overall taxes throughout retirement. For example, a 68-year-old retiree with a lot of money in a traditional IRA whose taxable income was going to be $10,000 below the next tax bracket could convert $10,000 to a Roth account for the year. This would fill up the lower tax bracket now and reduce the eventual tax bracket later. This idea would also lower RMDs from the remaining traditional IRA starting when the retiree turns 72. It would also remove this converted money and its future earnings from RMD considerations until the retiree passed away. The idea sounds wonderful; however, the current tax brackets are much more compressed. For example, there is a 10% difference from the 12% bracket and the 22% bracket, but the remaining federal brackets are 22%, 24%, 32%, 35%, and 37%. There is an 8% difference between 24% and 32%, but the other differences are pretty small. Also, the advisor should ensure that making a large conversion at the lower tax bracket would not mean more of the client's Social Security income would be taxed. This is called the Social Security "tax torpedo." Clients in higher brackets are already past the point where the maximum amount of their Social Security benefits are already taxed. On the other hand, this technique could be more profitable in states with high income tax rates. Another issue with this order of spending is that a client might want to save a highly appreciated asset to pass on to heirs with a stepped-up basis.

In all, distribution strategies can be highly complicated. However, complicated retirement distribution strategies are beyond the scope of the CFP Board exam.

Two final issues: Emergency funds are extremely critical for proper retirement preparations. Retirees still have unexpected expenses. Second, while saving *for* retirement ends at retirement, there is still a need to save *in* retirement. For example, a retiree is likely to need a new car at some time in retirement. Thus, a car down payment fund should be a part of the retirement budget. The same goes for home and vehicle maintenance.

TEST TIP

If a test question simply asks for the basic order of retirement withdrawals, the answer would be taxable accounts, then tax-deferred accounts, then tax-free/tax exempt accounts.

Reading: Net Unrealized Appreciation

LO 6.1.2: Interpret the tax consequences of net unrealized appreciation (NUA).

The **net unrealized appreciation (NUA)** tax concept has already been discussed several times in this course. A taxpayer who, upon formal separation from service, receives a lump-sum distribution from a qualified retirement plan of employer stock into a taxable brokerage account, will not be liable for income tax on the net unrealized appreciation portion of the distribution until the stock is sold or otherwise disposed of. Furthermore, the NUA portion of the stock is always taxed at long-term capital gains rates, as opposed to ordinary income tax rates, upon disposition.

NUA is defined as the excess of the fair market value (FMV) of employer securities distributed over the cost or basis of the securities to the retirement plan trust, typically the total value of the securities at the time of employer contribution to the ESOP, stock bonus plan, or 401(k). This initial cost or basis of the securities is taxed as ordinary income in the year of distribution. The NUA portion at the time of the lump-sum distribution will always be taxed as a long-term capital gain (LTCG), regardless of the holding period after the lump-sum distribution, even after death (as an Income in Respect of Decedent asset) to beneficiaries (at their LTCG rate).

While increasingly less relevant every year, there are two additional favorable tax treatments potentially available as a lump-sum treatment from a qualified plan participant. For participants born before January 2, 1936, with at least five years of participation in the plan, 10-year forward averaging may be elected. Because the birth date requirement for these tax treatments is before January 2, 1936, an extremely small number of participants now qualify; we will not get into detail of these elections for CFP® exam purposes. The same thing is true for the third type of special taxation that is available for capital gains from pre-1974 contributions. You are only responsible for knowing that it exists for lump sum distributions. Also, you should only apply this knowledge if a test question specifically addresses it. For example, a test question asks if one tax characteristic of all distributions from retirement accounts is that they are taxed as ordinary income. This is true for test purposes because capital gains treatment for pre-1974 contributions is a very technical issue that only involves a tiny fraction of people and the test question is not designed to go to that depth. Next, these elections are not available for distributions from IRAs or tax-advantaged plans. However, 403(b) and 457 plans are allowed to offer retirement plan loans.

EXAMPLE: Net unrealized appreciation

Andrew received a lump-sum distribution of 10,000 shares of stock from his employer's ESOP plan, valued at $1 million. The value of these shares contributed over the years was $250,000 (basis to the trust). Of this, $750,000 ($1 million – $250,000) is treated as NUA and NUA is not taxed immediately on distribution from the retirement plan. The basis amount of $250,000 is immediately taxed as ordinary income in the year of the lump-sum distribution. Andrew's adjusted basis in these shares now equals $250,000 (the amount of the ordinary income that was taxed at distribution—in this case, $25/share). When Andrew subsequently sells the stock, the $750,000 NUA amount is taxed as long-term capital gain and any appreciation on the shares that has occurred after the lump-sum distribution date will be subject to either short-term or long-term capital gains, depending on the holding period from the initial distribution. If Andrew holds the stock at least a year and a day after the distribution, then all gains will be long-term capital gains. If he sells the stock before a year and a day after the distribution, any gain after the day of distribution is taxed as short-term capital gain. Any stock sold for a price below the date of distribution price would mean the loss would be in the form of less NUA long-term capital gains.

Note that, in the event employer stock is distributed from a qualified plan before the participant's death, the NUA portion does not receive a step-up in basis. Rather, it is treated as income in respect of a decedent, to be discussed in the *FP516: Estate Planning* course of this program. Any additional appreciation in the stock, once removed from the plan, is eligible for a step-up in basis at the employee's death under the step-up to FMV rules in effect on the date of the participant's death. As a result, the basis of the stock to the beneficiary is usually equal to the FMV of the stock at the participant's death, less the amount that is treated as NUA. Finally, if the individual separates from service after attaining age 55, then the ordinary income amount from the basis in the stock is not subject to the 10% EWP.

TEST TIP

Note that NUA treatment is not available to a tax-advantaged plan. In fact, the ability to offer loans and NUA treatment are major advantages for applicable qualified plans over tax-advantaged plans.

TOPIC 6.2: REQUIRED MINIMUM DISTRIBUTIONS

Reading: Required Beginning Date (RBD) for Required Minimum Distributions (RMDs)

LO 6.2.1: Examine the relationship between the required beginning date for an individual and the required minimum distributions.

The **required beginning date (RBD)** for the first distribution from a qualified plan, Section 403(b), Section 457 plan or traditional IRA is April 1 of the year following the year in which the retired plan participant (or owner of the IRA) becomes age

72. Note that Roth IRAs are not subject to RMDs during the life of the original owner. Roth IRAs do become subject to RMDs when the original owner dies and the beneficiary gets the account. Employer Roth accounts, like a Roth 401(k), are subject to the RMD rules for the original account owner. The year in which someone turns 72 is called the **trigger year**. While the trigger year is the first year most employer retirement plan participants and all traditional IRA owners must start **required minimum distributions (RMDs)**, there is special rule for the deadline for the first RMD payment. The first RMD amount is not due until April 1 of the year following the trigger year. For example, Antonio turned 72 this year. His full RMD for this year (his trigger year) must be taken by April 1st of next year. He will not have any adverse tax implications for this year if he has not withdrawn his entire RMD amount for this year by the end of this year. There will be no income tax penalty on his IRS Form 1040 for this year, but there will be implications for next year. Whatever shortfall remains for this year's RMD must be withdrawn by April 1st of next year or Antonio will have a 50% penalty on the shortfall for this year's RMD amount. For example, if his RMD for this year was $10,000, but he had only withdrawn $4,000 by April 1st of next year, then his shortfall would be $6,000 for this year's RMD and the 50% penalty would be $3,000 on next year's Form 1040.

After the trigger year, all subsequent RMD distributions must be made by December 31 of that year. This means that any RMD shortfall at the end of the trigger year will require the next year to have two RMD amounts. In the previous example, Antonio had a shortfall of $6,000 from this year's RMD. Thus, he effectively has two RMDs for next year. The $6,000 RMD must be withdrawn by April 1st of next year. Next year's RMD will be based on the account balance on December 31st of this year. It must be taken by December 31st of next year. Thus, different divisors and different account balances must be used in calculating the amount of RMD that is necessary for each RMD in the second year.

This raises the planning question: should a taxpayer delay the first distribution to the subsequent year? As a general rule, the answer to this question is *no*. Unless the retirement account has a basis or contains Roth assets, the distributions will be taxed as ordinary income. Thus, taking two required minimum distributions in the same tax year may increase the overall marginal tax rate for the client for the year. The second RMD may also increase the income taxation of Social Security benefits as described in Module 7.

There is a special rule for most employer plan participants who are still employed past age 72. Participants in qualified plans, Section 403(b) plans, and governmental Section 457 plans may defer the RBD until April 1 following the year of actual retirement, if the participant continues to work after age 72. In other words, in these types of plans (not any type of IRA), the participant's RBD for distributions is the later of April 1 following the year in which the participant attained age 72 or retired. This exception is not available, however, if the participant is a greater than 5% owner, either directly or through family attribution, of the business sponsoring the retirement plan. Family attribution means that the ownership held by other family members is added to the person's ownership to see if more than 5% of the firm is owned by that person. Family members are defined as the individual's spouse, children, grandchildren, and parents. Siblings do not count for family attribution purposes. For example, Rhonda owns 4% of the company she works for. However, her husband owns 10%. For the 5% test discussed here, she owns 14%. The intricate

details of the family attribution rules are beyond the scope of this course. Thus, employed business owners with more than 5% of the firm cannot delay RMDs from their employer's retirement plan like a rank-and-file worker can. Also, this rule for late retirement only applies to the retirement plan for the current employer. For example, Albert (who owns 5% or less of his current employer) is 72 and works for ABC Company. He also has his old 401(k) with a former employer, XYZ Company, and a traditional IRA. Albert will have an RMD for his traditional IRA and for his XYZ retirement plan, but he will not have an RMD from his ABC retirement plan. Albert's trigger year for his ABC retirement plan will be the year he retires. His RBD for that plan will be April 1 of the following year.

> **EXAMPLE: Required minimum distributions**
>
> Charles is a 50% partner with his brother in Specialty Sports. He reaches age 72 this year. Thus, he must begin taking distributions from the Specialty Sports profit-sharing plan no later than April 1st of next year, even though he may continue working full time at the company. Had Charles not been a greater than 5% owner, he could have elected to defer commencement of RMDs until April 1 of the year following his retirement date.

After distributions are required to begin from a qualified plan, Section 403(b) plan, governmental Section 457 plan, or IRA, if sufficient amounts are not withdrawn, a **50% penalty tax** is imposed on the difference in the amount of minimum distribution that should have been made and the amount of distribution that was made.

Reading: Calculating Required Minimum Distributions (RMDs)

LO 6.2.2: Calculate the required minimum distribution (RMD) for a given situation.

The RMD for any given year is calculated by dividing the participant's account balance as of the close of business on December 31 of the preceding year by an applicable divisor or distribution period. This divisor is determined by referencing the participant's age as of December 31 of the distribution year, in an IRS table known as the **Uniform Lifetime Table/Table III** (also known as Table 3). This table is always used to determine the RMD of all plan participants or IRA owners with one exception: if the participant's sole primary beneficiary for the retirement plan or IRA is the participant's spouse and the spouse is more than 10 years younger than the participant, then the actual joint life expectancies of the respective spouses may be used. The following table is a reproduction of the Uniform Lifetime Table. Before the SECURE Act, it could be tricky to determine the age used for the first RMD. Since 2020, for a retiree or traditional IRA, the age is always 72. For workers who own less than 5% of the firm and continue employment past age 72, the age to use for the retirement plan of their current employer only will be their age on their birthday for the year they actually retire or separate from service.

Table III (for use in 2022 and later)			
Uniform Lifetime Table			
Table for Determining Applicable Divisor for Minimum Distributions (Minimum Distribution Applicable Divisor)*			
Age	Applicable Divisor	Age	Applicable Divisor
70	29.1	93	10.1
71	28.2	94	9.5
72	27.4	95	8.9
73	26.5	96	8.4
74	25.5	97	7.8
75	24.6	98	7.3
76	23.7	99	6.8
77	22.9	100	6.4
78	22.0	101	6.0
79	21.1	102	5.6
80	20.2	103	5.2
81	19.4	104	4.9
82	18.5	105	4.6
83	17.7	106	4.3
84	16.8	107	4.1
85	16.0	108	3.9
86	15.2	109	3.7
87	14.4	110	3.5
88	13.7	111	3.4
89	12.9	112	3.3
90	12.2	113	3.1
91	11.5	114	3.0
92	10.8	115	2.9

* Use this table if the beneficiary is (1) someone other than spouse, or (2) a spouse who is no more than 10 years younger than the participant.

> **EXAMPLE: Required minimum distribution**
>
> Barney attained age of 72 this year. If his IRA account balance was $500,000 on December 31st of last year (remember to use the prior year's account balance), his RMD will be $18,248 ($500,000 divided by 27.4). This is the result even though Barney can delay this year's RMD until April 1st next year, with no penalty, if he chooses. (Note: If Barney must take two RMDs next year, his second RMD, required to be taken by December 31st of next year, would be calculated by dividing his December 31st this year, account balance by 26.5 because he would be 73 years old on December 31st of next year.)

It is important to recognize that the Uniform Lifetime Table, also called *Table III*, is designed to liquidate your client's account balance over the joint and survivor life expectancy of the owner and a hypothetical beneficiary who is 10 years younger

than the participant, recalculated annually. For retired individuals who need their RMDs to support themselves in their accustomed standard of living throughout their retirement years, this should be comforting. Taking RMD amounts is not designed to liquidate the person's entire account balance during the person's life.

As mentioned earlier, there is a special RMD table for original retirement plan owners whose spouses are more than 10 years younger than the owner. The divisors found in this table will be larger than the ones from the Uniform Table and thus result in a smaller RMD each year that reflects the increased life expectancy of the younger spouse.

There are three RMD tables. In addition to the two RMD tables previously discussed for living original owners, there is also an RMD table for those who inherit an IRA or employer retirement plan.

The technical names of the RMD tables are *Table I, single life expectancy table for use by beneficiaries*, *Table II, the joint and last survivor expectancy table, (For Use by Owners Whose Spouses Are More Than 10 Years Younger and Are the Sole Beneficiaries of Their IRAs),* and *Table III, the Uniform Table, (For Use by: Unmarried Owners, Married Owners Whose Spouses aren't More Than 10 Years Younger, and Married Owners Whose Spouses aren't the Sole Beneficiaries of Their IRAs).* This includes single filers and heads of households.

TEST TIP

Notice that the IRS lists these tables in a way most people consider backwards. The vast majority of living account owners use Table III (whether they are single or married). However, people actually married to someone more than 10 years younger use Table II. Then, when the original owner dies, everyone uses Table I. This ordering can be thought of as a countdown for a rocket launch: "3, 2, 1!" After this countdown, the account is no longer tied to the original owner or the initial beneficiary.

TEST TIP

It is important to be especially careful when reading a question about the initial RMD taken. If this year is the year the person turns 72, this year is called the *trigger year*. There is a major difference between asking "What is the RMD *for* this year?" and "What is the RMD that must be taken *in* this year?" The RMD for a year is the whole RMD. The RMD amount that must actually be taken in the trigger year is zero. This is true because the owner has until April 1 of the next year to finish the RMD for the trigger year. This is not a trick question. Clients need to know the difference for two reasons. First, for the original RMD year, clients who inadvertently fail to take their full trigger year RMD can escape the penalty by finishing it by April 1 of the next year. Second, the ability to control the timing of the RMD for the trigger year and the following year provides a tax planning opportunity. Note that this distinction might be made on the national CFP® exam.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

2. Sam, age 73, must take an RMD from his IRA this year. The calculated RMD for the year is $22,867. Sam withdraws $18,456 from his IRA for the year and no more. How much excise tax is Sam required to pay?
   A. $0
   B. $4,411
   C. $2,205.50
   D. $3,308.25

Answer the following questions using the following facts:

Danielle, who turned age 72 this year, owns 10% of The Moore Company. She has accumulated $5 million in Moore's 401(k) as of December 31st last year and $5.5 million as of December 31st this year. The applicable divisor for age 72 is 27.4.

3. What is the RMD, if any, Danielle must receive for this year?
   A. $0
   B. $182,482
   C. $195,313
   D. $200,730
4. If Danielle receives a distribution of $160,000 during this year, how much in penalties, if any, will she be required to pay on her tax return for this year, assuming she files this year's tax return on March 15th next year?
   A. $0
   B. $5,372
   C. $11,241
   D. $20,365
5. Which of the following statements regarding Danielle is CORRECT?
   A. If she continues to work for Moore Company, she is permitted to defer her RMD until after she retires.
   B. She can roll her account balance into a rollover IRA when she terminates employment.
   C. If she rolls her account balance into a rollover IRA and she does not commingle the funds with other IRA funds, subsequent distributions from the IRA will be taxed as long-term capital gain.
   D. If she takes her RMD for this year by April 1 of next year, she will not be required to take any other distributions next year.

TOPIC 6.3: EARLY DISTRIBUTIONS AND LOANS

Reading: Early Distribution Penalties and Penalty Exceptions for Qualified Plans and Section 403(b) Plans

LO 6.3.1: Determine the early distribution penalty for qualified plans and Section 403(b) plans as well as exceptions to this penalty.

Like IRAs, distributions taken from a qualified or Section 403(b) plan before the owner attains age 59½ are subject to an **early distribution penalty** of 10% (also known as the early withdrawal penalty or EWP) on the taxable portion of the distribution (in addition to ordinary income tax). However, also like IRAs, there are notable exceptions to the imposition of this 10% penalty. If any of the following circumstances are the reason for the distribution from a qualified plan, the penalty will not be imposed:

- Made on or after the attainment of age 59½
- Made because of the owner's total and permanent disability
- Made to the owner's beneficiary or estate due to the owner's death
- With respect to IRC Section 72(t), distributions made as a part of substantially equal periodic payments at least annually over the life expectancy of the owner, or the owner and a designated beneficiary; in addition, these payments, once begun, must continue for the greater of five years or until the owner attains the age of 59½
- Made for medical expenses exceeding 7.5% of the owner's AGI
- Made after separation from service from the employer after attainment of age 55
  - Note: *Attainment of age 55* means the person is age 55 by December 31 of the year of separation. For example, Mary left XYZ Company on June 3. She turned 55 on December 27 of that year. Because she is 55 in the year of separation, she is not subject to the 10% early withdrawal penalty from her qualified plan or 403(b). She would be subject to the 10% penalty for distributions from an IRA or another employer's retirement plan until she turns 59½.
- Made to a qualifying family member under a qualified domestic relations order (QDRO), or a separate maintenance agreement. A QDRO is a court order signed by a matrimonial judge, and will be discussed later in this course.

Note that six of these exceptions are the same as for IRAs as mentioned in the previous module.

PROFESSOR'S NOTE

The separation from service after attainment of age 55 exception, as well as the QDRO exception, are applicable only to qualified plan and 403(b) distributions. Also, ESOP dividends directly paid to plan participants are subject to ordinary income tax, but are exempt from the 10% EWP. Furthermore, IRA premature distribution exceptions for higher education costs, first-time home buyer costs, and paying for

health insurance premiums while the owner is unemployed (assuming the owner has filed for unemployment), do not apply to distributions made from a qualified plan or 403(b).

Reading: Loans from Qualified Plans, Section 403(b) Plans and Governmental Section 457 Plans

LO 6.3.2: Apply the rules and tax implications of loans from qualified plans, Section 403(b) plans, and governmental Section 457 plans.

To allow plan participants access to a portion of their vested retirement plan funds without incurring income tax or penalties, some plans allow provisions for plan loans. However, no type of IRA-funded plan may allow loans. Thus, SEP and SIMPLE IRAs cannot offer loans, but a SIMPLE 401(k) can. The most common type of plan to provide loan provisions is the traditional Section 401(k) plan.

Occasionally, Section 403(b) TSA plans and governmental Section 457 plans may allow loans. Because all retirement funding for a defined benefit plan comes from the employer, defined benefit plans rarely contain loan provisions. If a plan allows for loans, the IRC rules regarding repayment of the loan must be adhered to closely, or the loan may become a taxable distribution. Such a distribution results not only in income tax due, but in a 10% penalty, if made before the participant attains age 59½. The ability to take a retirement plan loan may help increase employee participation in 401(k) and 403(b) plans. Any increased participation by rank-and-file employees helps satisfy the nondiscrimination tests. For example, as the nonhighly compensated employees increase their plan contributions, highly compensated employees are allowed larger contributions while still passing the nondiscrimination tests.

Loans from a qualified, Section 403(b), or governmental Section 457 plan must be repaid within five years with interest. The only exception to this rule is when a plan loan is made to allow the participant to acquire a dwelling to be used as a principal residence. In this case, the loan must be repaid over a reasonable period (with the timeframe determined by the plan sponsor)—often 10 years. In addition, all loan repayments must be made in level installments at least quarterly.

Generally, plan loans are limited to half the vested account balance of the plan participant, not to exceed a dollar cap of $50,000. However, when the vested account balance is less than $20,000, loans up to $10,000 are available without regard to the half the vested account balance rule. Finally, when the vested balance is less than $10,000, the entire vested balance is available for a loan. The following table summarizes the maximum plan loans that are available based on the participant's account balance.

Vested Account Balance of Participant	Maximum Loan Amount Available
$10,000 or less	Vested account balance
$10,001–$20,000	$10,000
$20,001–$100,000	50% of vested account balance
More than $100,000	$50,000

The maximum loan balance must also be reduced further by the highest outstanding loan balance the participant had in the one-year period preceding the loan.

> **EXAMPLE: Qualified plan loan**
>
> Four years ago, Sharon borrowed $50,000 from her qualified plan. Last year, she made the final payment to satisfy the plan loan obligation. Her highest balance in the last 12 months was $10,000. Sharon now has a vested account balance of $300,000 and wants to borrow another $50,000. Because of the loan reduction rule, Sharon may only borrow $40,000. The $50,000 maximum loan amount must be reduced by $10,000, the outstanding loan balance in the last year.

Interest on a plan loan is treated for income tax purposes as consumer interest, meaning it is nondeductible. Also, even though the interest on a retirement plan loan is paid back to the plan participant's retirement account, a retirement plan loan is not income tax efficient in the sense that the retirement loan payments are after-tax money. The person does not get a deduction for the loan payments but the money from the loan is taxed when withdrawn. Thus, this money is taxed twice. First, it is taxed when earned and used to repay the retirement loan. The loan principal and interest are also taxed when withdrawn, unless an employer Roth account is used.

During some time periods in the past that were tied to certain federally declared disasters, Congress has allowed retirement plan loans due to these disasters to be made with different rules. For example, the 50% limit has been raised to 100% of the vested balance and the $50,000 limit has been raised to $100,000. Also, an additional year has been allowed to be tacked onto the loan repayment schedule. To date, these provisions have not been made permanent. Thus, students should not apply this information on a test unless the test question specifically addresses it.

One potential danger with a retirement plan loan is that an employee is almost always required by the employer's retirement plan document (not by the IRC) to accelerate the repayment of a loan if the worker stops working for the employer or the employer terminates the retirement plan. Usually, defaulted loan balances after a certain allowed repayment period are considered a *deemed distribution* from the retirement plan. By definition, a deemed distribution cannot be rolled into another employer retirement plan, a governmental 457 plan, or an IRA. That means the unpaid loan balance after the allowed period is subject to both income tax and the 10% early distribution penalty rules. The Tax Cut and Jobs Act of 2017 extended the repayment period for retirement plan loan defaults when a worker leaves their employer and when the retirement plan is terminated. In these two situations the worker has until the due date for their tax return for the year of the default, including extensions to get the money back into an employer retirement account or an IRA. Thus, these two groups of workers (former employees and current workers whose employer terminates the retirement plan) have a longer time to repay plan loans and, thereby reduce deemed distributions. This gives them an opportunity to keep more money inside their retirement accounts. The money placed in an IRA or new employer plan to replace either of these two types of loan default is considered a successful rollover and is called a qualified plan loan offset (QPLO). Additionally, if the new employer plan document allowes it, the actual loan (with the required amount to secure the loan) could be transferred into the new employer's retirement account and the payments could continue to the new employer's retirement plan.

The original loan would continue to be paid off as if nothing had changed. The option is not available for an IRA because IRAs are never allowed to offer loans.

Finally, the TCJA eliminated to the option to offer retirement plan loans using a credit card or similar arrangement.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

6. Which of the following distributions from a qualified plan would NOT be subject to the 10% early withdrawal penalty, assuming the participant has not attained age 59½ at the time of the distribution?
   I. Distribution for higher education costs for the taxpayer, spouse, child, or grandchild
   II. Distribution made to a qualifying family member under a QDRO
   III. Distribution made after separation from service from the employer after attainment of age 55
   IV. Distribution to pay employer-sponsored health insurance premiums on a pretax basis
   A. I and IV
   B. II and III
   C. III and IV
   D. I, II, and III
7. Which one of the following retirement plans generally has loan provisions?
   A. Defined benefit pension plans
   B. Money purchase pension plans
   C. Section 401(k) plans
   D. SEPs
8. Reggie and Jenny are both age 58 and have come to their financial planner, Jordan, a CFP® professional, for advice. Reggie was laid off from his job. He expects to be recalled to work within six months, as the layoff is to allow new machinery to be installed, after which time manufacturing will start again. In the meantime, unemployment benefits are not enough to meet their current financial needs. The couple is afraid of depleting their retirement assets to fill the gap but do not know what else to do. Reggie has an SEP plan account from his former employer with a balance of $360,000. Jenny has a Section 401(k) from her employer with a plan balance of $280,000 and it has loan provisions. They don't have a mortgage, but their savings account is being depleted by living expenses since Reggie ceased working. Which of the following is the best recommendation for Jordan to make to the couple?
   A. Take a distribution from Jenny's Section 401(k) plan for six months of expenses.
   B. Take substantially equal payments from Reggie's SEP until he attains age 59½.
   C. Jenny should take a loan from her Section 401(k) plan for the minimum amount needed.
   D. Reggie and Jenny should obtain a line of credit using their personal residence as collateral.

TOPIC 6.4: BENEFICIARY DESIGNATIONS AND SURVIVOR BENEFITS

Reading: Choice of Beneficiary for Qualified Plans, IRAs, Section 403(b) Plans, or Section 457 Plans

LO 6.4.1: Analyze a retirement plan scenario to determine outcomes with proposed beneficiary designations.

Note: Post-death required minimum distributions is a challenging subject. It is best to learn the options for a surviving spouse and a healthy adult child first. Next, know who can be an **eligible designated beneficiary (EDB)** and the problems involved when there is no designated beneficiary. Then, fill in the rest of the picture from there.

The choice of **beneficiary** for a qualified plan or IRA is not nearly as simple as most individuals think. Most married individuals automatically name their spouse as the beneficiary (which is a favored option under current law) and think little about what happens if the spouse does not survive the participant. The choice for unmarried individuals may also be difficult.

The manner in which qualified plan or IRA benefits are distributed when someone inherits a retirement account depends on these questions:

- Is there an EDB, designated beneficiary, or only a "beneficiary" on the account?
- Have RMDs already begun at the time of the participant-owner's death?
- Did the owner die before or after January 2, 2020?

For the RMD rules and stretching retirement assets, it is important to differentiate between a beneficiary, designated beneficiary, and EDB. Depending on a host of factors, any beneficiary can become the new owner of retirement assets following the death of the retirement account owner. However, a designated beneficiary is the person whose age and status might be used to calculate the RMD. A **designated beneficiary** must be a person or qualifying trust that is named by the original owner of the retirement account. This naming can be on a beneficiary designation form or it can be by the terms of the retirement plan document. The point is that the categories of beneficiary for stretching retirement assets (EDBs, designated beneficiaries, and beneficiaries) are different from the retirement account beneficiary designation forms. The account beneficiary designation forms held by the custodian of the account (primary and secondary beneficiaries) transfer ownership, but they do not automatically confer the categories for the ability to stretch the money under the SECURE Act. That is an independent appraisal of the situation at the owner's death. For example, when he opened his IRA account, Chappie James made his daughter the primary beneficiary and his older sister the secondary beneficiary. That means his daughter will receive the money if she is alive when Chappie dies. If she does not survive him, Chappie's older sister will get the money. Whether his daughter or his sister would be an EDB or not depends on their situation at his death. For example, if the daughter is a healthy adult when Chappie dies, she will only be a designated beneficiary. If his daughter predeceased him, his sister would

get the money as a secondary beneficiary. The older sister would be an EDB because she is not more than 10 years younger than Chappie. The point is the custodian's beneficiary designation form does not address the beneficiaries as regards their SECURE Act stretching categories. The beneficiary designation forms simply address who will receive the assets when the owner dies.

The SECURE Act added the category of EDB for deaths in 2020 and later. Thus, there are RMD rules for deaths before 2020 and RMD rules for deaths from 2020 on. Only the RMD rules for death in 2020 and later are highly testable. However, if the CFP Board exam asks about a death prior to 2020, treat a person like an EDB under the SECURE Act. Also, there are no changes under the SECURE Act for those who are spouses or just beneficiaries (estate or charity). There are five types of individuals who can qualify as EDBs: the surviving spouse; people not more than 10 years younger than the deceased (e.g., a sister 2 years older or a friend 8 years younger); a disabled person; a chronically ill person (similar to someone eligible for long-term care benefits); and a minor child of the decedent (not a grandchild unless the grandchild is adopted). The person's eligibility to be an EDB is determined on the date of death. The major advantage of being an EDB is that the person's life expectancy may be used to determine RMDs instead of the 10-year rule discussed next. For a minor child of the decedent, the use of a life expectancy factor to calculate the RMD ends at the age of majority. From that time on, the 10-year rule applies. The current proposed regulations say the age of majority is 21. This is very unlikely to change when the final regulations are set.

TEST TIP

The types of people who are EDBs can be remembered by thinking of "Mrs. T.D. McDonald."

Mrs. – Spouses. A surviving spouse can be an EDB as long as the spouse is the sole beneficiary of the retirement account. You cannot think of Mr. T.D. McDonald because he could be married or unmarried.

T. – Ten years as in "not more than ten years younger than the decedent owner." This is a sister six years younger or a friend four years older. This category reflects the fact that Table III (The Uniform Table) used by most living people assumes a hypothetical person 10 years younger. Thus, allowing these people to use their own life expectancies is not a major change from what was already happening. This category can be thought of as near peer age people.

D. – Disabled people. The test here is the same as Social Security. People must be totally and permanently disabled. "Permanently" means they must be expected to be disabled for at least a year or die due to the disabling event.

M – Minor children of the deceased. Notice this is not minor grandchildren. Also, the use of the minor child's life expectancy only lasts until the majority. The current proposed regulations define majority as age 21.

C – Chronically ill. Essentially this is like qualifying for long-term care insurance benefits (activities of daily living (ADLs) and dementia). It is not a chronic illness like diabetes.

A person who is not an EDB is legally considered a designated beneficiary. However, it can be wise to think of them informally as a "non-eligible designated beneficiary/NDB"—which is not an official term. Since 2020, being a designated beneficiary essentially means the survivor must completely drain the account by the end of the day on December 31 of the year containing the 10th anniversary of the owner's death. Note that this is actually 11 tax years, but it is called the 10-year rule. The most important type of designated beneficiary is a healthy adult child of the decedent (e.g., the decedent's healthy 45-year-old son).

For those who die before their required beginning date (RBD), the 10-year rule is very easy. It mirrors the five-year rule discussed below. Essentially, have the account at zero by December 31st of the year with the tenth anniversary of the death. However, if the decedent died on or after the RBD, then RMDs are a bit more complicated. Natalie Choate, perhaps the foremost authority on RMDs, says the 10-year rule for those dying on or after their RBDs is a two track system. The first track is annual RMDs starting the year after the death. In other words, the year of death has an RMD for the deceased based on Table III using the age of the deceased. Then we start the two-track system for deaths on or after the RBD. For Years 1–9, the RMD is based on the beneficiary's age in the year following the death. Determine the Table I factor for that age. Then reduce the factor by one for each subsequent year for Years 1–9. This annual years track is required because the law says the RMDs for this situation must stay "at least as rapidly" as before. The second track is for Year 10. The account must be emptied by the end of the year containing the tenth anniversary of the decedent's death. This is the same as the 10-year rule for decedents dying before their RBDs.

Under the SECURE Act, the remaining type of beneficiary is simply called a beneficiary. This is the least advantageous category. A designated beneficiary can usually at least stretch the inherited account 10 years. An EDB has the option to stretch the RMDs for a much longer time as detailed below. For deaths prior to the decedent's required beginning date (RBD), the beneficiary only has until December 31 of the year containing the fifth anniversary of the decedent's death. This is called the five-year rule. The two most prominent types of beneficiary (only) are charities and estates.

While a charity can be named as a beneficiary, by law, a charity is not allowed to be a designated beneficiary. However, this is not very important because the charity will want to receive the money quickly. Also, a charity is exempt from income taxes when receiving the retirement plan assets. Finally, the estate cannot be a designated beneficiary. The date for determining a designated beneficiary is September 30 of the year following the year of the participant-owner's death. The point of waiting until September 30 of the year following the year of the original owner's death is to allow those who want the money quickly to be distinguished from those who want to stretch the distributions out longer. For example, the client left 10% of his retirement account to a charity, 15% to his spendthrift brother (*spendthrift* meaning he has a problem living within his means), and the remaining 75% to his adult daughter. The charity would want the money right away and so would the spendthrift brother. Thus, the portions of the account going to the charity and the brother are likely to be gone before September 30 of the year following the year of death. Now, the healthy adult daughter would have the option to stretch the retirement assets according to the 10-year rule.

The September 30 date of the year following the year of the participant-owner's death is used to determine the identity of the designated beneficiary so a distribution may be calculated and made by the statutory deadline for a beginning qualified plan or IRA RMD distributions. The deadline for starting RMD distributions may be as early as December 31 of the year following the year of the participant-owner's death.

TEST TIP

There is a time line for RMD category determinations. Whether or not someone can be an EDB is determined on the date of death. Then, on September 30 of the year following the year of death, the question of who is the designated beneficiary is determined. In other words, becoming an EDB is a two-step process.

Example 1: Dad died today. He was 52, younger than his RBD. Mom is his primary beneficiary. As the spouse, she is eligible to be an EDB, but she would not officially become an EDB until September 30 of the year following the year of death.

Example 2: Mom died today. She was younger than her RBD. She had an IRA with her adult son as the sole beneficiary. The son was totally disabled six months after Mom's death. A healthy adult child is not eligible on the date of death to be an EDB. Thus, the son cannot become an EDB. When he became the designated beneficiary on September 30 of the year after the year of death he will fall under the 10-year rule.

Surviving Spouse as Eligible Designated Beneficiary

The participant-owner's spouse has more favorable tax alternatives available regarding required post-death distributions than any other individual beneficiary because a surviving spouse beneficiary may elect to be treated as the account owner or as the EDB.

While other EDBs must begin taking required distributions by December 31 of the year following the participant's death, the spouse (if the sole beneficiary) generally has other options, depending on whether or not death of the participant spouse occurred before the RBD or on or after the RBD for RMDs. Someone dying exactly on the RBD is in the later death category. The earlier category is for those who died before they were required to start distributions. If someone dies on or after the date she was required to start distributions, the second set of rules covered below takes effect. This applies to the participant's balance in a qualified plan, Section 403(b) plan, governmental Section 457 plan, or IRA.

Death Occurring Before the Required Beginning Date (RBD)

If the surviving spouse is the sole beneficiary of the plan, the surviving spouse can receive the retirement account as an inherited IRA. As an example, it may be titled "John Q. Public (deceased Jan 2, 2021) FBO Mary Public." Now Mary can take distributions at any age from this new account without being subject to the 10% early withdrawal penalty. She can also delay taking any distributions until

John would have been 72. When John would have been 72, Mary would have to start RMDs based on her current age at that time using Table I (Single Life Expectancy) and recalculate RMDs each year thereafter according to the figures in Table 1. For example, John died when he was 60 and Mary was 55. Mary had the account retitled as an inherited account. With this account, Mary could wait until John would have been 72. Her RMD for that year would be based on her age. She would recalculate it every year going forward. Only a surviving spouse EDB can recalculate their RMD every year. All other EDBs must use their initial Table I life expectancy and then subtract 1 from that factor for each subsequent year. This sounds very technical, but being able to return to Table I each year is a major advantage for a spouse who wants to stretch the account. Depending on the widow's age, recalculating slows the withdrawals by about a third.

The surviving spouse can also move the balance into her own employer retirement account if allowed, or into an IRA in her own name. In Mary's case, that would mean about five more years until she reached age 72 and was forced to start RMDs. However, once the money was in Mary's name, she would not be eligible for the exception to the 10% penalty due to death for any withdrawals prior to her turning 59½. She would still be eligible for the other exceptions. The surviving spouse can also elect to distribute the entire account balance within five years after the year of the owner's death (five-year rule). This election can be made only if the plan provisions allow the five-year rule.

Note: Roth IRAs do not have a RBD. Thus, if the original Roth IRA owner died at age 45 or 95, these would be the choices for a surviving spouse.

Death Occurring On or After the Required Beginning Date

The surviving spouse can roll over the plan balance into his own name and defer distributions until he attains age 72. With this approach, the surviving spouse's RMD situation is exactly the same as if they were always the original owner. Another option for the surviving spouse is to move the money to an inherited IRA, as mentioned earlier. If they move the money into an inherited account they have two options. First, they can base the RMDs on their own life using Table I, and thus recalculate the life expectancy each year based on their age. The other alternative for an inherited account would be to use the deceased owner's age as of the birthday in the year of death, then reduce the original life expectancy factor by one each year. Note the difference in choices before and after the RBD for inherited accounts. For deaths before the RBD, there is only one choice — the life expectancy of the surviving beneficiary. For deaths on or after the RBD, there are two choices for determining the life expectancy of an inherited account: the beneficiary or the deceased owner. Naturally, the person's life expectancy should be chosen to maximize the stretch by minimizing the RMDs going forward. This thought process is not unique to surviving spouses. It applies to any EDB.

Should a Surviving Spouse have an Inherited Account?

Which of these options is better? Should a surviving spouse move the money into their own name, or should they put the money into an inherited account? There are three essential factors involved in this decision.

- The first factor is the survivor's age. If the surviving spouse is under age 59½, moving the money into the surviving spouse's name removes the automatic exception from the 10% EWP. All withdrawals from an inherited account are automatically an exception from the 10% EWP because any distribution from an inherited account is defined as being due to a death.
- The second factor is the timing of the decedent's death relative to their required beginning date (RBD). If they die prior to their RBD, the first distribution from an inherited account can be delayed beyond the year following the year of death. For early deaths, the distribution from an inherited account can be delayed until the decedent would have been 72. For deaths on or after their RBD, inherited RMDs for a surviving spouse must start in the year following the year of death. If the money is moved into the spouse's name, the spouse's situation is the key RMDs in the following years. For early deaths, there are no RMDs for a surviving spouse EDB holding an inherited account until the year the decedent would have been 72. However, for late deaths, any RMD on money in the account on January 1 of a year must be taken before the remaining money can be moved to the surviving spouse EDB's own name. For example, Ichiro died this year at age 80. If there is money in an inherited account on January 1st of any next year, his widow would need to take her inherited RMD for that year and then she could transfer the remaining money into her own name. If Ichiro would have died prior to his RBD, his wife would have until December 31st of the year before the year Ichiro would have turned 72 to move the entire balance into her own name without first taking RMDs.
- The third factor is very subtle, but it is extremely important. This factor is which RMD table the surviving spouse will be under. Money in the surviving spouse's own name is under Table III or better. Table III calculates the life expectancy factor using the person's current age and someone ten years younger. If the widow remarries someone who is more than ten years younger, she would be under Table II (if he were the sole beneficiary). However, money in an inherited account is under Table I. Table I calculates the life expectancy of the inheritor only. Thus, Table III (and maybe eventually Table II) would be a better table to calculate low RMDs. For example, someone age 80 has a Table III life expectancy of 20.2 years. Under Table I the life expectancy for someone age 80 is 11.2. That means using Table III drops the RMD by almost 45% for someone age 80.

Bottom Lines:

1. If the surviving spouse is younger than 59½, using an inherited account means the 10% EWP will never apply to any withdrawals from the inherited account. Thus, you should start with an inherited account for a young surviving spouse EDB. Then, you will probably want to switch to move the money under the surviving spouse's name once they reach 59½.
2. When the surviving spouse EDB reaches 59½, it is almost always better to move the money into the surviving spouse's name for RMD purposes because the owner of a retirement account calculates RMDs using Table III (The Uniform Table), but an inheritor uses Table I (the single life expectancy table). Since Table III assumes the life expectancy of that person and a hypothetical person who is 10 years younger, Table III would give the smallest RMD.

3. Technically, instead of moving the money into the spouse's name when the spouse is 59½, the surviving spouse EDB could wait up until the year before RMDs would be required and then move the account into the spouse's own name. This depends on when the decedent passes relative to the decedent's required beginning date.
   - If the decedent passed before their RBD, the surviving spouse EDB has until the year before the year the decedent would have been 72. That way there would not be an RMD required for the year the money was moved.
   - If the decedent passed on or after their RBD, the surviving spouse must start receiving inherited RMDs in the year after the death. (For the year of death, the decedent's RMD was determined by the decedent's age in Table III. If the decedent had not taken their full RMD, then the inheritor must take the decedent's remaining RMD for the year of the death.) To avoid an inherited RMD for the year after the death, the surviving spouse EDB would need to move their money into their own name during the year of death. If the decedent is 72 or older, it is likely the surviving spouse is at least 59½ or will be soon. Surviving spouses of decedents who passed away on or after their RBD who are younger than 59½ would require assessing the situation.

PROFESSOR'S NOTE

RMD rules are one of the most difficult subjects in the CFP® exam program. Students should concentrate on learning the spouse's options as an EDB; a healthy adult child as a designated beneficiary; who can be an EDB; and what happens when there is no designated beneficiary first. Also, emphasize the difference between a beneficiary, a designated beneficiary, and an EDB.

Nonspouse as Eligible Designated Beneficiary

Thinking of "Mrs. T.D. McDonald" helps you remember who can be an EDB. Thus, a nonspouse EDB is someone not more than 10 years younger than the decedent; someone who was chronically ill or disabled on the date of death; or a minor child of the decedent. A minor child is only treated as an EDB until the age of majority. The proposed regulations set this age at 21. After that, the 10-year rule applies. As with everyone who inherits a retirement account or IRA, distribution options depend on whether death of the participant-owner occurred before or on/after the RBD for RMDs. In other words, if someone dies exactly on the RBD, then the rules are for those who die on or after the RBD. Those who die one day before their RBD or earlier use the rules for the earlier deaths. These rules apply to the participant's balance in a qualified plan, Section 403(b) plan, governmental Section 457 plan, or IRA.

Death Occurring Before the Required Beginning Date

For a nonspouse EDB, the distribution period is the remaining life expectancy of the nonspouse EDB. Life expectancy is calculated using the age of the nonspouse EDB in the year following the year of the decedent's death, reduced by one for each subsequent year. The RMDs start in the next year because the decedent was not old enough to have started RMDs.

The nonspouse EDB can also elect to distribute the entire account balance before the end of the fifth year following the year of the participant-owner's death (five-year rule). The five-year rule can be thought of as an escape method if the EDB did not take a required distribution and wanted to avoid the penalty. However, limiting the stretch to five years is a high price to pay for an EDB missing an early RMD.

Death Occurring On or After the Required Beginning Date

For a nonspouse EDB, the distribution must be distributed at least as rapidly as the longer of the remaining life expectancy of the designated beneficiary or the deceased owner's life expectancy that would have been applicable for RMD purposes. Life expectancy is calculated using the age of the nonspouse EDB in the year following the year of the employee's death, reduced by one for each subsequent year. For example, Benjamin O. Davis, Jr. passed away at age 79. He left an IRA to his older brother and another IRA to his sister who was five years younger. Since they are both "not more than 10 years younger" than Benjamin, they are both EDBs. Since he died on or after his RBD, the RMDs have already started. We use Benjamin's age in the year of death for his life expectancy. We compare that to the beneficiary's age in the year following his death. The brother would use Benjamin's life expectancy from Table I because Benjamin was younger than his brother. Benjamin's sister would use her own life expectancy because she was younger than Benjamin. After the initial RMD life expectancy is found in Table I all subsequent RMDs would subtract one from the previous year's life expectancy factor.

All beneficiaries are permitted to move death benefits from a qualified plan, Section 403(b) plan, governmental Section 457(b) plan, or IRA using a direct trustee-to-trustee transfer into an inherited IRA. No other contributions or rollovers may be made to the inherited IRA, and no rollovers may be made from the inherited IRA. Only allow transfers and never rollovers ensure that a disinterested third party is vouching that the money is actually inherited retirement money. Allowing a rollover to an inherited account would tempt the beneficiary to move money that was not inherited into an inherited account. This would totally bypass the 10% EWP because it would place the money into an account that was always exempt from the 10% EWP due to someone's death. The direct trustee-to-trustee transfer to an inherited IRA is permitted whether death occurred before or after the RBD. Taxable distributions from the inherited IRA are includable in the income for the tax year it is received.

The Situation for a Designated Beneficiary

A designated beneficiary is a person who does not qualify as an EDB. Although it is not an actual term, a designated beneficiary can be thought of as a "non-eligible designated beneficiary" or "NDB." They are people who do not meet any of the five categories of EDBs. The most important example is a healthy adult child of the decedent. The SECURE Act is expected to raise over $16 billion in the 2020s by creating this category. The main RMD rule for those who are only designated beneficiaries is the 10-year rule. The only requirement of the 10-year rule is that the inherited retirement account must be totally gone by December 31 of the year containing the 10th anniversary of the decedent's death. This is extremely important.

As discussed previously, for those who die before their required beginning date (RBD), the 10-year rule is very easy. Have the account at zero by December 31st of the year with the tenth anniversary of the death. However, if the decedent died on or after the RBD, then RMDs are a bit more complicated. First, there is an RMD for the year of death. This RMD is based on the decedent's age that year and Table III. This RMD is known at the first of the year. The year of death can be thought of as Year 0. Second, inherited RMDs will start the year following the year of death. For inherited RMDs, Natalie Choate describes the rules as a two track system. The first track is annual RMDs starting the year after the death. For Years 1–9, the RMD is based on the beneficiary's age in the year following the death. You determine the Table I factor for that age, then reduce the factor by one for each subsequent year for Years 1–9. The second track is for Year 10. The account must be emptied by the end of the year containing the tenth anniversary of the decedent's death. This is the same as the 10-year rule for decedents dying before their RBDs.

Qualifying Trust as Beneficiary

The use of trusts was greatly changed by the SECURE Act. Thus, an abundance of caution and qualified legal advice is needed before using a trust as the beneficiary of a retirement account in 2020 and beyond. If a **qualifying trust** is named as beneficiary, the beneficiaries of the trust could be treated as their correct categorization (EDB, designated beneficiary, or just a beneficiary) so long as

- the trust is valid under state law;
- the trust is irrevocable or will become so on the participant's death (such as revocable living trust);
- the beneficiaries of the trust are identifiable from the trust instrument; and
- appropriate documentation has been provided to the plan administrator (e.g., a copy of the trust document is given to the plan administrator at or before the participant's death).

Assuming all these requirements are met, and assuming the beneficiaries are nonspouse EDBs, the trust can then use the life expectancy of the oldest trust beneficiary as the measuring life upon which to calculate the minus one method. However, if the trust beneficiaries are only designated beneficiaries, then the 10-year rule would apply. In truth, the passage of the SECURE Act has greatly complicated the use of trusts as the beneficiary of a retirement account. Thus, proper legal help should be sought before using a trust as the beneficiary of a retirement account (employer retirement plan or IRA). This area is beyond the scope of the CFP program.

Qualifying Charity as Beneficiary

While a charity is only treated as a beneficiary for purposes of the post-death RMD rules, this is not really an important issue because the **qualifying public charity** will want the money immediately. First, their charitable operations always need funding. Second, a qualifying charity does not owe income tax. In addition, an unlimited deduction is allowed for transfer (estate and gift) tax purposes if the charity is named as the sole beneficiary at the participant's death. Actually, a non-Roth retirement account can be an excellent choice for a client who has charitable intentions. For example, if a client wanted to leave $100,000 to a charity,

it would be more tax efficient to leave the charity $100,000 in a traditional IRA instead of $100,000 of highly appreciated stock. It is better tax wise for the family member to get $100,000 of stock with a stepped-up basis than to receive $100,000 in a traditional retirement account. Withdrawals from the traditional (non-Roth) retirement account would be subject to income tax. The nonretirement asset that received a stepped-up basis would only owe income tax on gains over the date of death value.

On the other hand, leaving a Roth retirement account to a charity instead of other property is a terrible idea. With a Roth account that has already passed the five-year holding period test, family members are essentially income taxed like a charity. They do not owe any income tax or the 10% EWP on withdrawals (because these withdrawals would be qualified distributions). There are also no income tax implications on investment changes inside the inherited Roth account. Finally, inherited Roth IRAs are always under the rules for distributions for deaths prior to the RBD because there is no required beginning date for a Roth IRA for the original owner.

Estate as Beneficiary

It is usually not prudent to name the decedent's estate as the beneficiary of any qualified plan or IRA. This is generally because of the post-death RMD rules and the income tax rules. There could be probate considerations as well.

An estate cannot be treated as a designated beneficiary. If death occurs before the RBD, benefits payable to the estate have to be distributed under the five-year rule (either as a single lump sum or in installments, but fully distributed before the end of the fifth year following the year of the participant-owner's death).

If death occurs after the required beginning date, a single lump-sum distribution is still available, but any installment payments must continue over the deceased participant's remaining distribution period, reduced by one each year. The application of either of these rules (as compared to the stretching-out effect possible with a designated beneficiary) is usually not advantageous.

From an income tax perspective, the drawback of naming the estate as beneficiary is that an estate reaches the highest marginal income tax bracket after generating just $14,450 of taxable income in 2023. This is to be compared to an individual beneficiary designation where the individual does not reach the top marginal income tax bracket in 2023 until taxable income of $578,125 (single) or $693,750 (MFJ) is generated. The point is not to memorize the exact numbers at which additional income is taxed at the full rate. However, you should be wary of receiving taxable income from a retirement account as a non-qualifying trust or estate.

Separate Accounts for Separate Beneficiaries

For purposes of the post-death RMD rules, separate accounts are portions of a participant-owner's benefit representing the separate interests of beneficiaries under the plan as of the participant's date of death. The applicable distribution period is determined for each of these accounts based on their status as an EDB, designated beneficiary, or just a beneficiary. Also, in order to separate the various accounts,

the division should be made before December 31 of the year following the year of death.

For trust accounts, regulations state that if a qualifying trust is the beneficiary of the participant's plan interest, separate account treatment is not available to the trust beneficiaries. The IRS has repeatedly stated the establishment of separate shares does not entitle multiple beneficiaries of the same trust to use their own life expectancy as the applicable distribution period. Rather, the life expectancy of the oldest trust beneficiary (the shortest life expectancy) must be used. In all, since the passage of the SECURE Act, using a trust as the beneficiary of a retirement account or IRA requires legal advice that is well beyond the scope of this course.

Summary of the Postdeath Required Minimum Distribution Rules

The following is a summary of the RMD rules subsequent to a participant-owner's death and considers whether death occurred before or after the RBD for starting these distributions.

Beneficiary	Death Before RBD	Death on or After RBD
No designated beneficiary (includes charity, decedent's estate, and trusts with no designated beneficiary)	Five-year rule	Remaining distribution period of decedent, reduced by one each subsequent year
Nonspouse EDB*	(1) Remaining life expectancy of the beneficiary in the year following the year of death, reduced by one for each subsequent year, or (2) elect five-year rule, if plan provisions allow	Remaining life expectancy of the beneficiary in the year following the year of death, reduced by one for each subsequent year (may use owner's, if longer, had death not occurred)
Spouse EDB	(1) Distributions over spouse's remaining single life expectancy, beginning in the year the decedent would have attained age 72; (2) roll over and treat as spouse's own; or (3) elect five-year rule, if plan provisions allow	(1) Distributions over spouse's remaining single life expectancy, beginning in the year following the year of death recalculated using Table I; (2) distributions based on the deceased owner's age at death, reduced by one for each subsequent year beginning the year following the year of death; or (3) roll over and treat as spouse's own
Designated Beneficiary/ "Non-Eligible Designated Beneficiary"/"NDB"	10-year rule	"Two-Track" RMDs: for Years 1–9, use the beneficiary's age from Table I for the year after death, then subtract 1 for each subsequent year through Year 9. For Year 10, empty account by end of Year 10.

* A nonspouse EDB in a qualified plan, Section 403(b) plan, governmental Section 457 plan, or IRA also may transfer an inherited amount into an inherited IRA, preserving the right to take distributions over the non-spouse beneficiary's remaining life expectancy.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

9. Slade is age 68 and his spouse, Karla, is age 64. If Slade dies, what is the best option for his IRA if Karla wants to delay distributions as long as possible?
   A. Roll over his IRA to her IRA and take distributions based on her own RBD (age 72).
   B. Move the assets to an inherited IRA and take distributions when Slade would have reached age 72.
   C. Take the balance by the end of the fifth year following the year of death.
   D. Withdraw a lump sum and invest the money elsewhere.

10. Continuing with the facts of the previous question, assume that Karla dies instead of Slade. What is Slade's best option for Karla's IRA if he wants to delay distributions as long as possible?
   A. Roll over her IRA to his IRA and take distributions based on his own RBD (age 72).
   B. Move the assets to an inherited IRA and take distributions when Karla would have reached age 72.
   C. Take the balance by the end of the fifth year following the year of death.
   D. Withdraw a lump sum and invest the money elsewhere.

11. Monty has died and named his adult daughter, Shannon, as the beneficiary of his qualified plan. Monty had not begun making RMDs from this account because he died at age 62. Which of the following is an RMD rule for Shannon?
   A. She must start distributions by September 30 of the year following the year of Monty's death.
   B. She must start distributions by December 31 of the year of Monty's death.
   C. The account must be completely drained by the close of business on December 31 of the year containing the 10th anniversary of his death.
   D. The account must be completely drained by the close of business on December 31 of the year containing the 5th anniversary of his death.

12. Olga, an unmarried individual, recently died at age 67, leaving behind an IRA with a FMV of $200,000. Before her death, Olga named her daughter, Erica, age 41, as the beneficiary of her IRA. Now that Olga has died, Erica has come to you for advice with respect to how these IRA benefits should be distributed. What do you tell her?
   A. Erica can roll the IRA over into an inherited IRA and take distributions beginning at age 72.
   B. In the year following Olga's death, Erica must begin taking distributions from Olga's IRA based on Erica's remaining life expectancy, reduced by one each subsequent year.
   C. Erica must withdraw the entire account by December 31 of the year containing the 10th anniversary of Olga's death.
   D. As a nonspouse beneficiary, Erica must take a lump-sum distribution by the end of the year.

Reading: Automatic Survivor Benefits (QJSAs and QPSAs)

LO 6.4.2: Describe the automatic survivor benefits for plans in which they are required.

Under ERISA, all defined benefit plans and those defined contribution plans that are subject to minimum funding standards (e.g., money purchase and target benefit pension plans) must offer automatic survivor benefits. These automatic survivor benefits are in the form of

- a qualified joint and survivor annuity (QJSA); and
- a qualified preretirement survivor annuity (QPSA).

These automatic survivor benefits may also apply to any other defined contribution plan (such as a Section 401(k) plan) unless

- the plan provides that, at the participant's death, the vested account balance will be paid in full to the surviving spouse;
- the participant does not elect payments in the form of a life annuity; and
- with respect to such participant, the plan is not a direct or indirect transferee of a plan to which the automatic survivor annuity requirements apply.

The automatic survivor benefit rules do not apply to IRAs, but they do apply to Section 403(b) plans that match employee elective deferrals.

Plans that are subject to the automatic survivor benefit requirements must provide that, unless waived by the participant with the written consent of the spouse, retirement benefits will be paid in the form of a qualified joint and survivor annuity (QJSA). This means an annuity for the life of the participant, with a survivor annuity for the life of her spouse that is not less than 50% or greater than 100% of the amount of the annuity payable during the life of the participant.

In addition, such plans must provide that if a vested participant dies before the annuity starting date, leaving it to a surviving spouse beneficiary, benefits will be paid in the form of a qualified preretirement survivor annuity (QPSA). This means annuity payments for the life of the surviving spouse of the participant must begin no later than the month in which the participant would have reached the earliest retirement age under the plan, and is the actuarial equivalent of not less than half of the participant's vested account balance as of the assumed retirement date.

To elect any option that eliminates an automatic survivor benefit for a married participant's spouse, the participant and the spouse must consent on a notarized written form to waive the spousal right to the QJSA or QPSA. Another option to waive the spousal benefit would be the spouse signing a document waiving the spousal benefit in the presence of a an official of the retirement plan.

A couple needs to be married for at least a year before the spouse actually has the QJSA/QPSA rights. The point of these rules is to protect the rights of the spouse who helped the employer have a profitable business. It would be hard to give much credit to a new spouse who married the retiring worker shortly before retirement.

PROFESSOR'S NOTE

Pension plans are required to offer a QPSA and a QJSA or the mandatory annual contribution plans. They can be remembered by the phrase "*be my cash target*"—*b* for benefit in defined benefit plans; *my* for money purchase plans; *cash* for cash balance plans; and *target* for target benefit plans.

PRACTICE QUESTIONS

Choose the best answer for the following question. The answer can be found at the end of this module.

13. All of the following forms of qualified plans must generally provide for a QJSA form of benefit except
    A. a money purchase pension plan.
    B. a target benefit pension plan.
    C. a cash balance pension plan.
    D. an ESOP.

TOPIC 6.5: OTHER DISTRIBUTION CONSIDERATIONS

Reading: Qualified Domestic Relations Orders (QDROs) and Roth IRA Postdeath Distributions

LO 6.5.1: Apply retirement distribution rules when QDROs or the death of an IRA owner is involved.

In general, under ERISA, a qualified plan benefit cannot be assigned or alienated by a participant, voluntarily or involuntarily, while it is not in payable status. This provides for creditor protection of the benefit. There is one major exception to this rule involving the claims of spouses and dependents in domestic relations situations (divorce or separate maintenance) known as a **qualified domestic relations order (QDRO)**.

A QDRO is a decree, order, or property settlement under state law relating to child support, alimony, or marital property rights that assigns all or part of a participant's plan benefits to an alternate payee. The alternate payee is usually the participant's ex-spouse; however, the alternate payee can also be a named dependent (like the couple's child). The QDRO may specify when the alternate payee will receive the plan benefit. Naturally, the QDRO can only select a distribution option already permitted by the retirement plan document. An alternate payee includes (most commonly) a spouse or former spouse, child, or other dependent of the participant. The order may be executed with respect to benefits payable under a qualified plan, Section 403(b) plan, and governmental Section 457 plan. Note that IRAs are not dealt with by QDROs.

Distributions made from a qualified plan to an alternate payee pursuant to a QDRO or other court order are still subject to income tax but are exempt from the 10% premature distribution penalty.

Additionally, an alternate payee who is the former spouse of the participant, and who receives a distribution by reason of a QDRO or other court order, may roll over the distribution in the same manner as if she were the participant (including to her own IRA).

IRAs and Annuities

A matrimonial court may also issue a domestic relations order, decree, property settlement, or other order that can have a simliar effect on an IRA or annuity that a QDRO has on a qualified plan. IRAs and annuities are assets that are subject to division or assignment when separating property of divorcing taxpayers. In some states, all that is needed is a notarized separation agreement by the parties for the assignment of the IRA to be effective. For the CFP® exam, understand that the QDRO and domestic relations orders are able to assign the ownership of part or all of a participant's balance in the retirement asset.

Roth IRA Post-Death Distributions

It is important to remember that there are no lifetime RMD requirements (unlike those that apply to other retirement accounts) for the original owner of a Roth IRA. In addition, contributions may still be made to a Roth IRA after the owner attains age 72 assuming the person has earned income or a spouse with earned income to cover it. This used to be unique. Now, the SECURE Act also allows contributions to a traditional IRA for those with earned income. The ability to delay RMDs until the Roth IRA account owner dies makes a Roth IRA a very powerful wealth accumulation vehicle that is only made stronger if qualified distributions are made, because they are entirely free of income tax.

If a Roth IRA owner dies, the minimum distribution rules that apply to traditional IRAs apply as though the Roth IRA owner died before the RBD applicable to traditional IRAs. Because there is no RBD for a Roth IRA, all deaths at any age are under the same rules as a traditional IRA when the death occurs before the RBD. For example, Grandpa died at age 98. His Roth IRA beneficiary's RMDs are determined by the death before RBD rules.

If a distribution to a beneficiary occurs before completion of the five-year period that would have determined qualified distributions had the owner not died, the distribution of earnings is generally includable in the beneficiary's gross income to the same extent it would have been included in the owner's income had it been distributed to the IRA owner when he was alive. In other words, the five-year holding period for all Roth accounts begins with the first contribution or conversion. It is not affected by the death of the owner. Even dying does not restart the Roth clock. The 10% EWP on early distributions would not apply because the distribution was made to the beneficiary as a result of the IRA owner's death.

MODULE 6 ANSWER KEY FOR PRACTICE QUESTIONS

1. **B** Five-year forward averaging for individuals born before January 2, 1936, was repealed and is no longer an available tax treatment for lump-sum distributions from a qualified plan participant.

2. **C** The correct answer is $2,205.50. Sam will have to pay a 50% penalty tax on the amount of the RMD that he did not withdraw from his account. [0.50 ($22,867 - $18,456)] = $2,205.50.

3. **B** The minimum distribution that must be received for this year is calculated by dividing Danielle's account balance on December 31st of last year ($5 million), by the factor for age 72 (27.4). This results in an RMD of $182,482 ($5 million divided by 27.4). She has until April 1st next year, to take this RMD.

4. **A** Danielle may defer her first RMD until April 1st next year, with no penalty. Therefore, she has until April 1st next year, to take the rest of her trigger year (first) RMD, which is calculated for this year based on her balance on December 31st of last year, without penalty. Naturally, she will also be required to take her RMD for next year by the end of next year.

5. **B** Danielle is a greater than 5% owner of The Moore Company (she owns 10%); therefore, she is not allowed to defer her RMD until after she retires. Taxable distributions from an IRA are taxed as ordinary income. If she waits until April 1 of the next year to take her first RMD, she must take a second distribution by December 31 of that same year. She must also begin distributions from any traditional IRAs and other employer retirement plans she has. Finally, she can continue to contribute to the 401(k), even while taking RMDs from her other retirement accounts. She can also contribute to a traditional or Roth IRA, depending on her income and tax filing status.

6. **B** Only choices II and III are correct. Statement I is incorrect because the exception to the 10% premature distribution penalty for higher education expenses only applies to IRAs and not qualified plans and 403(b)s. Statement IV is incorrect because the health insurance premium provision only applies to certain unemployed individuals for distributions from an IRA but not from a qualified plan.

7. **C** Defined benefit and money purchase pension plans do not generally have loan provisions. SEPs are a type of IRA and, therefore, cannot have loan provisions. Loan provisions are established in the plan document and are common for plans that have elective deferrals, such as a Section 401(k) and Section 403(b) plan.

8. **C** There would be no early distribution penalty by taking a loan from Jenny's Section 401(k) plan and the loan can be repaid over time. As long as the loan is repaid on time, it will not substantially reduce their retirement assets. If she took a distribution instead of a loan, there would be a 10% early distribution penalty. If Reggie takes the substantially equal payments from his SEP, they must continue for the greater of five years or until he attains age 59½. This will reduce their retirement assets. While it may be possible to obtain a line of credit using the home as collateral, the decrease in income and the fact that they are having difficulty living on one income makes it unlikely they could qualify.

9. **A** Because Karla is younger than Slade, she should roll over his IRA proceeds to her own IRA and delay taking the proceeds until age 72, based on her life expectancy.

10. **B** If Karla predeceases Slade, the preferable option is reversed. Slade should move the assets into an inherited IRA and take distributions when Karla would have been age 72, based on his life expectancy.

11. **C** Shannon must clean out the account by December 31 of the year containing the 10th anniversary of his death. This is the 10-year rule. There are no other RMD rules for this account.

12. **C** Erica is not an EDB, but she is a designated beneficiary. Olga died before her RBD. Thus, Erica is definitely under the 10-year rule.

13. **D** Of the plans listed, only an ESOP is not subject to the minimum funding standards, because a profit-sharing plan does not fund for or promise a benefit in the form of a pension. Thus, it is generally exempt from the rules that mandate the QJSA form of benefit.

MODULE 7

Social Security

INTRODUCTION

A part of nearly every American's retirement planning is the government-sponsored retirement program known as Social Security. When adopted in the 1930s (largely as a result of the Great Depression), Social Security was intended only to supplement an individual's retirement savings, but over the years, it has become much more than that. For many Americans, Social Security is the base of financial protection when earnings are lost due to retirement, disability, or death.

This module discusses the basics of the Social Security system, including who is covered (and not covered), payment into the system, how benefits are calculated, what types of benefits are available, and the taxation of those benefits. Benefit eligibility is largely determined according to whether an individual is fully or currently insured under the system. Those terms will be defined in this unit and examples given with respect to resulting available benefits.

The taxation of Social Security benefits was first mentioned in the *FP514: Income Tax Planning* course.

TOPICS, LEARNING OBJECTIVES, AND READINGS

The topics covered in this module are:

- Topic 7.1: Social Security Funding, Coverage, and Benefits
- Topic 7.2: Types and Amounts of Social Security Benefits Available

Throughout this module, you will see learning objectives (LOs) that emphasize the knowledge and application skills you will gain from this module. These specific statements, based on the 2021 CFP Board's Principal Knowledge Topics List (the blueprint for the current CFP Board exam), advise you regarding what you should know and be able to do at the completion of this module.

The following table shows a list of module topics, learning objectives, and readings.

Learning Objective		Readings
Topic 7.1: Social Security Funding, Coverage, and Benefits		
7.1.1	Relate how the Social Security program is funded, the coverage provided, and the eligibility for benefits.	Social Security Funding, Coverage, and Benefits
Topic 7.2: Types and Amounts of Social Security Benefits Available		
7.2.1	Distinguish the Social Security retirement, disability, and survivorship benefits available to covered workers.	Types of Social Security Benefits
7.2.2	Analyze a situation to determine the amount of Social Security benefit a covered worker would receive.	Social Security Benefits and Taxation

KEY TERMS

average indexed monthly earnings (AIME)
currently insured
disability benefit
Federal Insurance Contributions Act (FICA)
full retirement age (FRA)
fully insured
Medicare
old age, survivors, and disability insurance (OASDI) program
primary insurance amount (PIA)
provisional income
retirement benefits
Self-Employment Contributions Act (SECA)
self-employment (SE) tax
Social Security
survivors benefits
taxable wage base

TOPIC 7.1: SOCIAL SECURITY FUNDING, COVERAGE, AND BENEFITS

Reading: Social Security Funding, Coverage, and Benefits

LO 7.1.1: Relate how the Social Security program is funded, the coverage provided, and the eligibility for benefits.

Funding of the Social Security Program

Technically, **Social Security** is known as the **old age, survivors, and disability insurance (OASDI) program**. It was created through the Social Security Act of 1935 and is designed to protect eligible workers and their dependents from financial loss resulting from death, disability, and the risk of superannuation (running out of money during the participant's lifetime). Approximately 96% of all U.S. workers participate and are covered by the program.

Social Security is funded through a series of taxes paid by the participant and participant's employer, commonly referred to as payroll taxes. Accordingly, an employee will pay a **Federal Insurance Contributions Act (FICA)** tax of 7.65%, and the employer will separately pay 7.65%, for a combined total of 15.3%. Of this amount, the employer share of 7.65% may be separately broken down into a tax of 6.2% specifically dedicated to Social Security and 1.45% for **Medicare** funding.

Similarly, the employee's FICA tax is split in the same way, i.e. 6.2% for Social Security and 1.45% for Medicare funding. Social Security taxes are paid on wages up to the **taxable wage base** (TWB) of $160,200 (2023). There is not a taxable wage base cap associated with Medicare funding, thus the compensation against which the 2.9% tax (1.45% from the employer and 1.45% from the worker) is assessed is unlimited in amount.

A self-employed individual must pay both the employer and employee portions of the funding of Social Security. This tax is known as the **self-employment (SE) tax**. The name of the law that requires the self-employed to pay into Social Security is the **Self-Employment Contributions Act (SECA)**.

A 0.9% Additional Medicare Tax applies to taxpayers whose compensation exceeds stated threshold amounts. For more information, *see FP514 Tax Planning* course.

Coverage In and Exclusions From the Social Security Program

Almost all employees pay into and are covered by the Social Security program. These include the following:

- Employees of private, for-profit companies
- Self-employed individuals
- Employees of tax-exempt organizations
- Members of the armed services
- Approximately 75% of state and local government employees (Note: some public school teachers employed by state or local school districts do not pay into the system and are not covered)
- Federal civil service workers hired after 1983, including members of Congress
- The major exceptions to coverage in the Social Security program are:
  - certain federal civil service workers who remained covered under the Civil Service Retirement System after 1983;
  - approximately 25% of state and local government employees (Note: each state and local government unit with a pension plan decides whether to elect Social Security coverage; some have not);
  - workers covered under the federal Railroad Retirement Act; and
  - some other exceptions.

While not covered for Social Security purposes, these workers are covered by Medicare if they separately meet those rules (discussed in the *FP512: Risk Management, Insurance and Employee Benefits Planning* course). Three major categories of people who are eligible for Medicare without being eligible for Social Security retirement based on their own work histories are spouses, railroad retirees, and state and local government employees (like public school employees working for school districts which have opted out of Social Security but not the Medicare system).

There are also some special provisions under the Social Security program. These individuals may or may not be covered depending on whether or not certain other circumstances exist. These special provisions include the following.

- Household or domestic employees—if a household worker is paid above a specified amount, Social Security and Medicare taxes must be withheld from her wages. The law exempts household workers younger than the age of 18 who are students or who have another principal occupation.
- Agricultural workers—an agricultural worker is generally covered by Social Security and wages subject to payroll taxes if paid at least $150 or more in the calendar year for farm work or if the employer pays at least $2,500 for farm labor for all employees for the year.
- Family workers—if a taxpayer is self-employed and hires her spouse, parent, or child age 18 or older in the course of the self-employed business, that employment is covered. Alternatively if, for example, the child is younger than 18, and is employed in the taxpayer's unincorporated business, he is not covered.
- Members of the clergy who opt out for conscience. Essentially, members of the clergy can only opt out within the first two years after ordination if they are religiously opposed to the receipt of government insurance benefits tied to ministerial earnings.

PRACTICE QUESTIONS

Choose the best answer for each of the questions below. The answers can be found at the end of this module.

1. Social Security is funded through
   I. employee payroll taxes
   II. employer payroll taxes
   III. self-employment tax
   IV. sales tax
   A. II only
   B. I and II
   C. III and IV
   D. I, II, and III
2. Which of the following groups of employees are covered under Social Security?
   I. Members of Congress
   II. Railroad workers
   III. Members of the armed forces
   IV. Employees of tax-exempt organizations
   A. I and IV
   B. II and IV
   C. I, III, and IV
   D. II and III

TOPIC 7.2: TYPES AND AMOUNTS OF SOCIAL SECURITY BENEFITS AVAILABLE

Reading: Types of Social Security Benefits

LO 7.2.1: Distinguish the Social Security retirement, disability, and survivorship benefits available to covered workers.

Benefit Eligibility

The type of benefits for which a worker covered by Social Security is eligible depends on whether the worker is considered **fully insured** or **currently insured**.

To be **fully insured**, the minimum number of work credits needed is 6 and the maximum number needed is 40. For your status to be fully insured, you must have at least 1 work credit for each calendar year after you reach age 21. A worker earns 1 credit of coverage for every $1,640 (2023) of compensation earned, up to a maximum of 4 credits per year. A worker is fully insured for life once 40 credits of coverage have been earned. However, there is also a separate qualification requirement to receive disability income benefits from the Social Security program. To qualify for disability benefits under the program, workers must be so severely impaired, physically or mentally, that they cannot perform any substantial gainful activity. In addition, this impairment must be expected to last at least 12 months or result in death. Disability benefits under the program are not payable to workers disabled solely because of alcoholism or drug addiction.

Presuming the definition of Social Security disability is met, a worker must also have earned a minimum number of credits of coverage based on the worker's year of birth and a portion of the credits must have been earned in recent years. The most important test is that individuals age 31 and above must have earned *at least* 20 of the most recent 40 credits as of the date of disability onset. The 20 credits in the last 10 years applies for workers ages 31 through 42. Fewer credits are needed for younger workers and more credits are needed to be eligible for Social Security disability at ages 43 through 62 but the details of exactly how many credits other than ages 31 through 42 are beyond the scope of the course. Thus, once workers have not worked for over five years, they are not eligible for Social Security disability benefits even if they are fully insured for all other benefits. The point of these Social Security requirements is to measure whether or not a person is a part of the labor force. It is hard for someone living off an inheritance to be considered unable to receive portfolio income due to a disability. However, former workers who "retire" early or stay at home to raise children or provide care for elderly or needy family members need to know whether or not they would receive Social Security disability benefits if disaster strikes.

TEST TIP

To calculate the number of credits needed to be fully insured, subtract 22 (because this is the first year after age 21 according to Social Security rules) from the person's age, but remember that 6 is the minimum and we stop counting at 40. For example, Tina is 25. How many quarters does she need to be fully insured? The answer is six. 25 – 22 = 3, but 6 is the minimum number. Mark, who is 30, needs eight credits. 30 – 22 = 8 and 8 is more than the minimum of 6. Juanita who is 64, needs 40 credits. 64 – 22 = 42. However, 40 is the maximum number required to be fully insured. Many people are confused about why you should subtract 22 from the person's current age when the rules say one credit per year since the person was age 21. The reason is that Social Security actually subtracts one year from the person's current age, then subtracts 21.

A fully insured worker is generally eligible for the following benefits:

- **Retirement benefits**
- Spousal retirement benefits
- Surviving spouse benefit for widow(er) age 60 or older
- Surviving spouse benefit caring for a dependent child (if spouse is caring for a dependent child younger than age 16)
- Dependent benefit
- Dependent parent benefit (if parent is age 62 or older)
- Lump-sum death benefit of $255

PROFESSOR'S NOTE

Many students focus exclusively on the 40 credits definition. However, if that were true no one would be fully insured until they had 10 years of work. This would be catastrophic for the coverage of young Americans.

Currently insured coverage is a more limited form of coverage and eligibility for benefits than fully insured status. Currently insured coverage is achieved if the worker has earned six credits of coverage during the 13 calendar quarters ending with the calendar quarter in which the individual died, most recently became eligible for disability benefits, or became entitled to retirement insurance benefits.

A currently insured worker is generally eligible only for the following benefits:

- Surviving spouse caring for a dependent child
- Dependent benefit
- Lump-sum death benefit of $255

PROFESSOR'S NOTE

The point of the currently insured definition is to cover young families when a breadwinner passes away.

Primary Insurance Amount (PIA)

All benefit amounts paid under the Social Security program are based on an amount known as the worker's **primary insurance amount (PIA)**. A worker's PIA is calculated using his **average indexed monthly earnings (AIME)**, which is based on the worker's lifetime earnings history. Annual earnings in excess of the Social Security taxable wage base are not considered ($160,200 for 2023). The Social Security Administration calculates both the AIME and PIA for the worker. The AIME adds the highest 35 inflation-adjusted years and divides by 420 (35 years × 12 months is 420). Also, the higher the AIME, the higher the PIA will be. For example, someone with $75,000 for 30 years will have an AIME of $5,357 ($75,000 × 30/420 = $5,357). However, someone $70,000 × 35 years would have an AIME of $5,833 ($70,000 × 35/420 = $5,833). Note the reduction for averaging in five years with no earnings. The AIME is used to calculate the PIA. The bend points for the exact calculation changes each year with inflation, but essentially the first $1,000 of AIME gives 90% toward the PIA. The next $5,000 counts 32% toward PIA and any amount of AIME over $6,000 counts 15% toward the worker's PIA. Individuals can get an estimate of their Social Security benefits through the Retirement Estimator on the Social Security website (www.ssa.gov).

The PIA is the amount payable to any worker based on attainment of **full retirement age (FRA)**, which is age 65 for workers born before 1938. Beginning with workers born in 1938, the FRA gradually increases from age 65, reaching age 67 for workers born in 1960 and later.

If the worker starts taking her retirement benefit prior to full retirement age under the Social Security program (for example, starting at age 62 instead of her FRA), the amount will be less than the PIA available at FRA. The maximum reduction of benefits is 30% for a worker whose full retirement age is 67. These are workers born in 1960 or later. When taking Social Security retirement benefits early, the PIA is reduced by 5⁄9 of 1% per month for the first 36 months and 5⁄12 of 1% for any additional months. This is how the maximum reduction is 30% for a worker born in 1960 or later.

For example, Ray started receiving his Social Security retirement benefits 44 months before his FRA. If his PIA was $2,000/month, Ray's actual monthly benefit would be $1,534. He would be reduced 5⁄9 of 1% for the first 36 months. This is a 20% reduction. He is reduced an additional 5⁄12 of 1% for the final 8 months. This is an additional 3.3% reduction. Thus the total reduction is 23.3%. This leaves 76.7%, so his actual monthly benefit will be $1,534.

TEST TIP

The reduction for the first 3 years is 20% (5⁄9 of 1% per month × 36 months = 20%). The annualized rate for months over 36 months is 5% (5⁄12 of 1% × 12 = 5%).

If a worker elects to delay claiming Social Security retirement benefits beyond full retirement age, benefits will be increased for each year up to, but not beyond, age 70. Currently, for a worker born in 1943 or later, the annual benefit increase is 8% per year (8⁄12 of 1% per month). This increase is not compounded.

As seen in the calculation of the PIA from the AIME, Social Security benefits are designed to provide a higher replacement ratio for lower-paid workers. As incomes rise, Social Security benefits also rise, but at a slower rate. Thus, Social Security provides a higher pre-retirement income replacement for lower-paid workers than for higher-paid workers.

Starting in 1975, Social Security benefits increase almost every year, since they are pegged to inflation. Based on the Consumer Price Index, a hypothetical "basket of goods" that consumers purchase, the Social Security Administration declares a cost of living adjustment (COLA) in December that will apply to benefits that will be paid in the following year. The COLA was 0% in 2011 and 2012, and as high as 14.3% in 1980.

Retirement, Disability, and Survivors' Benefits

The types and amounts of benefits available under Social Security depend on whether the worker is fully insured or currently insured. The benefits are retirement, survivor, and disability income.

Retirement Benefits

The following individuals are eligible to receive **retirement benefits** based on the employment record of the Social Security insured worker:

- The retired worker (at age 62 or older)
- The spouse of the retired worker (at age 62 or older) (Note: the spouse is entitled to receive 50% of the worker's PIA if the spouse begins spousal retirement benefits at the spouse's FRA. There is no increase in spouse's retirement benefit if the spouse delays past FRA. However, the spousal retirement benefit is reduced if the spouse starts receiving Social Security spousal retirement benefits earlier than the spouse's FRA. The reduction is $^{25}/_{36}$ of a percent for the first 36 months and then the standard $^{5}/_{12}$ of a percent per month for any months earlier than 36 months. The spousal retirement benefit is not affected by the worker starting Social Security benefits earlier than the worker's FRA. Note that the current spouse (unlike a divorced spouse, as per below) may only qualify if the worker spouse is actually receiving Social Security retirement benefits.
- The divorced spouse who is age 62 or older and was married to the worker for at least 10 years and is unmarried, if the worker is at least age 62 (whether retired or not)
- An unmarried child who is under age 18, under age 19 if still in high school, or at any age if the child became disabled before age 22
- A spouse (or divorced spouse married to the worker for at least 10 years) currently taking care of a dependent child of the worker under the age of 16
- A parent currently taking care of a dependent child who became disabled before the age of 22

Survivor Benefits

The following survivors are eligible to receive **survivor benefits** based on the employment record of the Social Security insured worker:

- Surviving spouse retirement benefit—current or qualifying divorced spouse—for widow(er) age 60 or older (benefit is permanently reduced if widow(er) has not obtained the special survivor retirement FRA). The calculation of survivor benefits is a two-step process. First, the survivor benefit is what the Social Security retired worker was actually receiving at the point of death. Thus, if the worker starts Social Security retirement benefits early, the widow's survivor benefits will be permanently reduced. If the worker delays the start of Social Security past FRA (up to age 70), then the survivor benefit is permanently increased. The second step in calculating the survivor benefit is to permanently lower the survivor benefit if it is taken early. The survivor's age when survivor benefits commence is compared to the special survivor FRA if the survivor benefits begin earlier than the special survivor FRA. Compare the survivor's age when survivor benefits commence to the special survivor FRA. The special survivor FRA is increasing toward 67 on a two-year delay when compared to the worker FRA. Thus, the survivor FRA will be age 67 for those born in 1962 or later. If the survivor has reached her survivor FRA before starting survivor benefits, then there will be no reduction due to starting survivor benefits early. The worker's retirement benefit will be the survivor retirement benefit. If survivor benefits commence before the widow reaches her survivor FRA, the reduction for every month is based on the survivor's year of birth. The details are beyond the scope of the course.
- A disabled widow(er) age 50 or older
- A surviving spouse currently taking care of a dependent child under the age of 16
- An unmarried child under age 18, under age 19 if still in high school, or at any age, if the child became disabled before age 22
- A dependent parent age 62 or older
- The divorced spouse who is age 60 or older and was married to the worker for at least 10 years and is unmarried (remarriage after age 60 will not affect eligibility for survivor benefits)

A lump-sum death benefit of $255 is also payable to any surviving spouse or child of the Social Security worker or eligible child of the Social Security worker. Only one $255 death benefit is payable per worker. For example, if the death benefit was paid to the surviving spouse, it would not be available to an eligible child. If there was no surviving spouse, only one dependent child would be eligible to receive the benefit.

Disability Benefits

The following individuals may receive income from a **disability benefit** from the Social Security program based on the worker's employment record. The definition of fully insured differs slightly when considering disability benefits:

- The disabled worker (Note: the disability benefit is equal to 100% of the worker's PIA or retirement benefit)
- The spouse of the disabled worker
- An unmarried child (of the disabled worker) under age 18 or under age 19 if still in high school
- An unmarried child (of the disabled worker) of any age who became disabled before attaining age 22
- The divorced spouse who is age 62 or older and was married to the worker for at least 10 years and is unmarried

Maximum Family Benefit

There is a limit on the total amount of benefits that members of one family may receive based on the worker's employment record, called a **maximum family benefit**. The limitation is based on a separate table provided by the Social Security Administration. This limitation applies before any reduction for early retirement or any increase for late retirement but does not apply if both the husband and wife receive a retirement benefit based only on their own respective employment records. The amount payable to a divorced spouse is also not included in the limitation, except if the surviving divorced spouse qualifies for benefits only on the basis of caring for a dependent child of the worker.

Summary of Basic Social Security Coverage and Benefits (% of PIA)
(All Are Subject to Family Maximum Dollar Benefits and Assume Normal Retirement Age.)

Beneficiaries	Retirement Insurance	Disability Insurance[1]	Survivorship Insurance[2]	
Required Credit to Earn Coverage FICA must be paid on $1,640 (2023) of earnings to receive one Social Security credit (a maximum of 4 credits may be earned each year)	Required to be fully insured (40 credits)	If < age 24, 6 credits. If < age 31, credits in at least half the quarters available since age 21. If ≥ age 31, fully insured and credits in at least 20 of the last 40 quarters.	Fully insured (F.I. definition and status is different than the one required for retirement benefits.)	Currently insured credits in at least 6 of last 13 quarters
Covered Worker	100% at NRA[3]	100%	Deceased (none)	Deceased (none)
Spouse				
NRA	50%	50%	100%	0
Age 62	32.5%–35%	35%	82.9%	0
Age 60	N/A	N/A	71.5%	0
Child < 18 (< 19 if in high school)	50%	50%	75%	75%
Spouse if Caretaker of Child < 16 or disabled	50%	50%	75%	75%
Dependent Parents ≥ Age 62	N/A	N/A	75–82.5%[4]	N/A
Divorced Spouse	Same as spouse[6]	Same as spouse[6]	Same as spouse[5]	N/A

1. A blind person need not be fully insured to receive benefits; special rules apply.
2. Plus a death benefit of $255 to spouse or dependent child, if fully or currently insured.
3. NRA = normal retirement age. Also referred to by Social Security Administration as FRA—full retirement age.
4. 75% each if two dependent parents; 82.5% if one dependent parent.
5. The divorced spouse must have been married at least 10 years to the worker and not have remarried before age 60.
6. The divorced spouse must have been married at least 10 years to the worker, be unmarried, and have attained age 62.

Note: Benefits paid to an eligible divorced spouse are not considered in applying the family maximum benefit limits.

Employment Prior to and After FRA

A worker who has attained full retirement age (FRA) will not experience a reduction in Social Security benefits if the worker continues to have earned income after claiming Social Security retirement benefits. However, a limit on earnings from employment applies to workers or beneficiaries under their FRA if Social Security benefits are being received. This earnings limit is a retirement earnings test and is a separate issue from income taxes on Social Security benefits (to be discussed shortly).

Prior to the year in which FRA is attained, if a worker-beneficiary earns more than the threshold amount, $1 in Social Security benefits will be withheld for every $2 in earnings above the limit. In 2023, the limit is $21,240. There is a special monthly test that may be applied in the first calendar year of retirement. Under this special test, earnings prior to the month of retirement are not considered in the annual limit and the retiree may receive benefits in a given month if he does not earn more than one-twelfth of the annual earnings limit in that month. In the year in which FRA is attained, the benefit reduction formula changes to $1 in benefits withheld for every $3 earned in excess of the threshold. The threshold is much higher in the year FRA is attained. In 2023, this threshold is $56,520.

For example, a worker may have earned $100,000 in the months prior to starting Social Security retirement benefits. Any compensation for before Social Security retirement benefits begin do not reduce the eventual monthly benefit. However, once Social Security benefits start, any monthly earnings for the rest of the first calendar year above the monthly limit will zero out benefits for that month. The monthly earnings amount is 1⁄12 of the annual limit for that year. For example, if Sam was 63 and started receiving Social Security retirement benefits in June, then the annual limit in 2023 would be $21,240 and the monthly limit would be $1,770. If Sam worked and made $1,771 or more in September and November, then there would be no Social Security retirement benefit for those months. There would be the full Social Security retirement benefits in the other months, from June through December. After the first calendar year of retirement, if the worker has not yet attained FRA, the annual earnings limit will apply instead of the monthly limit. This is where benefits are reduced either $1 for $2 of excess annual earnings or $1 for every $3 of excess earnings. These adjustments to the Social Security benefits for earned income are made in the following year.

The annual earnings limit no longer applies once a worker has attained FRA. Benefits will not be reduced, regardless of earned income.

> **EXAMPLE: Social Security retirement benefits**
>
> David started receiving Social Security retirement benefits at age 63. When he was 64, he started a new job and earned $31,240 in 2023. His Social Security retirement benefits for the next year will be reduced by $5,000 ($10,000 of earnings above $21,240 in 2023 times 50%).

Reading: Social Security Benefits and Taxation

LO 7.2.2: Analyze a situation to determine the amount of Social Security benefit a covered worker would receive.

Taxation of Social Security Benefits

Social Security retirement beneficiaries with significant total incomes may be required to include up to 85% of their Social Security benefits as income for federal income tax purposes. Special step-rate thresholds determine the amount of Social Security retirement benefits that must be included in income for federal income tax purposes.

- The first threshold or base amount is $25,000 of provisional income for all single, unmarried taxpayers and $32,000 of provisional income for married taxpayers filing jointly (Note: this threshold amount is $0 for married taxpayers filing separate returns and who do not live apart for the entire taxable year).
- The second threshold or base amount is $34,000 of provisional income for all single, unmarried taxpayers and $44,000 of provisional income for married taxpayers filing jointly (Note: the same limitation of $0 also applies for married taxpayers filing separate returns and not living apart).

If the first threshold is exceeded in any taxable year, generally 50% of the amount by which the Social Security benefits exceed the threshold is subject to income tax. If the second threshold is exceeded in any taxable year, generally 85% of the amount by which the Social Security benefits exceed the (second) threshold is subject to income tax. However, this amount cannot exceed the smaller of:

- 85% of the actual Social Security benefits received in any taxable year; or
- 50% of the benefits plus 85% of any excess over the second threshold.

Provisional income is the beneficiary's modified adjusted gross income (MAGI) plus one-half of the Social Security or tier 1 railroad retirement benefits. In turn, MAGI is the beneficiary's adjusted gross income plus any tax-exempt interest, including muni bonds, interest earned on savings bonds used to finance higher education, amounts excluded under an employer's adoption assistance program and any foreign earned income or foreign housing expense (either deducted or excluded).

TEST TIP

The following example is to aid the student in understanding the application of the thresholds. It is not expected that the student will have to calculate the taxable Social Security income for a taxpayer. Knowledge of the theory, however, may be tested.

EXAMPLE: Taxation of Social Security benefits

Ted and Alice, both age 70, have AGI of $50,000 as shown on their IRS Form 1040. They also have received $3,000 of municipal bond interest and have been paid $20,000 in Social Security benefits. They file as married filing jointly. Accordingly, $17,000 of their total of $20,000 Social Security benefits received is subject to income tax (at their marginal income tax rate), calculated as follows.

Preliminary Form 1040 AGI:	$50,000
+ Municipal bond interest:	$ 3,000
MAGI	$53,000
+ 50% of $20,000 in Social Security benefits:	$10,000
Provisional income:	**$63,000**
Excess provisional income over first threshold ($32,000):	$31,000
Excess provisional income over second threshold ($44,000):	$19,000

Social Security benefits included in AGI for the tax year is the lesser of:

50% of excess provisional income over first threshold plus 35% of excess over second threshold (.50 × $31,000 + .35 × $19,000):	$22,150
85% of benefits (.85 × $20,000):	**$17,000**
50% of benefits, plus 85% of excess over second threshold (.50 × $20,000 + .85 × $19,000):	$26,150

The lesser of these three figures, $17,000, is added to the preliminary AGI of $50,000, resulting in AGI on Form 1040 to be $67,000.

PROFESSOR'S NOTE

The thresholds for taxation of Social Security income were set in 1993 and are not indexed. Today many retirees are being income taxed on their Social Security benefits. This is an example of a benefit cut that few people protest. Also, the increased income taxes from Social Security benefits help finance the Social Security system.

Windfall Elimination Provision and Government Pension Offset

The Windfall Elimination Provision and the Government Pension Offset are two special elements in the Social Security laws that may serve to reduce a worker's benefits from Social Security.

The Windfall Elimination Provision may apply to a worker who qualifies for a Social Security retirement or disability benefit from other employment covered by Social Security but who also earns a pension from an employer who does not withhold Social Security taxes. An example of such an employer could be a government agency or an employer in a foreign country. Under this provision, the formula used to calculate a worker's PIA is reduced, resulting in a lower benefit. Because Social Security benefits are designed to pay a higher percentage of career

average earnings for lower paid workers than paid to higher earning workers this is considered a windfall or in other words and extra benefits that needs to be eliminated.

Again, a worker whose primary employment does not pay Social Security taxes, but who also qualifies for a Social Security benefit through other covered employment would receive a Social Security benefit as if they were a career low-earning worker. This results in a PIA that is a higher percentage of career covered earnings. The Windfall Elimination Provision accounts for the noncovered employment pension and results in a lower Social Security benefit. The Windfall Elimination Provision does not apply to survivors benefits under Social Security.

The Government Pension Offset may apply to Social Security benefits for spouses, widows, or widowers. If a worker receives a pension from a federal, state, or local government based on compensation on which Social Security taxes were not paid, Social Security benefits for that person as a spouse or widow(er) may be reduced. The Social Security benefit is reduced by two-thirds of the government pension. The reason for this offset is because if a spouse, widow, or widower is receiving a Social Security benefit as a spouse, widow, or widower, the amount is offset by any amount the beneficiary qualifies to receive from Social Security based on their own work record. The Government Pension Offset mirrors this offset.

Here is a recap of the WEP and GPO:

- They both act solely on Social Security benefits. Any retirement benefits other than Social Security are never reduced.
- The WEP reduces a worker's Social Security retirement benefits that are based on the worker's own Social Security earnings record. This happens when the worker receives Social Security retirement benefits based on that person's own work history but also has retirement benefits from a state or local government which has opted out of the Social Security system.
- For example, Sally worked as a teacher for a public school district that had opted out of Social Security. However, she also earned 40 credits or more at work that were covered by the Social Security system away from the school district. Her Social Security retirement PIA was $1,000 per month. However, this was reduced to $600 per month due to the WEP. The calculation of the WEP reduction is beyond the scope of the course, but the WEP reduction cannot be more than half. Thus, a worker with 40 Social Security credits will always be eligible to receive something from Social Security after the WEP reduction.
- The GPO reduces Social Security spousal and survivor retirement benefits when a person is receiving a retirement benefit from an employer that had opted out of Social Security. For example, Sally, from the previous bullet, was married to Harry. They both started claiming Social Security retirement benefits when they were at their own full retirement ages. Harry's PIA was $2,400 per month. Thus, Sally's spousal retirement benefit at her FRA should be $1,200 per month (50% of his PIA). However, if she was receiving $1,500 per month from her public school teacher's retirement, then she would lose $1,000 per month (⅔ of her public school retirement is offset) of her spousal retirement benefits from Social Security. Thus, while Harry is alive, she would get $200 of Social Security spousal retirement benefits and $1,500 per month of teacher retirement benefits.

Since her WEP amount is $600 per month, she would get $600 per month from her own Social Security earnings record because that is higher than the $200 per month as a spousal benefit. If Harry died before Sally, she would initially be eligible to take his survivor benefit of $2,400. However, her $1,500 teacher retirement offsets $1,000 of her survivor benefits. Thus, her Social Security survivor benefit is reduced to $1,400. This is more than her $600 Social Security benefit on her own Social Security record, so Sally would receive $1,400 of survivor benefits from Social Security and her $1,500 of teacher retirement.

- One way to differentiate the WEP and the GPO is to remember the W in WEP is also tied to the W in worker. The WEP reduces the worker's own Social Security benefits. Thus, the GPO is the other one. Since it does not reduce Social Security benefits to the worker, it must reduce them to the spouse and survivor.

PRACTICE QUESTIONS

Choose the best answer for each of the questions below. The answers can be found at the end of this module.

3. Mark is 27 years old. How many credits does he need to be fully insured?
   A. 4
   B. 5
   C. 6
   D. 40
4. Cathy is 36. She worked for 12 years before her daughter was born six years ago. She was in a car accident last week and is now a quadriplegic. Will she be eligible for Social Security disability benefits after she has been disabled for five months?
   A. Yes. At 36, the minimum number of credits to be fully insured is 14 (36 – 22 = 14).
   B. No. She is over 31 and had not earned 20 of the last 40 credits when she became disabled.
   C. Yes. A quadriplegic is clearly disabled and needs assistance.
   D. No. She is not currently insured.
5. Bob's FRA is 67. His PIA is $1,800. How much will his Social Security monthly benefit be if he started 15 months early?
   A. $1,560
   B. $1,650
   C. $1,720
   D. $1,800
6. Wilma's FRA is 66. Her PIA is $2,000. What would her monthly Social Security retirement benefit be if she delayed starting her Social Security retirement benefits by 32 months?
   A. $2,000
   B. $2,320
   C. $2,427
   D. $2,640

7. William and Kate both have a FRA of 67. Kate is two years older than William. Kate has not worked enough credits to qualify for a Social Security retirement benefit. William's PIA is $2,000/month. They both retired when William turned 65 and was eligible for Medicare. William's Social Security retirement check was $1,733/month. What will Kate's Social Security spousal retirement benefit be?
   A. $800
   B. $867
   C. $833
   D. $1,000
8. What would Kate's spousal retirement benefits from the previous question be if she would have been have been two years younger than William and thus she would start receiving her spousal retirement benefits four years early when William started his at age 65?
   A. $400
   B. $700
   C. $750
   D. $1,000
9. Sinclair, now deceased, was divorced after 12 years of marriage. He had two dependent children, ages 4 and 6, who are cared for by their mother, age 45. Sinclair's mother, age 70, also survived him. At the time of Sinclair's death, he was currently, but not fully, insured under Social Security. What are Sinclair's survivors entitled to as a benefit under the Social Security program?
   I. A children's benefit
   II. A dependent parent's benefit
   III. A lump-sum death benefit of $255
   IV. A surviving spouse benefit to take care of a dependent child
   A. I and II
   B. III only
   C. II and IV
   D. I, III, and IV
10. Which of the following unmarried, dependent children is eligible for a survivors benefit from Social Security based on the employment record of his fully insured parent?
   A. A 19-year-old child who is disabled
   B. A 19-year-old child in junior college
   C. A 19-year-old child still in high school
   D. A 19-year-old child who lives away from home
11. Which of the following is included when calculating the provisional income for purposes of Social Security benefits taxation?
   I. Dividends from stock
   II. Municipal bond interest
   III. 50% of Social Security benefits received
   A. III only
   B. I and II
   C. II and III
   D. I, II, and III

MODULE 7 ANSWER KEY FOR PRACTICE QUESTIONS

1. **D** The answer is I, II, and III. Employee and employer payroll taxes and self-employment tax are the sources of funding for Social Security. Sales tax does not fund Social Security.

2. **C** The answer is I, III, and IV. Railroad workers are covered under the federal Railroad Retirement Act and have their own retirement system. They are not covered under the Social Security program.

3. **C** The answer is 6. Mark needs the minimum 6 credits. The one credit per year since age 21 test gives a minimum of 5 (27 – 22 = 5). However, the minimum number is always 6.

4. **B** The answer is no, she is over 31 and had not earned 20 of the last 40 credits when she became disabled. She is 31 and older so, in addition to the normal tests for being fully insured, she must have earned at least 20 of the last 40 credits to be eligible for Social Security disability. Being currently insured is a test for survivor benefits, not for disability benefits.

5. **B** The answer is $1,650. His Social Security retirement check would have been 100% of his PIA at age 67 (his FRA). He started those 15 months early so he loses 8.33% ($\frac{5}{9}$%/month × 15 = 8.33%). Thus, his reduced Social Security monthly benefits will be $1,650 (1 – 0.0833) × $1,800).

6. **C** The answer is $2,427. Her Social Security retirement check would have been 100% of her PIA at age 66 (her FRA). She started them 32 months late so she gains $\frac{8}{12}$ of a percent per month for 32 months. Thus, she gains 21.33% ($\frac{8}{12}$%/month × 32 = 21.33%). Her enhanced Social Security monthly benefits will be $2,427 (1.2133 × $2,000).

7. **D** The answer is $1,000. The spousal retirement benefit starts at 50% of the worker's PIA. In this case, $1,000. Her spousal retirement benefit will only be reduced if she starts receiving spousal retirement benefits early. The worker starting Social Security early will not affect the spousal retirement benefit while the worker is alive. On the other hand, the spousal retirement benefit will not be paid until the worker starts receiving the worker's Social Security benefit. There is an exception to this rule for ex-spouses as long as the marriage lasted longer than 10 years and the worker is eligible to receive Social Security benefits.

8. **B** The answer is $700. While the worker is alive the spousal retirement benefits begin at 50% of the worker's PIA. In this case, that is $1,000/month. However, Kate will be reduced by $\frac{25}{36}$ of 1 percent for the first 36 months (a 25% reduction). The final 12 months will result in an additional 5% reduction ($\frac{5}{12}$ × 12 months). This is a total reduction in the spousal benefit of 30%. Thus, Kate's $1,000 spousal retirement benefit will be reduced to $700/month. She has not earned enough credits to have her work Social Security retirement benefit based on her work history.

9. **D** The answer is I, III, and IV. The children's benefit is payable because Sinclair was currently insured. A lump-sum death benefit of $255 is payable. Sinclair's divorced spouse (the children's mother) is entitled to a caretaker's benefit for caring for his children. His dependent mother would only be entitled to a benefit if Sinclair had been fully insured.

10. **A** The answer is a 19-year-old child who is disabled. This child became disabled before age 22 and therefore is entitled to a survivors benefit. If the child was under age 19 and still in high school, he would also be entitled to a survivors benefit based on the parent's PIA. However, when he became 19, the benefits ended even though he was still in high school because the rule is under 19 if still in high school.

11. **D** The answer is I, II, and III. Dividends from stock are included as income when calculating the MAGI (which is the first step to calculating the total provisional income). Then, municipal bond interest and 50% of Social Security benefits received are added back. Note that qualified distributions from a Roth and also withdrawals of Roth contributions and conversions do not increase provisional income.

MODULE 8

Retirement Plan Selection for Employer-Sponsors and Needs Analysis

INTRODUCTION

This module begins with the selection of an appropriate retirement plan for a given type of business. It is important for a planner to gather comprehensive information about a client company, including details about the goals and motivations for having an employer-sponsored retirement plan, and then work to match the goals with the best type of plan suited to deliver the objectives of the client company or business owner. Most plans apply to for-profit enterprises, although two types of plans, the Section 403(b) plan and Section 457 plan, may only be established for tax-exempt (nonprofit) entities. Next, various wrap up issues for retirement plans in general will be discussed.

The unit ends with various ways to quantify how much money a client needs to meet the desired retirement income goals. As a part of this calculation, certain economic assumptions are made, including the rate of inflation before and during the retirement income period. In addition, an assumed total rate of return is used, as well as (and this is likely the most critical input) a life expectancy factor for the client once retirement age is attained. The unit ends with a discussion of the transition to retirement.

TOPICS, LEARNING OBJECTIVES, AND READINGS

The topics covered in this module are:

- Topic 8.1: Retirement Plan Selection
- Topic 8.2: Investment Asset Considerations for Retirement Plans
- Topic 8.3: Retirement Needs Analysis and Saving for Retirement

Throughout this module, you will see learning objectives (LOs) that emphasize the knowledge and application skills you will gain from this module. These specific statements, based on the 2021 CFP Board's Principal Knowledge Topics List (the

blueprint for the current CFP Board exam), advise you regarding what you should know and be able to do at the completion of this module.

The following table shows a list of module topics, learning objectives, and readings.

Learning Objective		Readings
Topic 8.1: Retirement Plan Selection		
8.1.1	Distinguish the factors that should be considered for retirement plan selection.	Retirement Plan Selection For Business Owners
8.1.2	Analyze the characteristics of employers that should be considered during retirement plan selection.	
Topic 8.2: Investment Asset Considerations for Retirement Plans		
8.2.1	Analyze the characteristics of investment assets to assess the potential suitability for a retirement plan.	Investment Considerations for Retirement Plans
8.2.2	Discriminate the tax consequences of life insurance as a qualified retirement plan asset.	
Topic 8.3: Retirement Needs Analysis and Saving for Retirement		
8.3.1	Analyze the key assumptions needed for a retirement needs analysis.	Assumptions for Retirement Planning
8.3.2	Calculate amounts needed for retirement considering client goals.	

KEY TERMS

100 times test
bridge employment
capital needs analysis
capital preservation approach
capital utilization approach
investment risk
level payment approach
liquidity
percentage test
pure protection cost
rate of inflation
rate of investment return
retirement needs analysis
retirement savings need
serial payment approach
Table 2001 cost
unrelated business taxable income (UBTI)
wage replacement ratio
wealth preservation approach

TOPIC 8.1: RETIREMENT PLAN SELECTION

Reading: Retirement Plan Selection for Business Owners

LO 8.1.1: Distinguish the factors that should be considered for retirement plan selection.

LO 8.1.2: Analyze the characteristics of employers that should be considered during retirement plan selection.

In many instances, the decision whether to implement a retirement plan for a business comes down to the threshold question, "can we afford not to?" A primary reason why the implementation of a retirement plan is important is because it makes business sense. Retirement plans have become popular and are potentially advantageous for many reasons. A business must proceed with implementing a plan or risk being left behind competitively.

Factors to Consider in Determining the Type of Retirement Plan to Be Adopted

The following are four primary factors that should guide the financial planner in recommending any type of retirement plan for a businessowner client:

- The owner's **retirement savings need**—the larger the sum of money the owner needs to save for personal retirement needs, the larger the annual amount needed to reach this goal. The annual savings needed for the owner's retirement may exceed the defined contribution plan annual additions dollar limit ($66,000 in 2023), influencing the owner to possibly adopt a defined benefit. On the other hand, a large savings need that is under $66,000 in 2023 could be accommodated by some method that skews employer contributing in the owner's favor, such as a new comparability, age-weighted profit-sharing or target benefit defined contribution plan.
- The owner's current age—the closer the owner is to the desired retirement date, the more immediate the owner's savings need will be. The owner will also probably wish to deposit large sums of money in a personal retirement account as quickly as possible. Again, this may indicate the need to implement some form of defined benefit plan or new comparability plan, age-weighted profit-sharing plan, or target benefit defined contribution plan.
- The owner's attitude toward **investment risk** (for the owner and the employees)—in defined contribution plans, the worker assumes the investment risk. In defined benefit plans, the employer assumes this risk. The owner-employer may not wish to assume the risk of investment for the employees. This may sway the financial planner toward the implementation of a defined contribution type plan or tax-advantaged retirement plan.
- The current financial condition of the business—the ability to sustain annual plan contributions will be critical in choosing between any type of pension plan (meaning mandatory annual contribution plan) versus any profit-sharing

plan (meaning mandatory annual contributions are not required) contribution for the business. For example, while some defined contribution profit-sharing plans allow for flexible employer plan contributions, all defined benefit plans and defined contribution pension plans require mandatory annual funding. If the current or foreseeable business cash flow will not support a mandatory plan contribution, the financial planner should orient his client's thinking away from a pension plan and toward a profit-sharing plan approach.

EXAMPLE: Retirement Plan Selection 1

Assume Marshall owns a small corporation with the following census information.

Employee	Age	Total Compensation	Includible Compensation
Marshall	30	$180,000	$180,000
Jack	30	$20,000	$20,000
Patty	35	$20,000	$20,000
John	30	$20,000	$20,000
Totals		$240,000	$240,000

What type of retirement plan would you recommend if Marshall wanted to provide the maximum annual benefit for himself?

Marshall can provide the maximum benefit for himself by implementing a Section 401(k) plan in conjunction with a profit-sharing or stock bonus plan. The Section 401(k) plan would allow employee elective deferrals and an employer contribution. The annual additions limit of $66,000 would apply, and the maximum deductible employer contribution is 25% of aggregate includible payroll. A 25% employer contribution for Marshall would be $45,000.

Because the maximum annual additions limit is $66,000 in 2023, Marshall could contribute an additional $21,000 elective deferral ($66,000 – $45,000), assuming ADP tests are met. However, the administrative expenses of a Section 401(k) plan for such a small employee group could outweigh the $21,000 additional benefit for Marshall and should be considered.

Another Section 401(k) alternative to consider could be a safe harbor Section 401(k) plan. A safe harbor design would eliminate ADP testing but would require mandatory contributions by the company and immediate vesting of company contributions. The advantages and disadvantages of each plan would need to be analyzed.

What other types of retirement plans might Marshall implement if he decided against the Section 401(k) plan?

A SEP or profit-sharing plan could certainly be appropriate, depending on other objectives, such as vesting, participation, and so forth. Either plan could be integrated with Social Security.

Either a defined contribution pension plan or a profit-sharing plan would allow a deductible contribution of up to 25% of includible compensation.

How would your recommendation change if Marshall were age 55?

Because Marshall would be significantly older than the rest of the employees, an age-weighted (cross-tested) type plan may be appropriate. Alternatively, a defined benefit plan would allow higher contributions for Marshall compared with the remaining employees.

EXAMPLE: Retirement Plan Selection 2

Assume Marshall and Jack own a small company with the following census information.

Employee	Age	Compensation
Marshall	55	$180,000
Jack	30	$160,000
Patty	35	$20,000
John	30	$20,000
Total		$380,000

How does the age difference between the owners of the business affect the retirement plan selection?

Because one owner is older and one owner is younger, an age-weighted plan will provide greater benefits to Marshall over Jack. By using a profit-sharing plan or a money purchase pension plan, however, both owners could receive annual additions up to $66,000 (2023). In addition, a defined benefit plan also could be added to provide higher benefits. However, Jack would not like the fact that the contribution for Marshall would be far higher than his contribution each year. Finally, they will probably wind up selecting a new comparability plan because both owners would receive the same contribution. Also, as long as the rank-and-file employees get their 5% or one-third of the owner's contribution percentage (whichever is less), then they would avoid nondiscrimination problems.

Review and Select Among Available Plans

As with any financial planning opportunity, the planner must know the universe of alternatives that is available to satisfy the client's goals. In retirement planning for the businessowner, these are the various types of qualified and tax-advantaged plans. Fortunately, in recent years, eligibility for these types of plans has been standardized such that all are generally available to a business entity, no matter what the form. The only notable exceptions to this statement are

- stock bonus plans and ESOP/LESOPs, which may not be adopted by unincorporated entities such as a sole proprietorship or partnership (also, a government or not-for-profit organization cannot have stock, so these employers would never select a stock bonus or ESOP/LESOP);
- Section 403(b) plans, which may only be adopted by Section 501(c)(3) nonprofit organizations (such as public schools employees, not-for-profit hospitals, and churches); and
- Section 457 plans, which may only be adopted by certain private tax-exempt organizations and state or local government entities.

With these exceptions, all forms of qualified or tax-advantaged plans are generally permitted for all forms of business entities.

Another factor in the selection of a retirement plan for an incorporated employer is how much of the plan can be invested in the employer's securities. Some plans can only have 10% of the retirement plan assets in employer securities when the employer securities are placed into the plan. These plans include defined benefit plans, cash balance plans, target benefit plans, money purchase plans, and SEP/SARSEPs. Other plans are not technically restricted in the percentage of employer assets that may be initially placed into the retirement plan. These include profit-sharing plans, 401(k) plans, and thrift savings plans. Stock bonus plans and ESOPs were specifically designed to hold employer securities, so there is no limitation on the percentage of the plan that can be contributed in employer securities.

Another important factor in the selection of a retirement plan is whether or not the employer must make mandatory annual contributions or if the employer wants the flexibility to contribute each year. The main mandatory annual contribution plans are the four pension plans. They can be remembered by the sentence, "be my cash target." (*B* for benefit in defined benefit plans, *M* for money purchase plans, *C* for cash balance plans, and *T* for target benefit plans.) If the employer does not want mandatory annual contributions, all these plans are eliminated. If the employer wants the annual contributions to be mandatory, then all plans other than the *be my cash target* plans are eliminated. While an employer could decide to make annual contributions to a plan in the *profit-sharing* category (nonmandatory annual contribution plans), this is not the way a test is written.

One way to separate SIMPLE IRAs and SEPs is to look at the part-time or very low-paid workers. With a SEP, workers who make more than $750 in 2023 (and met the time qualifications) must be included in the plan. For a SIMPLE IRA, a worker must make $5,000 before receiving an employer contribution. Thus, a number of workers who make more than $750 but less than $5,000 is an indication that a SIMPLE plan should be implemented over a SEP.

SIMPLE IRAs and SIMPLE 401(k)s are very similar. However, a SIMPLE IRA with a 3% match does not stop matching at the normal compensation limit of $330,000 in 2023. Thus, an owner earning more than $330,000 in 2023 is an indication that a SIMPLE IRA with a 3% match is better than a SIMPLE 401(k). Also, SIMPLE IRAs with a 3% match can lower the match to 1% for two years out of five. Thus, a SIMPLE IRA would be better than a SIMPLE 401(k) if the owner is afraid to commit to the whole 3% match. This is a major reason far more SIMPLE IRAs have been established relative to SIMPLE 401(k)s.

On the other hand, a SIMPLE 401(k) can choose to offer retirement plan loans. A SIMPLE IRA is a type of IRA and thus cannot offer a retirement plan loan option.

SIMPLE plans have a lower limit on contributions than other employer plans. The worker can only contribute $15,500 in 2023 unless they are age 50 or older. Then, the worker contribution maximum is raised to $19,000 because the SIMPLE catch-up is $3,500. The maximum an employer can contribute is 3%. Thus, if someone is age 50 or over and earned $250,000, the maximum that could be saved in a SIMPLE plan is $26,500 (3% of $250,000 is $7,500 from employer matching, plus $15,500 from the normal maximum on employee contributions, plus another $3,500 for being age 50 or older). While $26,500 is substantial, it is less than half of the $66,000 maximum that could be saved for retirement in most other plans in 2023.

TEST TIP

When taking a test, there will only be one answer that fulfills all the requirements. Thus, any strike against an answer eliminates that answer. It is best to read a clause and see if any answers are eliminated. For example, if the question says, "The owner wants complete contribution flexibility . . ." this eliminates any answer that requires mandatory annual contributions. Thus, if *money purchase plan* is a listed answer, it is eliminated. The key is being intimately familiar with the details of the various types of retirement plans. The following tables look at the plans from a variety of perspectives.

Figure 8.1: For-Profit Retirement Plans and Characteristics Summary (2023)

Type of Plan	Easily Understood by Employees?	Who Assumes Investment Risk?	Does Plan Favor Older Participants?	Does Plan Permit Elective Deferrals?*
Traditional defined benefit pension plan	No	Employer	Yes	No
Cash balance pension plan	No (but perhaps easier to understand than traditional defined benefit pension plan)	Employer	No	No
Traditional profit-sharing plan (without Section 401(k) feature)	Maybe	Employee	Maybe (if age-weighted)	No
Profit-sharing plan with Section 401(k) feature	Maybe	Employee	No	Yes, $22,500
Money purchase pension plan	Yes	Employee	No	No
Target benefit pension plan	No	Employee	Yes	No
SEP IRA	Yes	Employee	No	No
SIMPLE IRA	Yes	Employee	No	Yes, $15,500
SIMPLE 401(k)	Maybe	Employee	No	Yes, $15,500

*Contributions are the maximum amount of employee pretax contributions for calendar year 2023; catch-up contributions are also permitted for individuals age 50 or older.

Figure 8.2: Types of Retirement Plans Available to Various Business Forms*

	Retirement Plans								
Business Entity	**Profit Sharing**	**Stock Bonus and ESOP**	**Section 401(k) Provisions**	**Money Purchase**	**Target Benefit**	**Defined Benefit**	**SIMPLE and SEP**	**TSA**	**NQDC**
C Corporation	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes
S Corporation	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Not owner
Partnership	Yes	No	Yes	Yes	Yes	Yes	Yes	No	Not owner
Sole proprietorship	Yes	No	Yes	Yes	Yes	Yes	Yes	No	Not owner
Tax-exempt (501(c)(3)) organization	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes, for HCE (457)
Church (religious organization)	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	No (457)
Public school	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes (457)
State and local government	Yes	No	No	Yes	Yes	Yes	Yes	No	Yes (457)

Note: NQDC stands for nonqualified deferred compensation. The 457 plan is the NQDC plan in 501(c)(3), school districts, and governmental units.

*This chart generally summarizes the availability of new plan installations to various forms of business. In certain situations, existing plans may have been grandfathered in at the time of tax law changes, but installation of the particular plan type would not be permitted.

Figure 8.3: Summary of Qualified Plan Characteristics in 2023

	Defined Contribution Plans			Defined Benefit Plans	
Basic Statutory Characteristics	**Profit Sharing/ Stock Bonus**	**Money Purchase Pension**	**Target Benefit**	**Cash Balance**	**Defined Benefit**
Employer contribution:					
Maximum deduction	25% of includible payroll Flexible contribution	25% of includible payroll Fixed annual contribution to meet minimum funding requirement		Generally, fixed percentage of compensation; annual actuarial adjustment	Annual actuarial determination of minimum funding requirement
				Limited to amount necessary to fund benefit of up to the lesser of $265,000 (2023) or 100% of participant's average compensation over three highest consecutive calendar years	
Subject to minimum funding standard?	Generally, no	Yes		Yes	Yes
Employee contribution	401(k) provisions allowed	May permit voluntary after-tax contributions	N/A	N/A	May permit voluntary after-tax contributions
Forfeitures	Generally reallocated (may reduce employer contribution)	Reallocated or applied to reduce employer contribution		Must be applied to reduce employer contribution	
Additional Characteristics					
Annual additions limit (415 limit)	Annual additions to a participant's account may not exceed the lesser of 100% or $66,000 in 2023			N/A	N/A
Annual benefit limit (415 limit)	N/A			Participant's annual benefit under the plan may not exceed the lesser of $265,000 (2023) or 100% of participant's average compensation over three highest consecutive calendar years	
Most favored age group	Young	Young	Older	Young	Older
Bearer of investment risk	Employee	Employee		Employer	Employer
Maintenance of plan funds	Individual accounts			Pooled funds	
Certainty of retirement benefit	Uncertain			Guaranteed minimum return (PBGC-insured) on fund	Specified annual benefit (PBGC-insured)

Figure 8.4 illustrates many of the company and client plan objectives that can be met using any type of qualified plan. Depending on the particular circumstances, the constraints of those circumstances, and the requirements of the particular plan, most qualified plans can incorporate design features that meet most, if not all, of the important objectives of the business owner client and his company.

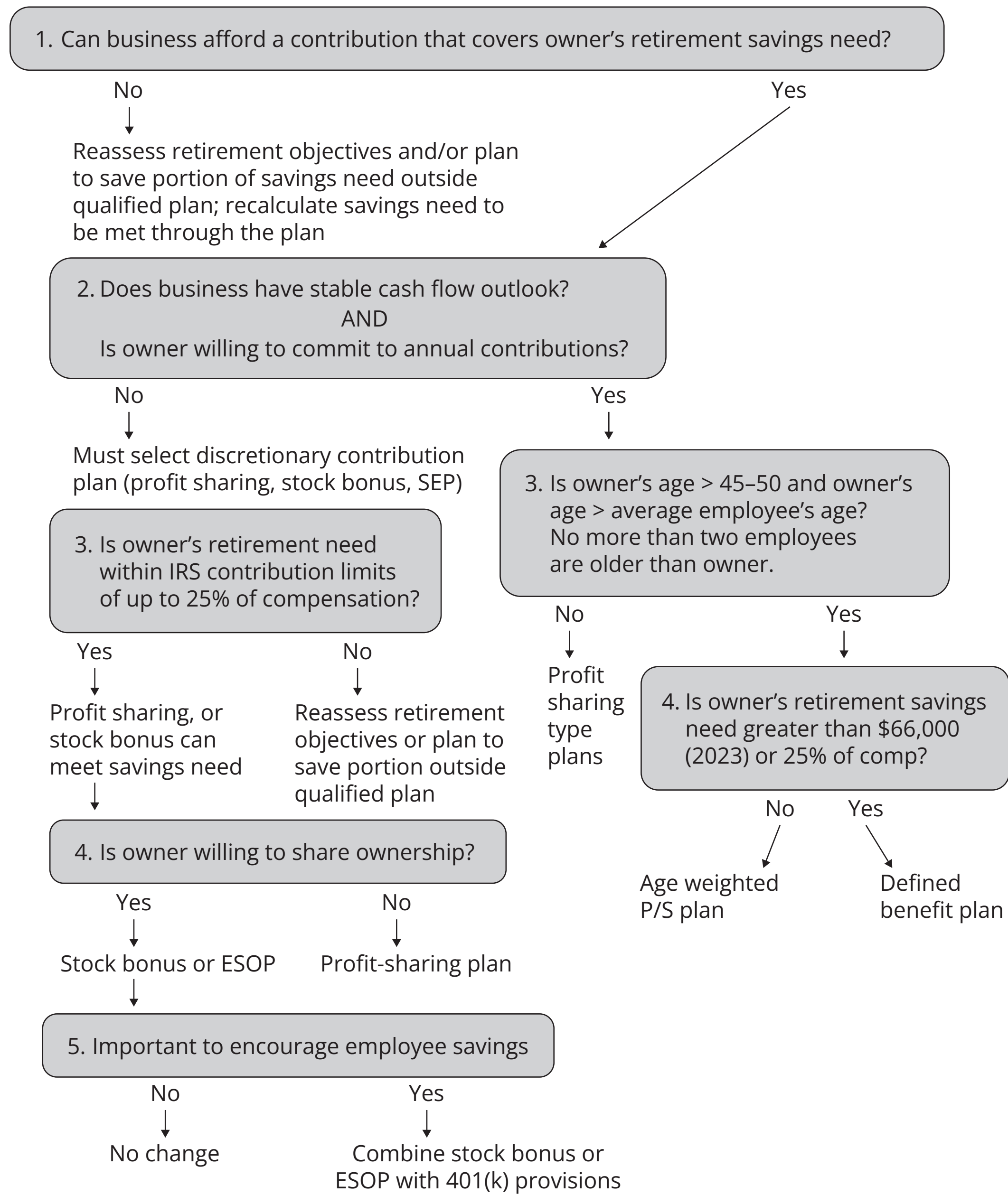
Some plans meet those objectives more efficiently than others. Where there seems to be more than one viable option, the best choice is generally the most efficient or simplest. For example, if the need is 25% or less of the owner's compensation, a profit sharing or profit sharing 401(k) plan would be a better choice than a defined benefit plan or money purchase plan, even though the owner is significantly older than the average age of the other employees. Why? Either of these alternatives involves either additional administration expenses or greater fixed commitments, while the profit sharing plan offers flexibility, simplicity, and lower administration cost.

Figure 8.4: Qualified Plan Objectives

	Most Appropriate Qualified Plan to Meet Objective			
	Specific Design Features of Any Qualified Plan	**Defined Contribution**	**Profit Sharing/ 401(k)**	**Defined Benefit**
Personal Objectives				
Maximize personal tax benefits	Yes			
Maximize personal retirement benefits	Yes			
Achieve retirement income objective				Yes
Provide estate protection	Yes			
Business Objectives				
Reduce corporate income tax	Yes			
Reward valued employees	Yes			
Motivate employees		Yes (PS)	Yes	
Recruit employees	Yes			
Reduce turnover	Yes			
Increase employee satisfaction	Yes			
Altruistic Objectives				
Provide employees with retirement income	Yes			
Promote employee savings			Yes	
Provide flexible compensation			Yes	
Share profits		Yes (PS)		
Share ownership		Yes (stock bonus & ESOP)		

Although something as complicated as retirement plan selection cannot be completely captured easily, the following plan selection flow chart is an example of what to consider and the implications implied.

Figure 8.5: Plan Selection Flow Chart (2023)



EXAMPLE: Retirement Plan Selection 3

ABC Company would like to implement a retirement plan for the benefit of its employees. It has the following business objectives:

- Attract and retain employees
- Allow the employer to make all initial contributions to the plan using company stock
- Allow for integration of the plan with Social Security

Therefore, with no more information than this, any type of pension plan would not be appropriate because it does not permit more than 10% of plan assets to be invested in employer securities. Nor is an ESOP appropriate because it cannot be integrated with Social Security. Finally, a SEP or SIMPLE IRA would not be appropriate because employer contributions would have to be made in cash.

After eliminating other possible plans, the most advantageous type of retirement plan to meet ABC's objectives would likely be a stock bonus (profit-sharing type) plan.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

1. The goal of the highly profitable RDF Company is to maximize retirement benefits to the highly compensated employees of the company. These people also happen to be the oldest employees. Which of the following plans best accomplishes this goal, assuming a new plan is to be implemented?
   A. An age-based profit-sharing plan
   B. A money purchase pension plan
   C. A target benefit pension plan
   D. A traditional defined benefit pension plan

2. Which of the following types of plans may be structured to provide for some type of deferral of taxable income for retirement?
   I. Nondeductible traditional IRA
   II. Roth IRA
   III. SIMPLE 401(k) plan
   IV. Nonqualified deferred compensation plan
   A. I and III
   B. I, III, and IV
   C. II and IV
   D. I, II, III, and IV

Module 8

3. Charles is a 30-year-old CPA with his own tax practice. For most of the year, he works by himself, preparing and reviewing income tax returns. For the last five years, he has hired three part-time employees to assist him during the busy season. Each of these employees works approximately 200 hours, earning an average salary of $3,000 per year. Charles would like to establish a retirement plan that would allow him to save for his own retirement, without significant administrative costs. Which of the following plans would be most appropriate for Charles?
   A. SEP IRA
   B. Traditional Section 401(k) plan
   C. SIMPLE IRA
   D. Section 457 plan
4. Jack, a CFP® professional, has a client, age 45, who is the sole proprietor of a small company with five employees. The client has given Jack an employee census and requested that Jack recommend a retirement plan that will fit in with the client's desire to retire at age 62 and also help retain employees. The company has historically had positive cash flows. Jack has developed recommendations for plans using a variety of scenarios for his client and written a plan. What does Jack do next?
   A. Jack presents the recommendations to his client and clearly explains his findings and the alternatives available.
   B. Jack mails the written plan to the client and waits to hear from him.
   C. Jack creates a prioritized plan to implement his recommendations.
   D. Jack calls a third-party administrator to set up the plan Jack has recommended.

TOPIC 8.2: INVESTMENT ASSET CONSIDERATIONS FOR RETIREMENT PLANS

Reading: Investment Considerations for Retirement Plans

LO 8.2.1: Analyze the characteristics of investment assets to assess the potential suitability for a retirement plan.

LO 8.2.2: Discriminate the tax consequences of life insurance as a qualified retirement plan asset.

The foremost consideration in determining the composition of assets in which a qualified or tax-advantaged retirement plan should invest in is who bears the investment risk: the employer or employee. In an individual account defined contribution type of plan, the investment risk is assumed directly by the employee. As a result, sponsors of such plans typically provide participants with a choice of investment vehicles, among them fixed income investments, common stock, mutual funds, real estate, and, sometimes, employer stock. The employee is often permitted to self-direct contributions among a number of assets or mutual funds, usually with very little assistance from the employer or employer's plan representatives.

In contrast, the investment risk under a pooled account defined benefit type of plan is assumed almost entirely by the plan employer-sponsor. Accordingly, because this type of plan typically promises some fixed amount of benefit to the participant at the date of his retirement (and for which this benefit requires mandatory funding), an employer is usually somewhat conservative in its choice of investment assets to fund the plan. In addition, the necessity of developing a written investment policy standard (under ERISA) to assist in the meeting of investment objectives is usually much more critical for those employer-sponsors who have decided to implement a defined benefit type of qualified retirement plan.

In either type of retirement account (defined benefit or defined contribution), the selection of investments available to the plan and the evaluation of the fee structure are fiduciary duties, and must be carried out with the best interests of the plan participants in mind.

There are six primary characteristics of any investment vehicle that need to be considered in assessing the asset's potential suitability as a retirement plan asset. These are

- the investment's stability in value, also known as *capital preservation*;
- its ability to preserve the future purchasing power of the plan participant;
- the liquidity of the investment;
- the investment's tax advantages (e.g., it makes little sense to put a tax-advantaged investment, such as a municipal bond, within a tax-deferred investment vehicle, such as a qualified retirement plan);
- diversification properties; and
- marketability (the ability to convert the asset to cash quickly near the current price level).

When determining the liquidity of an investment choice, **liquidity** can be defined as the ability to sell or redeem an investment quickly and at a known price without significant loss of principal. While some investment choices can easily be converted to cash (e.g., mutual funds), they cannot always meet this definition. As with any investment, these factors may be categorized generally as characteristics of expected return and risk. They are relevant for each of the following five major classes of retirement plan assets:

- Money market instruments
- Fixed income assets (including bonds and guaranteed investment contracts)
- Common stocks (including employer stock)
- Mutual funds
- Real estate

The following is a summary of all of these types of assets and their appropriateness/use in a qualified or tax-advantaged retirement plan.

Figure 8.6: Assets Used in Qualified/Tax-Advantaged Plans

Asset Class	Appropriateness/ Use in Retirement Plan	Characteristics of Asset Risk	Expected Return Considerations
Money market instruments	Use primarily for liquidity purposes	Low risk; safety of principal; liquid	Minimal rate of expected return
Corporate and government bonds	Use to fund future fixed obligations	Moderate risk; inflation protection lower; not liquid	Higher (fixed) rate of return than money market
Guaranteed investment contracts	Use to fund future fixed obligations—common in defined benefit plans	Low risk; guaranteed payments; liquid	Real rate of return similar to bonds (fixed income)
Common stock	Use to generate capital appreciation and some income	Highest risk; inflation protection; not liquid	Highest historical rates of expected return (but volatile)
Employer stock	Use primarily as employee incentive	Higher risk; lack of diversification	Return tied to corporate earnings
Mutual funds	Use primarily for diversification purposes	Diversification minimizes systematic risk	Comparable historical return to that of stock (consider expenses)
Real estate (direct and indirect)	Use as inflation hedge in some plans	Highest risk depending on location; not liquid	Real rate of return may be comparable to common stock

Unrelated Business Taxable Income (UBTI)

Unrelated business taxable income (UBTI) generally is considered the gross income derived from any unrelated trade or business (meaning any trade or business that is not related to the provision of retirement income for plan participants) regularly carried on by the retirement plan, less any deductions directly connected with carrying on this trade or business. It is generated by the qualified plan trust and usually arises from property acquired with any funds that are borrowed by the trust. The major exception to the purchase of securities with borrowed money is employer securities that are purchased by an ESOP, as this is a specific ERISA exception to the UBTI rules. Also, the first $1,000 of UBTI is excluded. This is an attempt to simplify the administration of UBTI in situations with tiny amounts of UBTI.

The following items are excluded, however, from the calculation of UBTI and do not count against the $1,000-per-year exclusion:

- Dividends, interest, and royalties
- Rents from rental real estate owned by the trust
- All gains or losses from the disposition of property, with certain exceptions

- The liquidity of the of the investment
- Certain amounts received from controlled entities and foreign corporations

Life Insurance in a Qualified Retirement Plan or 403(b) Plan

Life insurance can be purchased as an asset by a qualified plan (but not by any type of IRA, including a SIMPLE IRA or SEP). The advantage of purchasing life insurance by the retirement plan is twofold—(1) it can satisfy the need for additional life insurance protection for the owner of a small business, and (2) it can generate an immediate income tax deduction for the payment of the life insurance premiums (as qualified plan contributions) that may not otherwise be possible.

The amount of life insurance that may be held inside a qualified plan is limited under law. These are known as the **incidental benefit rules** of life insurance investment, and the amount of insurance held by the plan must meet one of the following two tests:

- The **percentage test**—under this test, the aggregate contributions paid for a life insurance policy owned by the plan on the lives of the plan participants may not exceed a certain percentage of the employer contributions to the plan as follows:
  - For the purchase of a whole life policy, no more than 50% of the employer contributions to the plan may be used.
  - For the purchase of any other life insurance policy (for example, term or universal life), no more than 25% of the employer contributions to the plan may be used.

  Defined contribution plans use the percentage test rules in determining whether they have achieved compliance with the incidental benefit rules.
- The **100 times test**—under this test, the life insurance limitation is based on a ratio of the death benefit paid by the policy to the expected monthly benefit of the employee-participant payable by the plan. Specifically, using the 100 times test, the death benefit payable from the life insurance policy cannot exceed 100 times the expected monthly benefit for the employee-participant.

  Defined benefit plans typically use the 100 times test rules in determining whether they have achieved compliance with the incidental benefit rules.

Tax Issues During the Participant's Lifetime

For employees, if a qualified plan owns life insurance on the life of a participant, the employer is allowed to fully deduct the premiums and the participant must only include in her income the **pure protection cost** of life insurance provided by the plan. The pure protection element amount is measured by the difference between the policy face amount and the policy cash value. The amount of inclusion in taxable income is the lesser of the cost of the insurance to the qualified plan or the **Table 2001 cost** as determined by a table in the Treasury Regulations. This amount is also treated as nontaxable basis to the employee-participant once distributions begin to be made from the plan. On the other hand, this amount is offset by any employee contribution to the plan.

On the other hand, self-employed individuals covered with life insurance inside the employer's retirement plan are income taxed differently. Only the portion of the premium that exceeds the pure protection value is deductible—not the entire premium. In other words, the pure life insurance element as valued by Table 2001 is not deductible. However, the self-employed participant does not get a basis in the plan for these Table 2001 costs contributions like an employee would.

Tax Issues at the Participant's Death

Taxation of an insured death benefit received by a beneficiary of the plan participant may be summarized as follows:

- The total of all Table 2001 costs (or, if lower, the insurance cost to the qualified plan) may be recovered tax free from the plan death benefit.
- The pure insurance element of the plan death benefit is income tax free to the participant's beneficiaries (as life insurance proceeds).
- The remainder of the distribution is taxable as a qualified plan distribution.

Qualified Longevity Annuity Contracts (QLAC)

Since 2015, an additional funding choice is available to IRA owners and Section 401(k) plan participants. The additional choice is referred to as a *qualified longevity annuity contract (QLAC)*. A QLAC will allow participants to allocate the lesser of 25% or $155,000 (2023) in their account to the purchase of a deferred annuity from which payments begin at an older age (usually up to age 85). The annuity allocation provides a stream of income to the participant for the balance of a participant's lifetime once payments commence. The funds allocated to the longevity annuity will not be considered in the calculation of required minimum distributions at age 72.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

5. What type of investment is generally appropriate to hold within any form of tax-deferred retirement plan?
   - A. Zero-coupon bond
   - B. Municipal bond
   - C. No dividend paying common stock
   - D. Life insurance
6. Which of the following statements regarding the incidental benefit rules of life insurance owned by a qualified plan is CORRECT?
   - I. For defined contribution plans, no more than 25% of the plan's assets may be in the form of universal life insurance.
   - II. For defined benefit plans, the life insurance death benefit cannot exceed 100 times the expected monthly benefit for an employee.
   - A. I only
   - B. II only
   - C. Both I and II
   - D. Neither I nor II

TOPIC 8.3: RETIREMENT NEEDS ANALYSIS AND SAVING FOR RETIREMENT

Reading: Assumptions for Retirement Planning

LO 8.3.1: Analyze the key assumptions needed for a retirement needs analysis.

There are three primary assumptions made in any **retirement needs analysis** calculation. They are

- the anticipated annual rate of inflation;
- the projected rate of annual investment return; and
- the client's age at retirement and anticipated life expectancy.

Rate of Inflation

Projecting future inflation rates is inherently problematic, but since 1926, the Consumer Price Index has averaged approximately 3% per year. Under the rule of 72, this means prices will double every 24 years (72 divided by 3) and is a good example of how a planner may impress upon the client the need to save with inflation-adjusted dollars. However, the **rate of inflation** for retiree-senior citizens may well be higher than 3% per year. This is primarily because of the rising cost of health care in the United States. One approach is to assume a higher annual rate of inflation in the **retirement savings need** analysis calculation of about 4–5% annually. A second approach would be to attempt to model retiree spending. People in retirement often spend more in early retirement because they have active lifestyles. In mid-retirement, their spending slows as their lifestyle becomes more settled. Late in retirement, their spending slows dramatically with the exceptions of healthcare and long-term care. Modelling these types of spending patterns is beyond the scope of the course.

TEST TIP

If you need to know the assumed rate of inflation, the test must give it to you. However, sometimes the rate of inflation is given when it is not needed for that specific calculation. In this case, part of the evaluation is knowing whether or not the inflation rate is needed for that calculation.

Rate of Investment Return

When selecting an assumed **rate of investment return**, most planners tend to use a flat average annual rate of return, which has the disadvantage of not taking into consideration the annual volatility of the return. Additionally, most estimates tend to be based on past performance, which may not be accurate when planning for extended periods in the future.

Taxes also impact the investment return achieved. Before retirement, the planner may use a before-tax rate of return in the assumptions, particularly if tax-advantaged savings vehicles (such as an employer retirement plan or IRA) are

used in the planning process. However, at the time of either optional or required retirement plan distributions, the client's anticipated marginal income tax rate is very important. This rate should be a blend of the client's federal and state marginal income tax rates but should be projected based only on current rates because it is not feasible to accurately predict future income tax rates.

Client's Projected Retirement Age and Anticipated Life Expectancy

Like inflation and investment return rates, projecting a client's life expectancy (time in the retirement period) is very difficult. By definition, "life expectancy" means that 50% of the people will have passed away by that age. That leaves half the original population still alive. While actuarial life expectancy tables are of some assistance (e.g., the actuarial factor applied from the required minimum distribution table is 27.4 at a client's age 72 for 2022 and following), these tables do not take into account family health history or, more importantly, how healthy (or unhealthy) the client is at the date of retirement. Also, RMD Table III estimates the life expectancy for the account owner and a hypothetical beneficiary who is 10 years younger than the account owner.

In addition, if the client has a considerably younger spouse, certainly the spouse's much longer life expectancy needs to be considered. Whatever actuarial table is used to determine the life expectancy of any individual client, it is likely prudent to add a factor of 5–10 years to the specified expectancy to provide a cushion for the client (or spouse) outliving the anticipated norm. Lifestyle should also be considered when planning for a client's retirement. Does the client want to travel during retirement? Does the client plan on maintaining his current lifestyle or making changes in the retirement years? The costs associated with the lifestyle choices the client makes should be included in the retirement planning assumptions.

The analysis should be recalculated any time there is a significant change in the circumstances of the client. One-year changes in tax rates should not trigger a recalculation (such as a temporary change in FICA rates or income tax tables). Significant life events (e.g., marriage, divorce, births, deaths, or employment, health, and income changes) should be the major triggers considered. Also, life expectancy has grown by one to two years per decade. Part of the increase in life expectancy comes from improved medical care. Another reason for the increase is healthier lifestyle choices.

Most retirement needs analysis calculations utilize fixed assumptions, but the use of probability simulation may yield more accurate results. The most useful technique is the Monte Carlo simulation, with which multiple outcomes can be considered to determine the likelihood of a given model supporting a client's retirement income goals.

LO 8.3.2: Calculate amounts needed for retirement considering client goals.

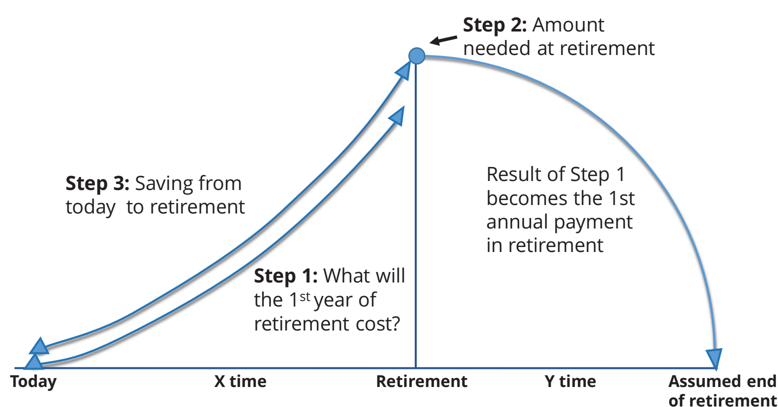
Financial Needs at Retirement

When determining how much the client should save to accomplish retirement income goals, the planner must first determine the lump-sum capital amount necessary to fund the projected income needed over the entire retirement period. Thus, a two-step calculation is required:

1. Inflate the projected first-year retirement income needed (expressed in present value dollars) to future dollars at the time of retirement. In other words, how much income will be needed to fund the first year of retirement? This calculation usually assumes Social Security benefits will keep up with inflation. Thus, the real question is how much will be needed from the client's retirement accounts. For example, the client's goal is to replace $75,000/year in today's purchasing power. Their Social Security estimates are $40,000/year in today's dollars. Thus, their retirement plans would need to replace $35,000 in today's dollars when they retire.
2. Calculate the total retirement fund needed (lump-sum capital amount) to meet the projected income demands. To do this, the planner must calculate the present value of an annuity due using an inflation-adjusted rate of return.

Retirement needs tend to be 60–80% of preretirement income to maintain the individual's preretirement lifestyle. This percentage is called the **wage replacement ratio (WRR)**. The savings rate required beginning at age 25 to achieve a 60–80% WRR is approximately 10–15% of gross income. This figure is significantly higher than the typical personal savings rate in the United States, which has been approximately 5% for many years. Also, few people start saving for retirement in their 20s. The longer a person waits to begin saving for retirement, the higher the saving rate will need to be. The process of analyzing the accumulation of sufficient resources for retirement is called **capital needs analysis** or *retirement needs analysis*. There are essentially three steps: First, estimate the annual income needed from their retirement plans for the first year of retirement. Second, calculate the amount of capital needed at the start of retirement to fund the estimated retirement cash flows using the capital utilization method. This step will usually be a serial payment in which each year's withdrawal increases by the rate of inflation to maintain a constant purchasing power. Thus, the interest rate will be adjusted for both inflation and the growth of the portfolio. Then if asked, account for the extra principal needed at retirement for the capital preservation or wealth preservation methods. Third, determine the required savings amount needed to accumulate the amount needed at retirement. The test may require any of these steps singularly or by applying Steps 1 and 2 or Steps 1, 2, and 3. With practice, you should be able to perform Steps 1–3 in about two minutes.

Here is a diagram of the overall processes for retirement calculations.



EXAMPLE: Retirement Needs Analysis 1

Your client, Steve, estimates he will need $60,000 annual income in today's dollars in excess of his Social Security benefits when he retires 10 years from now. He assumes a 3% annual rate of inflation, a 7% after-tax rate of return on available investments, and a 30-year retirement period. His total retirement fund needed to support this standard of living is $1,469,204, calculated as follows:

The client's first-year retirement income need is $80,635. In other words, it will take $80,635 in 10 years to buy what $60,000 buys today. This assumes inflation is 3%.

PV = –$60,000

I/YR = 3% (I/Y for the TI BA II Plus)

N = 10

FV = $80,634.9828

The total capital required to support this need for 30 years is $1,469,204.

In BEG mode (the client will make annual withdrawals at the beginning of each year)

PMT = $80,634.9828 (to use the full results of the previous calculation)

FV = 0

N = 30

I/YR = 3.8835% [(1.07 ÷ 1.03) – 1] × 100 (I/Y for the TI BA II Plus)

PV_{AD} = –$1,469,204

Note: The example is illustrated with the calculator set for 1 payment per year. If your calculation result does not match the example, check your calculator to be sure it is set for 1 payment per year. Also, the calculator needs to be in the Begin Mode for Step 2.

Results that are slightly different than this are due to rounding differences. Financial calculators use nine decimal places in their calculations, even if they show less. Thus, multistep calculator answers may be off by a small margin (+/– $25 out of $1.6 million) from the test answers and still be correct.

Often, there is another critical question that should be asked of the client during this stage of the retirement needs analysis process. Is the client comfortable using both the principal and income from the lump-sum capital amount to meet the retirement income needs or, alternatively, does the client wish to use only the income for living expenses (leaving the principal intact for transfer to any heirs)? Normally, for all but the very frugal wealthy, the answer to this question is that the client must use both the principal and income to support the retirement income need.

Accordingly, most retirement needs analysis calculations assume a **capital utilization approach**; nevertheless, be aware that an alternative calculation is to assume a **capital preservation approach**, a method that will require even more total capital to be accumulated at a client's projected date of retirement. The capital preservation approach would have the original capital balance needed at the retirement date under the capital utilization approach at the original life expectancy.

In the previous capital utilization approach example, the capital needed at retirement was calculated to be $1,469,204. In the capital preservation approach, this amount is then discounted at the expected investment return rate over the expected retirement period, and the result is added to the original capital utilization value. The sum is the amount of capital needed at retirement to generate the desired retirement income and leave a balance at the life expectancy equal to the original capital utilization value. In our example, the capital preservation approach value becomes $1,662,209. The two-step calculation is as follows:

FV = $1,469,204

N = 30

I/YR = 7% (I/Y for the TI BA II Plus)

PV = –$193,005 (additional capital needed for capital preservation)

$1,469,204 + $193,005 = $1,662,209

The capital preservation method has a number of advantages: First, it adds a margin of safety to the capital utilization approach. For example, what if the client is still alive at the end of the assumed retirement period? The capital utilization approach alone would mean all the retirement assets would have been spent except for Social Security, defined benefit plans, and any other assets that had been turned into a lifetime stream of income (life annuities). Also, what if the actual return was less than the assumed return or the actual spending was higher than the assumed spending? What about sequence of return risk? If the early retirement years included a large market loss, the assets might not last the entire time projected even though the average investment return met or exceeded the plan assumptions. For any of these reasons, or if clients wished to leave retirement assets to their beneficiaries, the capital preservation approach provides the possibility of either a cushion or a legacy.

Wealth Preservation Approach

While the capital preservation method would provide the heirs with the same number of dollars at the original life expectancy as the capital utilization method started with at retirement (assuming all assumptions were met exactly), would the heirs receive the same wealth (amount of purchasing power) as the deceased had when they retired? No. In the problem we have been working, your client Steve would have $1,469,204 when he retired using the capital utilization method. The capital preservation method would still have $1,469,204 in the account at Steve's death after 30 years of retirement. However, the $1,469,204 in 30 years would only buy as much as $605,293 would have bought when Steve retired. But what if the client wants to leave a legacy that equaled the purchasing power of the capital utilization number? The wealth preservation approach accomplishes this goal. By discounting the $1,469,204 by the inflation-adjusted growth rate instead of just the investment return, the additional amount needed at retirement would be $468,474 calculated as follows:

FV = $1,469,204

N = 30

I/YR = 3.8835% [(1.07 ÷ 1.03) – 1] × 100 (I/Y for the TI BA II Plus)

PV = -$468,474 (additional capital needed for the wealth preservation approach)

$1,469,204 + $468,474 = $1,937,678

Future Value of Accumulated Resources

It is necessary to determine how much, if any, of the required lump-sum capital amount needed at retirement will be satisfied through the future growth of currently available client assets or resources. Unfortunately, many clients have very little already saved that may be dedicated to their retirement income goals. A planner's first responsibility is to assist the client in implementing a periodic savings program.

However, if some assets have already been set aside at the time of performing the retirement needs analysis, the value of these assets should be included in the calculation. Including the existing funds will result in a lower calculated current savings amount needed or, perhaps, provide the client with the flexibility to consider a capital preservation approach or wealth preservation approach instead of a capital utilization approach.

EXAMPLE: Retirement Needs Analysis 2

In the previous example, it was determined that the total capital required to support Steve's retirement need for 30 years is $1,469,204 using the capital utilization approach. Now assume that Steve has already dedicated a total of $450,000 to the retirement income goals. What is the future value of this amount in 10 years at a 7% after-tax rate of investment return?

PV = –$450,000

I/YR = 7% (I/Y for TI BA II Plus)

N = 10

FV = $885,218.1108

As a result, we can now subtract the available amount of resources ($885,218) from the capital requirement need of $1,469,204. This yields a projected deficit at retirement of $583,986 ($1,469,204 – $885,218).

In considering the amount of accumulated resources, some clients will want the financial planner to consider Social Security retirement benefits, while others will not. However, while Social Security retirement benefits are the foundation of retirement income for the majority of people, Social Security will generally not meet a client's total retirement needs. Therefore, some retirement planners think it is prudent to prepare a conservative savings program based on the capital needed using only personal savings and employer-sponsored benefits. This approach will call for extremely high retirement contributions.

On the other hand, most planners include Social Security benefits in their retirement planning. There are two ways Social Security retirement benefits are included in retirement planning calculations:

- When the Social Security estimate is given in today's dollars, today's Social Security benefits can be subtracted from today's retirement income goal. For example, if the question said, "Joe and Mary have a retirement income goal of $100,000 per year in today's dollars when they retire in 25 years. Their Social Security benefits are estimated to be $40,000 in today's dollars. Inflation is estimated to be 4% . . . " the retirement income coming from retirement savings would be $60,000 in today's dollars ($100,000 – $40,000). Thus, $60,000 is

inflated by 4% for 25 years to determine the target income for the first year of retirement. This amount is $159,950 per year.

- If the Social Security benefit is stated relative to the retirement date instead of in today's dollars, then that amount is subtracted from the goal amount at retirement to determine the income goal from retirement savings. For example, if the question said, "Joe and Mary have a goal of $100,000 per year in today's dollars when they retire in 25 years. Their Social Security benefits when they retire will be $40,000. Inflation is estimated to be 4% . . . " the retirement income coming from the retirement savings calculation would use $100,000 in today's dollars, inflated by 4% for 25 years; after this, $40,000 would be subtracted from that amount. The income goal becomes $266,583.63 – $40,000 = $226,584.

Note: Social Security benefit estimates from the Social Security Administration are in today's dollars. This gives a more accurate impression to members of the general public of what their Social Security benefits will provide them in retirement. For example, if Social Security told a 37-year-old his Social Security retirement benefits would be $2,000 per month and inflation averaged 3% per year for 40 years, his benefits would be about $6,524 per month, but they would only buy what $2,000 buys today.

Retirement Savings Need Calculation

How much does a client need to save on an annual basis to meet a retirement income goal (and support the client's retirement lifestyle)? In the second example, the client had already set aside certain available resources ($450,000) to assist in meeting the desired retirement income goal. However, if no (or very little) resources have been dedicated to this goal, the initial savings need would be much greater. In addition to this analysis, we must also consider whether the client wishes to use a level or serial payment approach when saving for retirement. While most clients may want to use a **level payment approach** making equal payments each period, the financial planner should also make the clients aware that a serial payment calculation is more realistic as it begins at a lower level and thus can seem more achievable at first.

Level Payment Approach

Returning to the first client example (needing $60,000 per year for 30 years in today's dollars, retiring 10 years from now), the client who has not saved anything needs to save $106,337 annually to accumulate his retirement lump-sum capital need of $1,469,204. What level payment will be needed at the end of each year to accomplish this goal?

1,469,204, FV

10, shift, N For the HP-10B, the shift button is two buttons above the On button. Hitting shift before N will adjust for the number of compounding periods per year that you set before starting the calculation. For the TI BA II Plus, the keystrokes for entering the number of compounding periods (after setting the desired number of periods per year) are: 10, 2ND, xP/Y, N. The xP/Y button is under the white "N" button. Both calculators should show "10.0000." The TI calculator requires you to press the "N" button after the "xP/Y" button.

7, I/YR (I/Y for the TI BA II Plus)

End mode (Shift, MAR) MAR is the second button from the top on the right of the HP-10bII/HP-10bII+. For the TI BA II Plus, the End/Begin Mode is entered by: 2ND, BEG, 2ND, SET, CE|C. Actually, like the HP-10bII, you can see if you are in the begin mode by whether or not the calculator is showing "BEGIN" in the window for HP-10bII and "BGN" for the TI BA II Plus. If you do not see these words, then the calculator is in the End Mode. Thus, these keystrokes are really for changing the calculator to the other mode.

Answer: –$106,337 If your calculator gave you a different answer even though you were compounding once per year and were in the End Mode, try recalling the PV. Both calculators use the keystrokes, "RCL, PV" to recall the PV. It is likely that you have something other than 0.0000 there. If so, enter 0 as the PV and recalculate the PMT.

Finally, the PMT came out negative because the payment is going out of your checkbook. In other words, the payment is an outflow, not an inflow.

TEST TIP

It is important to be aware of which mode the calculator should be in during these calculations. When determining how much needs to be in the account on the day a person retires, the calculator should be in the Begin mode because the CFP model assumes the client withdraws the annual sum for each year at the first of the year. However, when saving for a goal, the model assumes the person earns the money and then invests. Thus, the savings are usually in the End mode. However, the savings can be in the Begin mode if the client is ready to start the savings program today in the sense that the first regular payment will be today (at Time 0) of the calculation.

Serial Payment Approach

In a **serial payment approach**, an initial or first-year savings amount is calculated and then increased each year by inflation, anticipating an increase in the client's income at that same rate. The difference in the calculation between this approach and the previous approach is that the dollars used are *constant dollars* instead of *current dollars*. A *constant dollar* is inflation adjusted. It will purchase the same amount each year through time. An example is the U.S. Postal Service *forever stamp*. It will mail a First Class letter this year. It will still mail a First Class letter 20 years from now. Its purchasing power is constant. Contrast this constant purchasing power with a *current dollar*. A current dollar will not have the same purchasing power in the future. When doing calculations, it is critical to know if you are dealing with constant dollars or current dollars. If there is a mixture of types of dollars you will have to convert into one type of dollar for the final step in the calculation.

PROFESSOR'S NOTE

Current dollars can be called *green dollars*. A green dollar buys whatever it buys at the time. Level payments use green dollars. A *blue dollar* is a mythical inflation-adjusted dollar. It buys the same amount as time passes. The concept of *Simon says* can also help here. If Simon says "$100,000 in today's dollars," then a serial payment is being asked

for. If Simon does not say something that identifies the dollars as constant dollars, then the calculation is in current dollars.

TEST TIP

The key to knowing which type of dollar is being asked about is reading the question carefully and looking for modifiers indicating what the inflation-adjusted interest rate is. If the question asks for a "serial payment" or uses language like "$100,000 in today's dollars," or "$250,000 in inflation-adjusted dollars," then the question is calling for an inflation-adjusted calculation. If the question asks for a "level payment" or does not add information to the dollar amount, then the calculation does not use the inflation-adjusted interest rate. Consider the example, "John needs another $1 million when he retires in 23 years." The $1 million is not qualified with an indication that it is inflation adjusted. Thus, you can expect to be asked for a level payment.

EXAMPLE: Retirement Needs Analysis 3

Using the same example in which Steve wants an additional $60,000 of inflation-adjusted income in addition to his Social Security benefits for 30 years in retirement, solve for a first-year serial payment of $94,295 as follows:

Steps 1 and 2 (Inflate the current need to determine the first retirement withdrawal and calculate the present value needed in the account on the first day of retirement): Steps 1 and 2 get us to the same $1,469,204 needed at retirement. Now, we will finish the calculation for a serial payment starting a year from now.

Step 3: What is the value of $1,469,204 in today's dollars?

Shift, Clear All (This clears the calculator. For the TI BA II Plus, hit 2ND, CLR TVM.)

1,469,204, FV

10, Shift, N For the TI BA II Plus, hit 10, 2ND, xP/Y, N.

3, I/YR   I/Y for the TI BA II Plus.

PV = -$1,093,225.76. This is the *in today's dollar* equivalent of $1,469,204 in the account in 10 years.

Many students find it difficult to understand why they have to adjust the initial goal number of $1,469,204 to $1,093,226. This is needed to take the inflation from today until the retirement date out of the calculation of the amount needed at retirement. This is necessary to avoid double counting the inflation from today until the assumed retirement date. All serial payments must be done in only one type of dollar—constant dollars. *Constant dollars* all have the same purchasing power. This is different than *current dollars*. Current dollars are not adjusted for purchasing power. All serial payment calculations are in constant dollars/*in today's dollars* (with *today* being defined as the start of the time period for the calculation - which can be thought of as Time 0).

Step 4: Calculate the first serial payment required at the end of the first year to reach the retirement goal.

1,093,225.76, FV

0, PV

10 Shift, N (The calculator should show 10.000 after the N button is pressed.)

[(1.07 ÷ 1.03) – 1] × 100 = 3.8835 I/YR   I/Y for the TI BA II Plus

PMT

This gives -$91,548.88

$91,548.88 × 1.03 = $94,295

Comments:

The initial calculator answer of $91,549 is the answer in *today's dollars* (meaning the dollars right now). However, because the check will not be written for a year, one year's inflation must be added. The serial payment in the second year and all following years must also be adjusted for inflation in the same manner.

If your number is off by a very small amount, the culprit is probably in the number of decimals used. The calculator uses more decimal places than it shows. For example, if you input $1,092,225.75 as the PV and enter the 3.8835 directly into I/YR from the calculation, you will get $91,548.88. If you clear the calculator and manually input 3.8835, you will get $91,548.86. The two cent difference in this situation is extremely small because the interest rate using the formula is 3.883495146%, even though it shows 3.8835. Also, 10 years is a fairly short time. In other situations, the difference in the answers can vary $10–$30. These small differences will not affect determining the answer on the test because the other answers will not be within the margin determined by the number of decimal places used.

It is common to make a mistake by not being in the correct mode (Begin mode vs. End mode) when a payment is involved. When clients retire, they will want to get their money to live off of for this coming year from their investment portfolio at the beginning of each year. They do not want to wait a year and then get their money for food. So, all calculations for withdrawing money each year in retirement will be in the Begin mode. However, saving for retirement calculations can be in either mode (Begin or End mode), but will usually be in the End Mode. First, systematic savings/investing usually start after one time period has passed. For example, you open an IRA with $1,000 (the PV), then start investing $500/month. The first investment of $500 comes one month after the initial investment. Thus, savings are almost always made in the End Mode. There is also educational value in switching from Begin Mode when calculating the amount needed at retirement to End Mode for saving for retirement, as it shows the student understands this issue.

Another common mistake is calculating a serial payment in the End mode (as an *ordinary annuity*) and then not manually adding a year worth of

inflation to account for the wait until the first payment is actually made. In a similar fashion, the test can ask for the second year's serial payment in the Begin mode (as an *annuity due*). The second annual serial payment in the Begin mode happens one year after the initial payment, so a year's worth of inflation must be added to the calculator produced answer. Either way, the calculator gave you the correct answer in this year's dollars, but if you do not actually make the payment for a year, then a year's worth of inflation must be added to maintain the same purchasing power.

PROFESSOR'S NOTE

One way to remember which payment mode to use is by focusing on the word *annuity*. If the payment should be in the Begin mode, the word *annuity* is at the beginning of the term (*annuity due*). If the payment should be in the End mode, the word *annuity* is at the end of the term (*ordinary annuity*).

Compare the resulting payments under both approaches. The annual payments made in the early years under the serial payment approach will be less than that calculated using the level payment approach. However, over time, the annual payment required under the serial payment approach will exceed that required using the level payment alternative. This is a similar issue to the premiums for annual renewable term versus whole life. The term policy will start with a lower cost than the whole life policy, but eventually the term premiums will exceed the old whole life premiums. For retirement calculations, this should make perfect sense. First, the actual goal is the same amount of money, it is just expressed differently. For example, if Step 2 calculated the amount needed at retirement to be $2 million, but when the pre-retirement inflation was removed the goal became $1,250,987 in today's dollars. Assuming everything was exactly as planned, $2 million will actually be in the account at retirement. However, that $2 million at retirement would have the same purchasing power as $1,250,987 has today. Fortunately for your client, you helped them get the $2 million into the account and it was what they needed to accomplish their inflation-adjusted withdrawals throughout their retirement.

Methods of Saving for Retirement

After performing a retirement needs analysis and calculating the necessary capital needed, it is important to evaluate the various retirement savings alternatives available to the client. The client should review his employer-sponsored retirement plan benefits.

For example, if they are not participating in an available employer-sponsored Section 401(k) plan, deferring some salary to take advantage of the employer-savings match is an excellent option. In addition, increasing elective deferrals to such a plan is worth considering.

If the individual is self-employed, the importance of establishing and contributing to a tax-advantaged retirement plan (such as a SEP, SIMPLE IRA, or a solo Section 401(k)) cannot be overstated. Other methods of taking advantage of employer-sponsored alternatives include nonqualified deferred compensation (NQDC) and equity-based compensation exercisable at an employee's projected retirement date.

There are also individual savings plan alternatives that may be implemented by the client. Popular among these are the traditional IRA and the Roth IRA, but there

are also insurance-backed retirement products, such as deferred fixed or variable annuities, as well as cash value life insurance policies.

Finally, there are taxable account alternatives, including investment portfolios structured to provide primarily capital appreciation (stocks) and fixed income (bonds). If it is determined the client is unable to meet the retirement savings goal, the client then has five alternatives:

- Retire later
- Save more
- Reduce the retirement income needs
- Restructure the asset allocation of the investment portfolio to increase investment return (while assuming additional investment risk)
- Some combination of the available alternatives

The most common choice is a combination of retire later and save more. The client should review her employer-sponsored retirement plan benefits.

Transitions to Retirement

As clients approach retirement age, many questions and concerns can arise. Often, one of clients' biggest concerns is the sufficiency of retirement income. Post-retirement income is often considerably less than during the working years. Whether or not it is sufficient depends on many factors, such as investment returns, inflation, health issues, and the client's spending habits in retirement.

A planner can assist the client by helping to construct a budget that illustrates the relationship of post-retirement expenses to the level of retirement income. This can alleviate some of the anxiety clients may feel about the unknown and can give them a sense of control over their retirement planning.

In addition to financial concerns, many retirees find the sudden lack of a place to go and a schedule to meet disconcerting. They may feel uneasy without the validation of having a place to go every day where they are valued and productive. Easing into retirement can lessen the difficulty. By cutting their hours gradually for some time prior to retirement and reducing their role in the workplace (i.e., winding down) the transition into retirement is less stressful for many clients. In all, people need to retire TO something, not just FROM work.

Bridge employment is a job that helps ease this transition. When a client is not ready to completely retire, feels safer having additional income, or must make up for a shortfall in retirement assets, a part- or full-time bridge job may be the answer. Even though bridge jobs seldom have the same compensation level clients enjoyed preretirement, there are many opportunities to use the employment to satisfy other interests clients have and allow them to put their talents to work.

When discussing with a client the possibility of post-retirement employment, the planner should take advantage of the various agencies available to counsel retirees in their area. For those with a college degree, it is possible that teaching in the public or private arenas would be a good fit. Entry-level positions in different fields can

provide some needed income as well as the social interaction the retiree was used to during his previous employment.

Once fully retired, clients may find they still need the opportunity to be in contact with others on a daily basis that they would miss if they fully retired and left the workforce. These clients often see the onset of retirement as an opportunity to learn a new skill, start a second career, volunteer in causes that are important to them, or travel.

If clients are concerned about becoming isolated in their later years and additional retirement funds aren't needed, planners may want to suggest that clients volunteer for a cause they support or where their help is truly needed. The Retired Senior Volunteer Program in a client's area can offer clients many options to help others, as can churches or other religious and civil organizations.

Retiring can be a complicated and emotional event for clients. However, presenting some of these options can help them make a smoother transition into retirement so they can enjoy their retirement years.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

7. A client needs an annual retirement income of $70,000 per year in today's dollars. In performing a retirement needs analysis, the client wants you to assume a 3.5% annual inflation rate, an 6% after-tax return, and a 30-year retirement period. The client plans to retire in 12 years. What is the annual payment needed at the end of each year to meet the client's retirement income goal using a level payment savings approach if the client already has $450,000 in their retirement accounts and Social Security is assumed to provide $30,000/year in today's dollars? The Social Security benefits are assumed to be inflation-adjusted throughout the client's life.
   A. $22,642
   B. $24,000
   C. $54,349
   D. $71,834
8. All of the following are commonly thought of as methods of saving for retirement except
   A. the traditional deductible IRA.
   B. the Roth IRA.
   C. a Section 529 plan.
   D. a Section 401(k) plan.

MODULE 8 ANSWER KEY FOR PRACTICE QUESTIONS

1. **D** The traditional defined benefit pension plan favors older participants and generally allows larger contributions than other plans. While age-based profit-sharing and target benefit plans also favor older participants, they are limited by the annual additions dollar limit that applies to all defined contribution type plans ($66,000 in 2023).

2. **D** Each of these individual accounts or plans may be structured to provide for deferral of taxable income in the sense that the earnings are not taxed each year while in the plan. The nondeductible traditional IRA defers income tax on only the earnings. The SIMPLE 401(k) and nonqualified deferred compensation plan defer income taxes on both the contribution and the earnings. The Roth IRA defers income taxes on the earnings each year. Roth distributions of earnings are subject to income taxes unless the distribution is a qualified distribution. Money that is converted into a Roth IRA defers income taxes until the conversion. Roth IRA contributions defer income tax on the earnings each year. All withdrawals of Roth contributions are tax free and there is no early withdrawal penalty under all circumstances because they are treated as a return of principal.

3. **C** A SEP IRA is incorrect because it would require coverage of all of Charles's part-time employees. A traditional Section 401(k) plan is incorrect because the plan would involve special nondiscrimination testing and annual filing of the Form 5500 series. A Section 457 plan is incorrect because it is available only for certain, private tax-exempt organizations and state and local governmental entities. A SIMPLE IRA would be the most appropriate plan because it involves low administrative costs and would meet Charles's retirement planning goals.

4. **A** Jack presents the recommendations to his client and clearly explains his findings and the alternatives available. Jack cannot create a plan to implement his recommendations until he has discussed the recommendations with his client, obtained feedback, and verified his client's acceptance of his recommendations. Jack cannot call anyone to assist in setting up a plan until one has been agreed upon by his client.

5. **A** Because zero-coupon bonds generate phantom income, they are generally appropriate to hold as an asset within any form of tax-deferred retirement plan. A non-dividend-paying stock would convert a capital gain to an ordinary income asset if owned by a retirement plan, although the growth of the stock would be beneficial. Life insurance as a plan funding vehicle is not permitted in plans funded with an IRA. Municipal bonds offer tax-exempt income. This is inappropriate for a retirement account because a retirement account does not pay income taxes each year during deferral, and withdrawals are taxed as ordinary income.

6. **B** For defined contribution plans, no more than 25% of the employer contributions to the plan (not assets in the plan) can be used to purchase universal life insurance. Statement II is correct.

7. **B** The annual level savings payment needed by your client to meet her retirement income goal is $58,697, calculated using the following three-step traditional Time Value of Money process:

Step 1:

Adjust the annual amount needed for inflation between now and retirement. $70,000 – $30,000 = $40,000

Clear calculator (Shift, C). The Shift button is directly above the C button on the HP-10bII/HP-10bII+. Since the Shift button was hit directly before the C button, the C button is technically the "C ALL" button. However, the C ALL button does not reset three important things: the End or Begin mode; the number of compounding periods per year; or the number of decimal places shown.

For the TI BA II Plus, clearing the calculator means hitting 2ND, CLR TVM.

40,000, +/-, PV (PVs are always negative except for loans.)

3.5, I/YR (I/Y for the TI BA II Plus)

12, shift, N (This should enter "12.0000" in N. If it does not, hit "1, shift, PMT" to set the number of compounding periods per year to 1.)

For the TI BA II Plus, hit 12, 2ND, xP/Y (the N button), N. You should see "12.0000." If you do, then hit N to enter the 12 compounding periods. If you do not get 12 compounding periods, set the number of compounding periods per year to one and try again.

FV calculator gives $60,442.7463. For the TI BA II Plus, hit CPT, FV.

Step 2:

How much is required at retirement to fund a serial payment of $60,442.7463 for 30 years with 3.5% inflation and an 6% after-tax return?

For the HP-10bII, +/-, +/-, PMT (Hitting "+/-" twice prepares the FV of $60,442.7463 from the last step to be entered as the PMT for this step as a positive number. This technique reduces the possibility of a typo and uses all the decimal places.)

For the TI BA II Plus, simply hit PMT and the $60,442.7463 computed as the FV will be entered as the PMT.

Begin mode (Shift, MAR for the HP-10bII or 2ND, BGN, 2ND, Enter, CE/C for the TI BA II Plus)

30, Shift, N for the HP-10bII or 30, 2ND, xP/Y, N for the TI BA II Plus

$[(1.06 \div 1.035) - 1] \times 100 = 2.4155$ I/YR I/Y for the TI BA II Plus

0, FV

PV Answer: $1,310,368.0528 CPT, PV for the TI BA II Plus

Module 8

Step 3:

What level payment at the end of each year is required to have $1,310,368.0528 in 12 years?

For the HP-10bII, +/-, FV (You had $1,310,368.0528 as the PV at the end of the last step, but it was negative. Hitting +/- once turns the whole number positive and prepares it to be entered as the FV.)

For the TI BA II Plus, do the same thing as the HP-10bII. Hit the +/- sign to make the computed answer for PV from the last step a positive $1,310,368.0528 FV for this step.

6, I/YR   I/Y for the TI BA II Plus

12, Shift, N   12, 2ND, xP/Y, N for the TI BA II Plus

450,000, +/-, PV

End mode (Shift, MAR or 2ND, BGN, 2ND, Enter, CE/C)

PMT Answer: $24,000.023 CPT, PMT for the TI BA II Plus

8. **C** A Section 529 plan is commonly used in the college education savings process and not as a method of saving for retirement.

MODULE 9

Deferred Compensation and Stock Plans

INTRODUCTION

Employers are generally concerned with employee retention and performance motivation as important factors in achieving the company's goals. These factors are especially critical at the executive level, where turnover could be very disruptive to the continuity of operations.

In an effort to retain certain highly valued employees, an employer can provide performance incentives and retirement benefits to employees through qualified plans. Qualified plans, however, cannot be offered only to select employees since they must comply with nondiscrimination rules to maintain their tax-favored status. Nonqualified plans, because they do not receive the favorable tax treatment of qualified plans, are not subject to the nondiscrimination requirements of the Internal Revenue Code (IRC) and therefore can be offered to employees on a discriminatory basis.

The material in this module provides focus on the more common types of nonqualified plans, including nonqualified deferred compensation plans and other types of executive compensation and benefits. In addition, this module discusses the tax consequences of various types of stock plans.

TOPICS, LEARNING OBJECTIVES, AND READINGS

The topics covered in this module are:

- Topic 9.1: Introduction to Nonqualified Plans
- Topic 9.2: Funding Methods
- Topic 9.3: Types of Nonqualified Deferred Compensation Plans
- Topic 9.4: Stock Options
- Topic 9.5: Equity-Based Compensation

Throughout this module, you will see learning objectives (LOs) that emphasize the knowledge and application skills you will gain. These specific statements, based on the 2021 CFP Board's Principal Knowledge Topics List (the blueprint for the current CFP Board exam), advise you regarding what you should know and be able to do at the completion of this module.

The following table shows a list of module topics, learning objectives, and readings.

Learning Objective		Readings
Topic 9.1: Introduction to Nonqualified Plans		
9.1.1	Distinguish among nonqualified plans.	Characteristics, Taxation, and Regulation of Nonqualified Plans
9.1.2	Evaluate the taxation and regulation of nonqualified plans.	Tax Principles and Regulations That Apply to Nonqualified Plans
Topic 9.2: Funding Methods		
9.2.1	Analyze the alternative funding methods for nonqualified deferred compensation plans.	Funding Methods for Nonqualified Deferred Compensation Plans
Topic 9.3: Types of Nonqualified Deferred Compensation Plans		
9.3.1	Differentiate among the various types of nonqualified deferred compensation plans used in retirement planning.	Various Types of Nonqualified Deferred Compensation Plans Used in Retirement Planning
9.3.2	Analyze a situation to identify the tax implications of a nonqualified deferred compensation plan.	Tax Implications of Nonqualified Deferred Compensation Plans
Topic 9.4: Stock Options		
9.4.1	Compare incentive stock options (ISOs), nonqualified stock options (NQSOs), and employee stock purchase plans (ESPPs) to determine which is most appropriate for a given situation.	Various Types of Stock Options
Topic 9.5: Equity-Based Compensation		
9.5.1	Identify the characteristics of various types of equity-based compensations used as incentives for executives.	Various Types of Equity-Based Compensation Plans
9.5.2	Evaluate the appropriate use of various types of equity-based compensation plans used as incentives for executives.	Various Types of Equity-Based Compensation Plans

KEY TERMS

83(b) election
alternative minimum tax (AMT)
assignment of income doctrine
bargain element
corporate-owned life insurance (COLI)
death-benefit-only (DBO) plans
elective nonqualified deferred compensation plan
employee stock purchase plan (ESPP)
excess benefit plan
excess parachute payment
golden parachute
incentive stock option (ISO)
junior stock plans
non-elective
parachute payment
performance programs
performance unit
phantom stock plan
rabbi trust
restricted stock plan
salary reduction plan
secular trust
severance plans
share plan
stock appreciation right (SAR)
stock options
supplemental executive retirement plan (SERP)
supplemental nonqualified plans
surety bond
tin parachutes
top hat plan
voluntary severance retirement plans (VSRPs)

TOPIC 9.1: INTRODUCTION TO NONQUALIFIED PLANS

Reading: Characteristics, Taxation, and Regulation of Nonqualified Plans

LO 9.1.1: Distinguish among nonqualified plans.

One of the major challenges of any business is attracting and retaining exceptional individuals who will become integral to the future growth of the business. Once an employee has been identified as having exceptional skills, the real challenge for the management or owners of the business is to adequately compensate the employee and provide incentives to continue working with the business. A common industry term for these exceptional individuals is "key employees." As we saw in Module 1, a "key employee" is also the term used for top-heavy testing. While the term "key employee" is legally defined for top-heavy testing, there is no legal definition for a key employee when dealing with deferred compensation plans. Thus, deferred compensation plans are offered to whichever employees the organization chooses. The point is that an organization offers a deferred compensation plan to the employees it deems especially important. When addressing nonqualified deferred compensation plans, the same logic applies to the term "highly compensated employees." In the context of qualified plan nondiscrimination testing, a "highly compensated employee" is legally defined. However, when someone is described as a highly compensated employee in the context of nonqualified deferred compensation planning, plans, the only thing being conveyed is that this person makes a lot of money and th organization also offers some type of nonqualified deferred compensation plan. As will be covered below, deferred compensation plans are used to recruit, reward, and retain select individuals the organization especially values.

First, you must understand the major differences between qualified plans (such as pension or profit-sharing plans) and nonqualified plans, which are an integral part of deferred compensation arrangements. Second, the tax implications of these forms of compensation must be carefully considered to achieve the desired result for

both the employee and the employer. You have studied the intricacies of qualified retirement plans. Now we are adding nonqualified retirement plans. We will be focusing only on deferred compensation plans and stock plans only in this module.

Qualified Plans			
Pension Plans	**Profit-Sharing Plans (DC)**	**Tax-Advantaged Plans**	**Nonqualified Plans**
Defined benefit (DB)	Profit sharing	Traditional IRA	Section 457 plans
Cash balance (DB)	Thrift plan	Roth IRA	ISO
Money Purchase (DC)	Stock bonus	SIMPLE IRA	ESPP
Target Benefit (DC)	ESOP (LESOP)	SEP	NQSO
	Age weighted	403(b) (TSA)	Deferred compensation plans
	Cross-tested (comparability)		
	401(k) plan		
	SIMPLE 401(k)		

Note: (DB) stands for *defined benefit*. (DC) stands for *defined contribution*. (TSA) stands for *tax sheltered annuity*.

Nonqualified Plans	
Retirement Benefits (salary reduction)	**Performance Incentive (restricted stock)**
Supplemental plans	Incentive stock options (ISOs)
Excess benefit	Nonqualified stock options (NSOs)
Supplemental executive retirement plan (SERP)	SAR
	Phantom stock
	Performance unit or share plans
	Junior stock

Qualified Plans

Qualified plans, covered previously, meet the stringent requirements of the IRC, as well as those of the Employee Retirement Income Security Act of 1974 (ERISA), and, therefore, qualify for favorable tax treatment. In pension and profit-sharing plans, an employee is generally not taxed on employer contributions or accumulated earnings until the funds are received from the plan. The employer, however, receives a deduction at the time of contribution.

Nonqualified Plans

In contrast, nonqualified plans do not qualify for the same special tax treatment as qualified plans. They do not permit the employer to take a deduction for plan contributions until the employee reports income from the plan, which is often at retirement. In addition, the earnings on plan assets are not tax-deferred; instead, earnings are taxed to the sponsor (employer) or to the participant (employee), depending on the plan design.

IRS rules and regulations permit an employee to agree to defer income to a nonqualified plan and not be taxed on the deferral until some point in the future. Treasury Revenue Ruling 60–31 spells out three principles that must be followed if a deferred compensation plan is to be effective in postponing current taxation. These principles are:

1. The agreement to defer compensation must be made before the dollars are earned. This date is now "before the beginning of the year" due to IRC Section 409A.
2. The agreement must represent only an *unsecured* promise (discussed later).
3. The agreement cannot be *funded* (i.e., any funds used to provide the benefit must be held by the employer as a general asset available to creditors).

Perhaps the biggest advantage of a nonqualified plan is that it is not subject to the nondiscrimination and many other burdensome rules imposed by the IRC and ERISA, including funding, participation, and vesting standards. As a result, a nonqualified plan can discriminate in favor of highly compensated employees. This characteristic enables employers to adequately compensate and provide performance incentives for certain valuable employees.

Nonqualified plans are ideal for businessowners and selected decision makers who want to provide special benefits for themselves without having to provide similar benefits to rank-and-file employees. They are also frequently established in companies where the higher-paid employees' participation in the company's qualified profit-sharing 401(k) plan has been substantially restricted due to nondiscrimination requirements. To enable these people to more closely achieve the levels of salary deferral they target, the company can maximize profit-sharing 401(k) plan benefits for certain, highly valued employees and then also establish a separate deferred compensation plan for those highly valued employees only. Under a slightly different alternative, the company can prohibit highly valued employee participation in the profit-sharing 401(k) plan, establishing a deferred compensation plan for these top paid employees only. This may prevent the 401(k) plan from becoming top-heavy, and will make it easier to demonstrate compliance with the 401(k) nondiscrimination tests.

Finally, in addition to providing retirement benefits, a nonqualified plan provides valuable employees with life insurance coverage, incentive pay, and severance benefits on a discriminatory basis.

PROFESSOR'S NOTE

The greatest advantage of a nonqualified plan is that it is not subject to the nondiscrimination rules imposed by the IRC and ERISA. Therefore, the plan can *discriminate* in favor of selected, highly valued executives.

EXAMPLE: Nonqualified plan

John is a sales representative for Echo Products, and will earn $400,000 this year. He can only contribute 4% into the company's 401(k) plan due to the ADP test. Because the maximum annual includible compensation limit for 401(k) plans is $330,000 in 2023, John can only defer $13,200

($330,000 × 0.04 = $13,200) into the 401(k), even though he would like to defer the 2023 maximum of $22,500.

Echo Products also offers a nonqualified salary deferral plan for sales representatives and upper management only, with a 100% match on the first 5% of compensation. If John deferred $20,000 into the nonqualified salary deferral plan (5% of his $400,000 compensation), then the company would match it, meaning a total of $40,000 credits to John's account.

Because this is a nonqualified plan, there is no $330,000 limit on includible compensation in 2023. Thus, John can contribute $13,200 into the 401(k) plan for 2023 (which is protected from creditors by ERISA), and get $40,000 into the salary deferral plan (which is at risk).

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

1. The major advantage of a nonqualified plan is that it
   A. can be discriminatory.
   B. is subject to ERISA nondiscrimination rules.
   C. provides coverage for rank-and-file employees.
   D. represents a secure promise by the employer.

Reading: Tax Principles and Regulations That Apply to Nonqualified Plans

LO 9.1.2: Evaluate the taxation and regulation of nonqualified plans.

A nonqualified plan provides for deferred compensation only if, during a taxable year, the employee has a legal right to this compensation but has not received it either actually or constructively. Taxes are also owed on any economic benefit received by the individual.

Constructive Receipt Doctrine

The constructive receipt doctrine states that any income constructively, though not *actually*, received is currently includible in taxable income. In other words, money will be considered taxable income to an executive who has unrestricted access to it, whether they receive it or not, as long as there is no substantial risk of forfeiture.

Substantial Risk of Forfeiture

Compensation is subject to a substantial risk of forfeiture if the right to it is conditioned on

- future performance of substantial services by an executive, or
- the occurrence of a condition related to organizational goals (e.g., attainment of a prescribed level of earnings or equity value or completion of an initial public offering).

In order for tax deferral to occur, the possibility of forfeiture must be substantial (i.e., there must be a significant chance the deferred compensation will be forfeited). Death and/or disability alone do not provide a substantial risk of forfeiture.

Economic Benefit Doctrine

Under the economic benefit doctrine, taxpayers have income when they receive the economic benefit of the proceeds. This occurs when the employer irrevocably places funds for the benefit of the employee beyond the reach of the employer's creditors. Income is thus received even if the employee does not have actual or even constructive receipt.

Regulation of Nonqualified Deferred Compensation Plans: Section 409A

IRC Section 409A provides specific rules about allowing deferral of income, and prohibits arrangements that allow participants control of or access to deferred amounts. Violations of these rules cause the deferral to be disallowed and, consequently, the employer's contribution becomes deductible to the employer and immediately taxable (with 409A penalties) to the participant.

Rules for Design and Administration

According to IRC Section 409A, a plan provides for deferred compensation only if, during a taxable year, the person has a legal right to this compensation but has not received it actually or constructively. All amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent they are not subject to *substantial risk of forfeiture* and were not previously included in income. The main thrust of the law is to capture for taxation purposes all amounts deferred under a nonqualified deferred compensation plan if the plan fails to meet the requirements of IRC Section 409A.

Election of Deferrals

Elections to defer compensation must occur in the year prior to the tax year of the delivery of services. When employees first become eligible to participate in a nonqualified plan during the current year (because they were recently hired or a new plan was put into place), they have 30 days after they first become eligible to participate to make a deferral election under the plan for the current year.

Where compensation is performance based (that is, under an incentive plan), the deferral election must be made no later than six months prior to the end of the 12-month performance period. Also, the incentive plan must be communicated within 90 days of the beginning of the performance period and the plan must have a 12-month performance period and use quantitative measures to assess performance.

Plan Distributions

Immediately before leaving the company, participants in nonqualified plans cannot determine when they will receive distributions from the plan; rather, the period over which the distribution will be paid must be specified in the plan document. (ACJA 2004)

Plan distributions are generally payable only in the following instances:

- At separation of service
- At death
- Upon disability
- At a change in ownership of the company
- When an unforeseeable emergency (as defined by the IRS) occurs
- At the age, date, or fixed schedule specified prior to the first deferral
- At the termination and liquidation of the plan

Acceleration of Benefits Test

The acceleration of benefits test requires that nonqualified deferred compensation benefits distribute at a predetermined date or dates as specified in the plan document and does not allow any modification *decreasing* the period required to qualify for benefit distribution. Generally, the distribution of plan benefits cannot occur prior to the date set at the time of the deferral election.

Benefits of Nonqualified Plans

To Employers

Use of nonqualified plans is generally appealing to companies that want to provide extra benefits for the businessowners or other highly valued executives in excess of qualified plan limitations. In addition to providing retirement benefits, a nonqualified plan can be used to provide valuable employees with insurance coverage, incentive pay, and severance benefits on a discriminatory basis. Deferred compensation is especially attractive for employers that are in a low or zero income tax bracket and thus do not need the immediate tax deduction associated with a qualified plan. For example, a not-for-profit hospital cannot benefit from a tax deduction, but it still needs to retain important employees.

PROFESSOR'S NOTE

Remember the three "Rs": nonqualified plans are often used to recruit, retain, or reward selected executives or other important employees.

To Executive Employees

Nonqualified plans are designed to benefit a select group of employees (typically management or highly paid employees) whose qualified plan benefits are limited by contribution limits imposed by IRC Section 415. These plans can also benefit outside directors and other nonemployee independent contractors who provide services to the employer.

Use of a deferred compensation arrangement is not appropriate for everyone. The following are several factors to consider:

- Executive's current marginal ordinary income tax and capital gain tax rates
- Marginal ordinary income and capital gain tax rates anticipated at the time of distribution
- Executive's investment expertise and available investment alternatives
- Employer's financial condition (risk of bankruptcy or insolvency)
- Whether there is an employer matching contribution and available investment options for deferrals
- Employer's fixed crediting rate on deferrals

Figure 9.1 compares selected characteristics of qualified and nonqualified plans.

Figure 9.1: A Comparison of Nonqualified and Qualified Plans

Characteristic	Qualified Plan	Nonqualified Plan
IRC Requirements:		
Discrimination	Plan may not discriminate	Plan may discriminate
Coverage	Employee coverage and participation requirements are imposed on the employer	Coverage and participation requirements do not apply
Compensation limit	Compensation limit applies	Compensation limit does not apply
Benefit limitations	Applies to both defined contribution and defined benefit plans	Benefit limitation does not apply
Vesting	Vesting schedules are required	Vesting schedules are not required
Penalties and excise taxes	Penalties and excise taxes apply	Penalties and excise taxes do not apply unless the plan violates AJCA (Section 409A)
ERISA requirements	Must satisfy ERISA requirements	Exempt from most ERISA requirements
Tax Treatment:		
Employer's deduction	Available in year of plan contribution	Available in year employee is taxed on benefits
Employee deferral	Tax deferred until plan distribution	Tax deferred if arrangement is unfunded or, if funded, is subject to substantial risk of forfeiture
Fund earnings	Accrue tax deferred until distribution	Are currently taxable to the employer in most cases
Distributions	Ordinary income tax rates apply; capital gains rates for net unrealized appreciation on employer securities	Ordinary income tax rates apply and benefits are taxed as wages
Tax-free rollovers	Assets are fully portable and may be rolled over into an IRA or another qualified plan	Assets are not portable and rollovers are not permitted
Creditor protection	Benefits are protected from the claims of both the employee's and the employer's bankruptcy and nonbankruptcy third-party creditors	Generally, benefits are fully subject to the claims of the employer's third-party creditors; benefits are subject to the claims of an employee's third-party creditors after they become payable or are nonforfeitable

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

2. Which of the following regarding nonqualified deferred compensation (NQDC) plans is CORRECT?
   A. They can discriminate in favor of certain executives.
   B. These plans are not flexible.
   C. They generally provide coverage for the owners of the business only.
   D. Fund earnings are not taxable to the employer.

TOPIC 9.2: FUNDING METHODS

Reading: Funding Methods for Nonqualified Deferred Compensation Plans

LO 9.2.1: Analyze the alternative funding methods for nonqualified deferred compensation plans.

While qualified plans such as 401(k) arrangements must always be funded, nonqualified deferred compensation plans can fall into one of three categories: unfunded, informally funded, and funded.

Unfunded Plans

To be an unfunded plan, the plan benefits are paid from the general assets of the employer and those assets remain subject to claims of the employer's creditors. These are sometimes referred to as pay-as-you-go plans, as they are backed simply by a promise of the employer to pay. IRS requirements provide that the

- deferral must be agreed on prior to the beginning of the year the compensation is earned, or within 30 days after becoming eligible to defer under the plan;
- employer's promise to pay the deferred amount must be merely a naked promise and not secured in any fashion, and not evidenced by any negotiable notes; and
- assets must be subject to claims of the employer's creditors.

Therefore, employees have *no* assurance that they will ever receive any of the promised funds. All could be lost through bankruptcy of the company or its inability to pay.

The trade-off for this uncertainty is the guarantee that none of the deferred compensation is income taxable to the employee until it is paid. As long as the company's earnings or assets are available to the company's creditors, and the deferred compensation agreement was executed prior to the performance of the employee's associated services, the employee will *not* have to pay income tax on the deferred income until it is received.

Informally Funded Plans

Informally funded plans are another type of unfunded plan for purposes of ERISA. Executives favor informally funded arrangements from a security aspect because they feel more confident that their benefits may be paid at some point in the future. Informally funded plans typically build a general reserve to fund the obligation to pay future benefits. As in any unfunded deferred compensation plan, there must be substantial risk of forfeiture (e.g., the executive must remain with the company for at least five years to receive the compensation). The funds remain subject to the claims of the employer's general creditors. Accordingly, even though the assets, which may include securities and other equity investments, are set aside on behalf of the employee, they are a *corporate* asset that may be used to satisfy corporate obligations. However, short of the company's insolvency or bankruptcy, these assets are not likely to be pursued.

> **EXAMPLE: Informally funded plan**
>
> Standard Co. has set up an investment account to meet its promise of future deferred compensation benefits. Every year, it contributes $150,000 to this account and manages the investments in it to optimize returns.
>
> Similar to any other corporate asset, this account is owned by Standard Co. If it ever needed cash for a business emergency or opportunity, the company could draw on this account. If Standard Co. ever lapsed into bankruptcy, its creditors could claim the assets in the account. No employee has an irrevocable interest in the assets of the account. Furthermore, the employees are not currently taxed on their deferred compensation benefits. Finally, the employer is subject to income taxes on the earnings of the account.

Remember that the primary focus of informally funded nonqualified deferred compensation is to avoid the application of the constructive receipt tax doctrine through the imposition of forfeiture provisions.

TEST TIP

For the CFP® exam, you may have to identify whether income is constructively received by an employee. As previously discussed, the constructive receipt doctrine states that any income constructively, though not *actually*, received is still includible in the income of the individual who is receiving the constructive benefit. A cash basis taxpayer (most taxpayers in the U.S.) is generally required to recognize income when the money is paid, *regardless* of when the income is earned. Accordingly, the constructive receipt doctrine is an exception to the general rule for cash basis taxpayers that may be overcome if the taxpayer-executive does not have an unrestricted right to the payable benefit.

The following sections are some of the more common methods of informally funding a deferred compensation arrangement.

Rabbi Trusts

Many employees fear that a hostile buyer or new management may try to avoid paying the deferred compensation benefits that have been promised to them. To alleviate these concerns, an employer may establish a **rabbi trust** with an independent financial institution, often a bank or trust company, serving as trustee responsible for holding contributions and earnings that will ultimately be used to satisfy the employer's obligations to its nonqualified plan participants. As per the definition of a grantor trust, the trust earnings are currently taxable to the grantor, who is the employer, rather than imposed on the employee. Employers cannot deduct trust contributions until they are includible in the gross income of the plan participant. Of course, if the employer is a not-for-profit organization, the fact the employer pays the income tax on rabbi trust earnings does not matter because a not-for-profit organization is not income taxed.

As grantor and owner of the trust assets, the employer may use these assets only to satisfy the obligation owed the executive. If properly structured, a rabbi trust will provide an employee with significant protection from a change in the control of an employer via an unfriendly takeover, or from the employer otherwise having a change of heart and attempting to avoid making payments due under the deferred compensation plan. A rabbi trust will *not*, however, protect an employee from the risk of an employer becoming insolvent or declaring bankruptcy and being unable to meet its obligations under a deferred compensation plan. In that case, the trust assets must be available to satisfy the general obligations of the employer's creditors. Because the creditors of an employer have access to rabbi trust assets, and they are technically unfunded plans, so placing assets in a rabbi trust will allow deferral of income tax for the executive.

The use of rabbi trusts has become widespread, and these trusts are the vehicle of choice for informally funding deferred compensation plans. Employers like that rabbi trusts allow a pool of assets to be gathered that can be used to pay benefit distributions. This eliminates the financial stress of having to pay benefits from current cash flow.

Corporate-Owned Life Insurance (COLI)

Corporate-owned life insurance (COLI) is commonly used by employers to informally fund future benefit obligations such as those promised under a deferred compensation plan. Here, the employer purchases cash value life insurance policies on individual employees, typically a select group of management or highly compensated employees. As the owner of the policies, the employer is responsible for paying the premiums. The employer is also the beneficiary of the policies and retains all rights to policy benefits, including the cash value buildup and the death proceeds. Interestingly, because the employee-participants do not have any contractual rights under the policy, the plan is considered unfunded for ERISA purposes and is, therefore, not subject to the participation, vesting, funding, distribution, fiduciary, and reporting rules that apply to funded plans (and qualified retirement plans).

When structured properly, COLI cash values accumulate on a tax-deferred basis to the employer. When it comes time to pay out a deferred compensation benefit,

the employer can withdraw from or borrow against the built-up cash value of the policy to make good on its obligation. Withdrawals are treated first as a nontaxable recovery of premiums. Distributions in excess of the investment in the contract are treated as taxable income to the employer. Loan proceeds are not considered distributions and are received tax free.

COLI is attractive to employers because it

- provides psychological assurance to deferred compensation plan participants that their benefits are secure;
- reduces strain on the company's cash flow when plan distributions are due;
- provides tax-deferred, and possibly tax-free, buildup of cash value; and
- enables the employer to recover some or all of the plan costs.

Major tax law changes have been disadvantageous to the use of COLI as a deferred compensation mechanism. First, for life insurance policies issued after June 20, 1986, interest on policy loans is not deductible to the extent that the aggregate of these loans on each insured individual by the employer exceeds $50,000. The second tax provision that affects these policies is the modified endowment contract rules (MEC). If the life insurance is treated as a MEC, withdrawals and loans from a life insurance policy will first be considered taxable income rather than a nontaxable recovery of basis, as is normally the rule.

Surety Bonds, Letters of Credit, and Indemnity Insurance

An additional way of informally funding a nonqualified deferred compensation arrangement is through the use of a third party's guarantee to make the deferred compensation payments if necessary. In this arrangement, the employee (not the employer) typically purchases a **surety bond**, which ensures the performance of an agreement if necessary. Two other approaches are letters of credit and indemnity insurance purchased from a bank or insurance company. These institutions then guarantee the payment of the specified amount of deferred compensation if the employer cannot make the payment. Accordingly, the employee will not be treated as being in constructive receipt of income as long as

- the employee pays the fee for the third-party guarantee out of their own funds, and
- the employer does not reimburse the employee for their out-of-pocket cost.

If, however, the employer pays for the cost of the third-party guarantee, the payment will be considered taxable income to the employee-recipient. As a practical matter, the cost of the letter, bond, or insurance may not justify establishing the arrangement in the first place. Furthermore, some authorities suggest that surety bonds and letters of credit should *not* be used as informal funding techniques for the following two reasons. First, the IRS has suspended rulings on informal funding with surety bonds and is reconsidering its earlier favorable ruling to a taxpayer on this method of funding. Second, there are no IRS guidelines on the use of letters of credit for informal funding. Because of the uncertainties surrounding the use of surety bonds and letters of credit, indemnity insurance is the best third-party guarantee technique available to an employee. The use of indemnity insurance for this purpose has been approved by the IRS.

Escrow Accounts and Sinking Funds

The placement of an executive's deferred compensation into an escrow account or a sinking fund may eliminate the opportunity for tax deferral in the compensation arrangement. The general rule is that if deferred compensation is placed in escrow for the benefit of the executive, it will immediately be taxable if rights to the amount set aside are not forfeitable. A valid structuring of the escrow agreement, therefore, places the executive's deferred compensation in a trusteed escrow or fund account in which the employee is not immediately vested. In this case, the executive's rights to the specified amounts are limited to those of an unsecured general creditor of the employer and not as a bona fide beneficiary.

Escrow accounts are typically funded with noninsurance products. A mere transfer of funds from one escrow account to another (i.e., to change investment vehicles) does not result in constructive receipt to the employee as long as their interest in the funds does not rise above the status of an unsecured general creditor. This would be the case even if the employee authorized or approved the transfer. Finally, the termination of the deferred compensation agreement, in and of itself, does not disqualify the arrangement if the terms of payment by the employer to the executive remain unchanged.

Figure 9.2 summarizes the methods of informal funding.

Figure 9.2: Methods of Informal Funding

	Common Investment Vehicle	IRS Stance
COLI	Life insurance products	Under review
Rabbi Trust	Life insurance, employer stock	Favorable
Surety Bond	Surety bond (from an insurance company)	Uncertain
Letter of Credit	Letter of credit (from a bank)	Uncertain
Indemnity Insurance	Indemnity insurance	Favorable
Escrow Account	Typically noninsurance products	Favorable

Funded (Section 83) Plans

A funded plan is one where the benefits promised by the employer are secured by rights to specific property, such as company stock, insurance, or some other negotiable item. The funding of the employer's liability is direct and the promised benefit will ultimately be paid with the designated property.

For an employee, there is certainty in knowing that their deferred compensation will be paid as promised, even if the company declares bankruptcy. There is, however, a price for this certainty. The IRC considers the guaranteed deferred amount as being received in the year in which it was earned, or when the employee is "substantially vested" in the plan. Thus, the employee must recognize deferred benefits as current income, even though those benefits may not be received for years. This is only a disadvantage, of course, to the extent that the employee wants to defer taxation to some future year and may or may not outweigh the advantage of the psychological comfort that comes with being guaranteed receipt of the future payment.

IRC Section 83 outlines two conditions that must be met for the employee to be able to defer income taxes on funded nonqualified plan benefits:

- The employee's funded account must be nontransferable (cannot be pledged, assigned, or reduced to cash).
- The employee's right to compensation must be subject to a substantial risk of forfeiture.

As discussed previously, this means that the employee's right to deferred compensation payments must be contingent on the performance of *substantial* services in the future. In the absence of a forfeiture provision, the employee is in *constructive receipt* of deferred compensation and is treated as having received a taxable economic benefit. The funded amount is then considered current income and is subject to current income taxation.

Secular Trusts

A **secular trust** is an irrevocable, fully funded trust established for providing nonqualified plan benefits to an employee. This type of trust is the ultimate security blanket for the employee-participant in a deferred compensation plan because funds in the trust are beyond the reach of the employer's creditors. Employees are also safe against a change of heart by their employer (the employer cannot access trust assets) and a change of control, such as an unfriendly takeover of the business.

Employees do, however, pay a price for this security. Once vested, the employee is deemed to be in constructive receipt of contributions made to the trust and is subject to immediate income and FICA taxes on these contributions. The employer may deduct contributions to the trust when they become vested to the employee. Then, at the time of payment, benefits are tax free to the extent they represent amounts previously taxed.

Given the tax results for employees, secular trusts are not commonly used, but they may be attractive to employers who want to ensure that funds are available for distribution to plan participants. In addition, while an employer must limit participation in an unfunded NQDC plan, such as a rabbi trust, to a select group of management or highly compensated employees, this rule does not apply to funded NQDC plans, thus making them available to rank-and-file employees. Appeal to employees may depend on their desire for security as well as assumptions about their current versus future tax bracket. If tax rates are expected to be *higher* when the employee retires, the secular trust may be the most tax-efficient way to provide for retirement income.

Because secular trusts are fully funded, they are subject to ERISA's requirements related to reporting and disclosure, participation and vesting, and fiduciary obligations. Meeting these requirements can be quite costly and burdensome to an employer.

Figure 9.3 compares the tax consequences of unfunded, funded, and informally funded deferred compensation plans.

Figure 9.3: Tax Consequences of Deferred Compensation Plans

	Employee Tax Consequences				Employer Tax Consequences	
	Subject to General Creditors' Claims	**Employer Contributes to Plan**	**Employee's Benefits Vest (become nonforfeitable)**	**Employee Retires, Payments Begin per Schedule**	**Deduct When Employee Taxed on Income**	**Taxed on Fund Earnings**
Unfunded plan	Yes	No constructive receipt; no tax to employee	No constructive receipt; no tax to employee	Taxed on payments received	Yes	Yes
Section 83 plans (funded plans)	No	If substantial risk of forfeiture, no tax to employee	Vesting eliminates risk of forfeiture; taxable to employee at time of vesting	Taxed on amounts not previously taxed	Yes	Yes, typically
Informally funded plan	Yes	No constructive receipt; no tax to employee	No constructive receipt; no tax to employee	Taxed on payments received	Yes	Yes, but no tax due if funded with COLI or other tax-favored investment

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

3. Potential beneficiaries who can receive payments from a rabbi trust include
   A. the participating employees of the company only.
   B. the participating employees of the company and the company.
   C. the participating employees, the creditors of the company, and the company.
   D. the employee and the creditors of the company.

4. Which of the following is a funding vehicle used in NQDC planning that does NOT afford income tax deferral of the underlying assets to the executive/employee?
   A. A secular trust
   B. A rabbi trust
   C. Corporate-owned life insurance (COLI)
   D. Stock with substantial risk of forfeiture

TOPIC 9.3: TYPES OF NONQUALIFIED DEFERRED COMPENSATION PLANS

Reading: Various Types of Nonqualified Deferred Compensation Plans Used in Retirement Planning

LO 9.3.1: Differentiate among the various types of nonqualified deferred compensation plans used in retirement planning.

The intent of all nonqualified deferred compensation plans is the same: to provide benefits to executives at some future date in excess of those provided to rank-and-file employees. Although nonqualified plans come with many different names, they typically fall into two broad categories: elective and non-elective.

The term deferred compensation describes both salary reduction plans (elective) and excess benefit plans and SERPs (non-elective). The distinction between the two types of plans is the source of benefit funds.

Elective (or Pure) Nonqualified Plans

In an **elective nonqualified deferred compensation plan**, employees choose to receive less current salary and bonus compensation than they would otherwise receive, postponing the receipt of that compensation until a future tax year.

Salary Reduction Plans

In a **salary reduction plan**, the employee elects to give up a specified portion of current compensation (salary, raise, or bonus). In turn, the employer promises to pay a benefit in a future tax year that is equal to the deferred amounts plus a predetermined rate of interest. This feature is similar to a 401(k) salary deferral plan because both plans permit an employee to defer the receipt of compensation.

A salary reduction plan is sometimes called an "in lieu of" plan because the employee is receiving the employer's promise to pay benefits in lieu of current income. Literally speaking, it is a pure deferred compensation plan.

Salary reduction plans enable employees to defer taxation on a portion of their earnings during high tax bracket years, postponing taxation until retirement when, presumably, the retired employee will be in a lower tax bracket. This expectation generally was realistic in the days when top federal tax brackets ranged from 50% to 70%, but it is doubtful today that a retired employee will enjoy a tax bracket substantially lower than their current rate. In fact, top marginal tax brackets could well return to their historical 50% to 70% range by the time the employee retires, thus reversing one of the intended benefits of tax deferral. The advantage of tax-deferred growth over the preretirement period, however, remains a significant consideration.

A plan provides for deferred compensation only if, during a taxable year, the employee has a legal right to this compensation but has not received it actually or constructively. From this definition, we can see that unfunded plans, including

salary deferral plans, fall squarely within this definition because the employee has a legal right to this compensation, but has not received it actually or constructively.

Non-Elective (or "Supplemental") Nonqualified Plans

Non-elective nonqualified plan or **supplemental nonqualified plans** are plans in which the employer funds the benefit and does *not* reduce the employee's current compensation to fund future payments. Such plans are, in essence, post-termination salary continuation plans and considered an additional fringe benefit meant to recruit and retain select, highly prized people. Both excess benefit and supplemental executive retirement plans (SERPs) are supplemental plans.

Excess Benefit Plans

IRC Section 415(b) restricts the annual amount of a defined benefit received from a qualified plan to the lesser of 100% of a participant's compensation or $265,000 (for 2023).

IRC Section 415(c) restricts the annual amount of a defined contribution made to a qualified plan to the lesser of 100% of a participant's compensation or $66,000 annually (for 2023).

The **excess benefit plan** was developed in response to these IRC Section 415 restrictions on qualified plan contributions and benefits. The goal of the excess benefit plan is to allow employees who participate in a qualified plan to exceed the limitations imposed by Section 415. The benefit that is provided to an employee under an excess benefit plan generally amounts to the difference between what the employee would have received under the employer's qualified retirement plan without applying the Section 415 limitations and what the employee receives under the qualified retirement plan. Some benefits specialists refer to these plans as "make whole" plans as they continue where qualified plans leave off.

EXAMPLE: Excess benefit plan

Patricia is the vice president of research and development for Pharmaceutical Research Corporation (PRC) and earns an annual salary of $400,000. She participates in a qualified profit-sharing plan offered by her employer. Several restrictions limit the amount of profit-sharing plan contributions that may be made on behalf of highly compensated employees such as Patricia. Per the IRC, the maximum amount of a participant's compensation that may be considered for purposes of determining her profit-sharing contribution is $330,000 (2023). Annual employer contributions to a qualified profit-sharing plan on behalf of all the participants cannot exceed 25% of the participating employees' payroll. Furthermore, IRC Section 415(c) limits annual employer contributions to $66,000 per participant (2023).

An excess benefit plan generally provides benefits or contributions that restore benefits or contributions lost due to the Section 415 dollar limits ($66,000 in contributions for defined contribution plans and an annual benefit of $265,000 for defined benefit plans in 2023). In this case, Patricia

earns $400,000 annually, so the contribution to the profit-sharing plan for her is limited to $66,000 in 2023.

To ensure that Patricia's talents will not be pirated away by an aggressive rival, PRC's benefits staff has provided her with an excess benefit plan designed to provide the $16,500 difference between the $82,500 potential contribution (discussed in the following section) and the $66,000 contribution allowed in the qualified plan by IRC Section 415. Payments of excess benefits like those planned for Patricia are typically made at the employee's retirement and paid in the same manner as those paid under the company's qualified plan.

Patricia can only receive a contribution to her excess benefit plan account of $16,500 per the following calculations:

- The 25% employer deduction limit (for defined contribution plans) multiplied by the qualified plan compensation limit for 2023 is $82,500 (25% × $330,000)
- $82,500 – $66,000 = $16,500, which is the difference between the potential contribution and the maximum contribution allowed in the qualified plan

PROFESSOR'S NOTE

The calculation of excess plan benefits uses the $330,000 compensation limit (2023). If Patricia's full $400,000 compensation were used, the plan would end up restoring more than contributions or benefits lost due to the operation of Section 415 after taking the annual compensation limit into account. The plan would become a SERP (discussed in the following section) in that case.

EXAMPLE: Excess benefit plan

Carolina Industries has a profit-sharing plan and contributes 10% of compensation to all eligible employees. Garrett, the marketing director, earns $360,000. The company provides an excess benefit plan for Garrett to make sure he receives retirement contributions of 10% of $360,000, not just 10% of $330,000, the annual compensation limit. Carolina Industries would contribute $33,000 into the profit-sharing plan for Garrett (10% of $330,000), and credit $3,000 to the excess benefit plan (10% of $30,000, the excess amount above $330,000).

Participation in an excess benefit plan is not limited to a select group of management or highly compensated employees (they are *not* top hat plans). In fact, you should recognize that excess benefit plans are not useful for employees who earn considerably more than the maximum amount of compensation for qualified plan purposes ($330,000 in 2023). This is because an excess benefit plan can be used *only* to make a participant whole for the loss of benefits caused by the IRC Section 415 limits, not the loss of benefits caused by the qualified plan compensation limit. Therefore, a SERP (discussed in the following), not an excess benefit plan, would be more appropriate for employees who earn considerably more than the qualified plan compensation limit.

Funding and Taxation of Excess Benefit Plans

An excess benefit plan may be either funded (i.e., specific property is set aside to secure the obligation accruing to the employee and is not subject to the company's creditors) or unfunded (i.e., a mere promise is made and there is the risk of nonpayment of the benefit due to a change in company policy or to a change in financial capacity).

If funded, as with a secular trust, the employee must include plan contributions in gross income in the year they are made or, if later, in the year the employee becomes vested in the contributions—that is, when there is no longer a substantial risk of forfeiture. The employer is entitled to the deduction (for plan contributions plus earnings) in the year the contribution is made, or the date the employee becomes vested in the contributions, whichever is later.

If unfunded, there are generally no income tax consequences to the employee until benefits are included in gross income. This may occur when benefits are actually or constructively received. The employer generally receives the deduction (of plan contributions plus earnings) in the year the employee receives the excess benefit plan benefits.

PROFESSOR'S NOTE

IRC Section 409A provides specific rules relating to deferral elections, distributions, and funding. These rules apply to most unfunded excess benefit plans. If not followed, the accrued benefits of affected participants may become immediately taxable and subject to penalties and interest charges.

Excess Benefit Plans and ERISA

Whether an excess benefit plan is subject to certain requirements under Title I of ERISA depends on whether the plan is funded or unfunded. A funded excess benefit plan is generally subject to the reporting, disclosure, and enforcement provisions of ERISA. However, the plan is not subject to the more complicated participation, vesting, and funding rules. An unfunded excess benefit plan is exempt from *all* the requirements of Title I of ERISA.

Supplemental Executive Retirement Plans (SERPs)

A **supplemental executive retirement plan (SERP)** increases benefits provided by the employer's qualified retirement plan for select employees. Using a SERP, the *employer* makes a commitment to fund a specific deferred benefit; the employee does not forgo current compensation. Thus, this plan is sometimes referred to as a salary continuation plan. Such a plan might be considered an additional fringe benefit that the employer could offer to induce an executive to join or stay with the company. SERPs are often referred to as "golden handcuffs" because if the executive risks losing a substantial amount of retirement benefits by leaving the company, the executive may rethink a career move. As such, a SERP that is designed with a delayed vesting schedule can be a successful retention tool.

Although SERPs are similar to excess benefit plans, there are differences:

	Excess Benefit Plans	SERPs
Employee Coverage	Technically can cover any employee	Provided only for management or other select employees
Funding	Can be funded or unfunded	Usually unfunded, but can be funded
Benefit amount	Can only be used to make a participant whole for the loss of benefits caused by the IRC Section 415 limits	Can provide benefits that greatly exceed those provided by the company's retirement plan

Tax Implications for the Employee/Executive

A key goal in implementing a SERP is to avoid current taxation to the executive. The objective is to defer the income tax liability until distributions are received. The following two rules can help achieve this tax deferral:

- *Vested but unfunded.* An executive will not realize income under a nonqualified plan, even though the executive is vested, if the employer's promise to pay future compensation is unsecured and unfunded.
- *Funded but not vested.* An executive will not realize income, even if the plan is funded, if the executive's right to receive the future benefit is not transferable and is subject to a substantial risk of forfeiture.

The plan benefit will ultimately only be taxed when the retirement benefits are paid to the executive or when the executive is in constructive receipt with no substantial risk of forfeiture. Benefits are considered a form of compensation and will be taxed as ordinary income whether received by the executive or any heirs.

Tax Implications for the Employer

SERPs are taxed to the employer like most other deferred compensation plans. Employers are not permitted a current tax deduction for contributions to a SERP. Their deduction for contributions is deferred until these amounts are included in the executive's income. When the benefit payments are included in the executive's income, generally during the retirement years, the employer may deduct the payments. In addition, earnings that accrue in a funded plan will be currently taxable to the employer.

Top Hat Plans

A **top hat plan** is a type of SERP established to provide unfunded deferred compensation benefits to a select group of management or highly prized employees. Such plans will avoid ERISA's minimum participation and vesting rules, funding rules, fiduciary responsibility rules, and trust requirement so long as they meet the following three prerequisites:

- Must be unfunded

- Must be maintained primarily for certain individuals
- Must provide deferred compensation for a select group of management or highly prized employees

These plans are still subject to ERISA's reporting and disclosure requirement, which can generally be satisfied by a single filing of a brief informational statement with the Labor Department and by providing plan documents to the Labor Department, if requested.

PROFESSOR'S NOTE

Generally, a plan is not funded for top hat purposes unless employee-participants have greater rights to plan assets than the sponsoring employer's general creditors. Although counterintuitive, assets *can* be set aside to pay benefits out of a top hat plan without funding the plan so long as they remain subject to the sponsor's general creditors in the event the sponsor becomes insolvent. Such a plan would be considered informally funded.

Figure 9.4 summarizes some of the most important characteristics of excess benefit plans, top hat plans, and SERPs.

Figure 9.4: Important Characteristics of Excess Benefit Plans, Top Hat Plans, and SERPs

	Excess Benefit Plans	Top Hat Plans and SERPs
Participation Restrictions	Plan may be established for any employee (but typically is established only for highly valued employees).	Plan can only be established for a select group of management or highly valued employees.
Source of Benefits	Benefits generally are paid by the employer out of general assets.	Benefits generally are paid by the employer out of general assets (unless a funded SERP).
Type of Funding	May be funded or unfunded.	Top hat plans must be unfunded; SERPs can be funded or unfunded.
Typical ERISA Compliance	Unfunded excess benefit plans are exempt from the requirements of ERISA. Funded excess benefit plans are subject to the fiduciary, written plan requirements, reporting and disclosure requirements, and the enforcement and claims provisions of ERISA. However, funded excess benefit plans are exempt from other ERISA requirements.	Top hat plans and unfunded SERPs are subject to brief reporting and disclosure requirements, and the enforcement and claims provisions of ERISA. However, top hat plans and unfunded SERPs are exempt from other ERISA requirements. A funded SERP is subject to the reporting, disclosure, enforcement, administration, participation, vesting, funding, fiduciary responsibility, and plan termination requirements of ERISA.

Death-Benefit-Only Plans (DBO)

Death-benefit-only (DBO) plans provide a death benefit only to the employee's designated beneficiary. A death-benefit-only plan is a type of ERISA welfare plan often misclassified as a nonqualified deferred compensation plan. A welfare plan is an employer-sponsored plan that provides, among other things, death, disability, sickness, accident, or unemployment benefits for its participants. A DBO plan is not considered to be an ERISA employee pension benefit plan because it does not provide retirement benefits, nor does it provide for the deferral of income. Welfare plans are subject to ERISA's reporting, disclosure, fiduciary, administration, and enforcement requirements; however, they are not subject to ERISA's participation, vesting, and funding requirements.

A DBO plan is a valuable tax-planning tool for a highly compensated employee who has a large estate that may be subject to significant federal estate taxes, even after the applicable credit and marital deduction are taken into account. A properly designed DBO plan is excluded from federal estate tax for a highly compensated employee who owns 50% or less of a closely held corporation's (i.e., the employer's) stock. All payments are taxed as ordinary income to the beneficiary.

The plan provides that a death benefit will be paid only when an executive

- has a specified number of years of service with the company,
- has made a designation of a beneficiary under the plan in accordance with plan rules, and
- dies in the active service of the company *before* retirement.

When a life insurance policy is used, the policy is owned by the company and the company is the beneficiary. The death benefit is paid by the company to the executive's beneficiary selected under the DBO plan—the executive does not select a beneficiary under the policy. Doing so would possibly defeat the purpose of the plan and cause the policy's proceeds to be included in the executive's estate for tax purposes. The executive does not have the right to change the beneficiary named in the plan or to change the terms or amount of payments under the plan. These requirements must also be met to keep the death benefit out of the executive's estate.

The benefit is based on the annual rate of pay of the deceased executive. To receive the death benefit, the widow or other designated beneficiary must survive the executive. However, the executive can designate under the plan a contingent beneficiary to receive the benefit in the event of the primary beneficiary's death.

EXAMPLE: Death-benefit-only plan

Charlie owns 48% of BioFuels, Inc. The company's estimated value is $20 million. Ted owns 40% and Mark, a former employee, owns the remaining 12%. Ted decides he needs to provide liquidity to his estate for tax and other reasons. The company will provide this liquidity through a DBO plan. Ted is 42 and will be covered by a $5 million policy, with the company as beneficiary of this policy. The company will also pay all premiums and own the policy. If Ted were to die, the company would collect on the policy and use the proceeds to pay Ted's surviving spouse. For example, the plan could pay a lump sum of $2 million to Ted's wife and the remaining cash, if any, after reimbursing the company for costs, would

be paid out to her as an annuity to age 95. Any payments to Ted's wife would be considered ordinary income and be taxable to her.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

5. Which of the following is a CORRECT statement about top hat plans?
   A. Top hat plans are subject to ERISA's reporting and disclosure requirements.
   B. A top hat plan is a type of salary deferral plan.
   C. Top hat plans must be funded.
   D. The plan can only be established for rank-and-file employees.
6. In which of these business applications of life insurance will the receipt of the death proceeds received from the insurance policy and payable from the employer be taxable as income to the beneficiaries of the insured executive?
   A. Section 162 plan
   B. DBO plan
   C. Split-dollar plan
   D. Key employee plan

Reading: Tax Implications of Nonqualified Deferred Compensation Plans

LO 9.3.2: Analyze a situation to identify the tax implications of a nonqualified deferred compensation plan.

Deferral Agreement

To review, if a deferred compensation plan is to be effective in postponing *current* taxation, these principles must be followed:

- The agreement to defer compensation to be earned in the next or subsequent tax years must be completed before the last day of the preceding tax year (i.e., by December 31). However, for the first year that an employee becomes eligible to participate in an unfunded NQDC plan, the election may be made within 30 days after the date of the employee's initial eligibility but only with respect to compensation for services to be performed after the date of the election (see IRC Section 409A).
- The agreement must represent only an *unsecured* promise.
- The agreement cannot be *funded* (i.e., any funds used to provide the benefit must be held by the employer as a general asset available to creditors).

Constructive Receipt Doctrine

The constructive receipt doctrine states that any income made available to a taxpayer at their discretion, even if not in their possession, is subject to immediate taxation. In other words, taxation occurs when income is actually *or* constructively received.

Treasury Regulations Section 1.451-2(a) provides in part that income, although not reduced to a taxpayer's possession, is *constructively received* in the taxable year during which it is:

- credited to the taxpayer's account,
- set apart for the taxpayer, or
- made available so that the taxpayer may draw on it anytime or could have drawn on it during the tax year if notice of intent to withdraw had been given.

However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Economic Benefit Doctrine

Another tax doctrine that is important to the potential taxation of compensation plans is the economic benefit doctrine. Under this doctrine, if an individual receives any economic or financial benefit, or property as compensation for services, the value of the benefit is includible as taxable income. This doctrine states that when the employee's benefit has become substantially vested or essentially equivalent to the receipt of cash, current income taxation will result. In other words, the doctrine applies when assets are unconditionally and irrevocably paid into a fund to be used for a taxpayer's sole benefit without restrictions or conditions based on the occurrence of future events.

In summary, the doctrine provides for the current taxation of economic and financial benefits that are

- fixed,
- placed in an irrevocable fund or trust to be used for the taxpayer's sole benefit, and
- not subject to the payor's (employer's) debtors.

Assignment of Income (Fruit of the Tree) Doctrine

The assignment of income doctrine is often related to the fruit of the tree. As such, the **assignment of income doctrine** is any arrangement by which funds are attributed to a different tree from that on which they grew will not be recognized for tax purposes. As long as a taxpayer retains control over the tree, they will be taxed on its fruit, even though they have assigned all rights to the fruit to another. Thus, even though a taxpayer effectively and irrevocably assigns the rights to receive income to another and that person collects the income directly, the original taxpayer/assignor, nonetheless, is liable for the tax on the income if control is retained. Suppose a taxpayer gifts the "tree" (property) to another individual. A transfer of an entire property interest to another individual will be effective in shifting income taxation of the property, except for amounts earned prior to the transfer.

PROFESSOR'S NOTE:

As a general rule, the assignment of income doctrine will not apply to a properly designed nonqualified deferred compensation arrangement.

Code Section 83

Section 83 of the IRC governs the tax treatment of property transferred to an employee for the performance of services. The two major determinants of taxation under Code Section 83 are (1) that the employee is not taxed on property until it is transferable (the employee acquires a beneficial ownership interest in the property), or (2) that the employee is not taxed on property as long as it is subject to a substantial risk of forfeiture.

Section 83 property includes such items as real and personal property, stock or promissory notes of an employer, and a beneficial interest in assets (including money). However, the term *property* does *not* include an unsecured and unfunded promise by an employer to pay deferred compensation to an employee at a later date, nor does it include an unsecured and informally funded arrangement. Section 83 does, however, govern the tax consequences of funded nonqualified deferred compensation arrangements.

Under Section 83, there is a *substantial risk of forfeiture* if such person's rights to the enjoyment of property are conditioned on the performance of substantial services. Thus, for example, if property is transferred to an employee on the condition that they remain employed with the employer for five years, there is a substantial risk of forfeiture to the employee's right to receive the property during those five years. At the end of those five years, the substantial risk of forfeiture expires, at which time the value of the employee's interest in the property will be included in their income. This will occur even though the property is not distributed until a later date.

If an employee becomes subject to income tax on property transferred in connection with the performance of services, the employee must include in income the difference between the current fair market value of the property and the amount paid for the property, if any. Since this represents payment for services, or compensation income, the income is taxed as ordinary income. As usual, the employer is entitled to a business expense deduction to the extent that the payment in property represents reasonable compensation. The amount of the deduction is the same as the amount that the employee was required to include in their income.

The 83(b) Election

The employee may elect to be taxed at the time of the original transfer, even though the property is subject to a substantial risk of forfeiture. This election is referred to as an **83(b) election**. Within 30 days of receipt of the property, the employee can elect to be taxed on the current spread between the fair market value and the price at which the property is offered; the employee includes any difference in income. Later, when the risk of forfeiture lapses, the employee does not recognize any additional income until sale of the property. The employee will recognize capital gain income, not ordinary income, when the property is sold. Therefore, any appreciation in the value of the property after the 83(b) election is made receives the more favorable capital gains tax treatment.

Three of the most popular types of Section 83(b) plans are nonqualified stock options, stock appreciation rights (SARs), and restricted stock plans. As can be ascertained from these names, the asset that is probably used most often as the benefit in a deferred compensation plan is stock, often that of the employer. The

granting of this stock as an employee benefit will serve as a performance incentive to the executive to improve the earnings of the employer as well as increase the value of their own stock holdings.

As a general rule, these plans are designed so they do not fall under Section 409A. To do so, they must meet certain requirements. The main requirements are that the exercise price must not be less than the market price at the time of grant and the option or right must not include any feature that permits a deferral of compensation until the right (SAR) is exercised or, in the case of an option, the option is exercised, disposed of, or the stock acquired by exercising an option becomes substantially vested.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

7. The doctrine of constructive receipt is
   A. triggered if there is an irrevocable transfer of funds made on the executive's behalf that may eventually provide a benefit to the executive.
   B. triggered if an executive will control the receipt of income within stated limits.
   C. triggered if an executive has the ability to access the funds or if the funds are securely set aside for the executive.
   D. also called the economic benefit rule.

TOPIC 9.4: STOCK OPTIONS

Reading: Various Types of Stock Options

LO 9.4.1: Compare incentive stock options (ISOs), nonqualified stock options (NQSOs), and employee stock purchase plans (ESPPs) to determine which is most appropriate for a given situation.

Stock options give the employee (usually an executive) the right to purchase a fixed number of shares of employer stock at a predetermined price over a stated period. The grant or award of a stock option is generally a nontaxable event because the option's exercise price is usually equal to the stock's trading price on the day of the award. The option, therefore, has no readily ascertainable value, and there is no economic benefit to the employee to tax.

The two types of stock options are incentive stock options (ISOs) or statutory options, which are tax qualified, and nonqualified stock options (NQSOs), which are not tax qualified.

Incentive Stock Options (ISOs): Requirements and Taxation

Numerous requirements must be met under the IRC for a stock option to qualify for tax-favored status as an **incentive stock option (ISO)**. These requirements are

also referred to as the special holding period rules (IRC Section 422) and include the following:

- The ISO must be part of a written plan approved by the stockholders of the corporation.
- The exercise date of the option cannot exceed 10 years from the date of its grant.
- The exercise price of the option cannot be less than the market price of the stock at the date of the grant.
- The maximum value of stock with respect to which ISOs may first become exercisable in any one year is $100,000. Stock is valued when the option is granted.
- The shares received through the exercise of the ISOs cannot be sold within two years from the date of the option's grant and one year from the date of the option's exercise, otherwise the favorable tax treatment will be lost.

In exchange for the satisfaction of these requirements, ISOs receive favorable income tax treatment:

- There is no regular taxable event at the ISO's exercise date. However, an individual **alternative minimum tax (AMT)** event occurs, whereby the employee must report the bargain element of the ISO as of the exercise date as an AMT adjustment item. The AMT is a system designed to ensure that individuals with large deductions and other tax benefits pay at least a minimum amount of tax. The individual AMT will be discussed further in the *FP514 Income Tax Planning* course of this program.
- The employee's taxable basis for regular income tax purposes is the ISO's exercise price. For AMT purposes, this basis is the ISO's exercise price plus the bargain element. You should also note that the employer does not receive an income tax deduction when the employee exercises an ISO. This is also the case if the employee satisfies the special holding period rules at the date of sale. In other words, it is possible that the company granting an ISO may never receive an income tax deduction.
- If the stock acquired by exercise of the ISO is not sold until after one year from the date of the option's exercise and two years from the date of its grant, any gain in the value of the stock is treated as a long-term capital gain to the employee. Additional Medicare tax may apply to the transaction.
- If the employee sells the stock within one year after exercise, or two years from the date of the ISO grant, the bargain element is taxed as ordinary income, reported by the employer on the employee's W-2—but it is not subject to FICA or payroll taxes. If the stock has appreciated beyond the FMV at the date of exercise, then the remaining gain would be capital gain (usually short-term, depending on how long the stock was held before disposition). The difference between the option price and the fair market value on the date of exercise is an add-back for purposes of the AMT.

EXAMPLE: Incentive stock options (ISOs)

As a part of his signing bonus four years ago, Tech, Inc. granted ISOs to Roger, allowing him to purchase 1,000 shares of Tech stock at $15 per share after one year of employment. Tech, Inc. stock was selling for $15 per share on the day the ISOs were granted. The options were exercisable anytime during a five-year window starting after his initial one-year waiting period ended. Roger is now in his third year of employment, and he exercised the ISOs on October 16th of this year, when the stock was selling for $22 per share. He anticipates selling the shares after October 16th of next year, when he hopes the stock price will be $25 per share. Because of these transactions, Roger recognizes no regular taxable income from compensation on either the option's grant or exercise date. In other words, he will not be income taxed on any of the transactions *as compensation* from Tech, Inc. However, he will have an AMT issue in the year the ISO is exercised. This is not a regular income tax issue; it is an AMT issue. Roger must recognize the bargain element of $7,000 [($22 – $15) × 1,000] as an individual AMT adjustment item as covered in the FP514 Tax Planning course. The second tax issue will come when he sells the stock. In this case, he would be income taxed as long-term capital gains next year when he sells the stock as long as the sale is on or after October 17th of next year. Why exactly October 17th of next year? Because the holding period starts the day after the acquisition and the date of disposition is also included.

How did he get this favorable tax treatment? First, the ISO exercise date was less than ten years from the date of the grant (Roger's first day of employment) and the exercise price was not less than the FMV of the stock on the date of the grant. Second, he will have met both ISO holding period requirements. The sale was at least two years after the date of the grant and one year after the exercise date. At no time is Tech, Inc. permitted an income tax deduction with respect to Roger's ISOs because he recognized no W-2 compensation income from the transactions.

What if he would have sold the stock less than a year after the exercise date or less than two years after the ISOs were granted? Then Roger would be income taxed on the bargain element. This amount would be reported on his W-2 in the year of the stock was sold, but it would not be subject to FICA or FUTA. If the stock has appreciated beyond the FMV at the date of exercise, then the remaining gain would be capital gain (usually short-term, depending on how long the stock was held before disposition). The capital gain would be the amount of the sale over the exercise price and the W-2 income attributable to the exercise of the option.

Use of ISOs

Any employee, including the employees of a parent or subsidiary corporation of the granting corporation, may receive a grant of ISOs. However, ISOs may not be granted to owners of more than 10% of the voting power of all classes of stock of the granting corporation unless the exercise price is at least 110% of the fair market value of the underlying stock.

ISOs are viable options for employees who a company may wish to employ and retain, especially in high-tech businesses where competition for talented professionals is strong. Without expending any cash, the employer is able to give an employee a stake in the company, while simultaneously providing an incentive to remain with the company and produce the desired results.

Figure 9.5: Summary of ISO Characteristics

Item	Characteristic
Qualification requirements	■ Must satisfy IRC Section 422 (holding period rules) at the time of grant. Grant must be under a qualified ISO plan.
Exercise price	■ Grant price must be fair market value at the time of the grant.
Eligibility	■ Only employees are eligible to receive the grant.
Holding period requirement for capital gains treatment	■ Must hold the stock at least 2 years from the grant date AND 1 year from the exercise date.
Disqualifying disposition	■ Occurs if the holding period requirement is not met.
Tax	■ There is no tax to the recipient of the grant at the time of the grant and no tax at the time of exercise. There is an AMT adjustment at the time of exercise for the bargain element. Disqualifying dispositions are taxed as ordinary income.
Restrictions	■ More-than-10% shareholders are subject to certain additional restrictions. ■ Both the plan and the grant have 10-year durations. ■ Only $100,000 of options may be granted annually based on the grant price (any amount over $100,000 will be treated as a nonqualified stock option).

Nonqualified Stock Options (NQSOs): Requirements and Taxation

The more popular type of stock option today is the **nonqualified, or regular, stock option**. If the NQSO does not have a readily ascertainable fair market value at the date of the grant (the usual case), the employee is not taxed until the date of the exercise of the option. On the exercise date, the bargain element represents income to the employee. The **bargain element** is the difference between the market value of the stock at any particular time and the option's exercise price. In the taxation of an NQSO, this bargain element is taxed at the date of the option's exercise as W-2 compensation income, which is a type of ordinary income, and is subject to payroll (FICA and FUTA [Federal Unemployment Tax Act] taxes) because the option was granted originally in lieu of salary. The employer also receives a deduction for the amount of the bargain element when the employee brings the amount into income. The stock's holding period, for purposes of determining long- or short-term capital gains treatment to the employee, begins with the exercise date. The taxable basis in the stock is equal to the option's exercise price plus the ordinary income recognized on the exercise date.

EXAMPLE: Nonqualified stock options (NQSOs)

Debra is a corporate executive with Cary Imports, whose stock is publicly traded. She has been granted NQSOs as part of her compensation package. The options give Debra the right to purchase 1,000 shares of Cary stock at $50 per share ($50,000 total) no earlier than five years from the date of the grant. Debra purchases this stock at the earliest possible date when its market value is $150 per share ($150,000 total). When Debra purchases the stock, her basis is the $50,000 she paid for the shares plus the $100,000 bargain element (the difference between the $150,000 market value of Cary stock at the date of Debra's exercise and the option's $50,000 exercise price). Debra must report this bargain element of $100,000 as ordinary income and pay FICA taxes on this amount at the same time. Cary Imports also receives a $100,000 income tax deduction at that time. Finally, Debra's taxable basis in the stock now becomes $150,000. She would need to hold the stock for more than one year after the exercise date before becoming entitled to long-term capital gains treatment on any appreciation of the stock.

Gifting an NQSO

A viable planning technique is for the employee/executive to gift the NQSO to either a family member or qualified charity before the option's exercise date. In this manner, the employee recognizes no gain on the transfer date and may potentially remove the option and shares of stock from the taxable assets of the employee/executive's estate. However, when either the family member or qualified charity exercises the option, the employee will have W-2 compensation income, which is a type of ordinary income, and this income will be subject to FICA or payroll taxes at the exercise date. If the donee is a qualified charity, the employee will be permitted a charitable income tax deduction on the transfer date (or the option's vesting date, if later).

Cashless Exercise of NQSOs

One of the problems of a nonqualified stock option plan is the requirement that the executive have cash available to pay income tax on exercise of the option. A cashless exercise is a solution to this. With a cashless exercise, the executive would sell the shares represented by the NQSO, and then use the proceeds from the sale to both pay for the stock and pay taxes. Any amount left over would then belong to the employee. Cashless exercises are very common, and many firms establish a working relationship with one broker-dealer so that employees can easily carry out a cashless exercise.

EXAMPLE: NQSO cashless exercise

Terry was granted an NQSO five years ago to purchase 100 shares of his employer's stock at $20 per share. He exercised the option when the fair market value of the stock was $30 per share. Terry is currently in the 32% marginal income tax bracket. If Terry undertakes a cashless exercise of

the option, he will receive a net amount of 23 shares of stock calculated as follows:

- The exercise cost of the NQSO is $2,000 (100 shares × $20 per share). In addition, he will need to pay ordinary income tax of $320 on the bargain element of the shares [($30 FMV – $20 exercise price) × 100 shares × 0.32]. Therefore, the total cost of the option is $2,320.
- In implementing a cashless exercise, Terry must sell enough employer shares to cover the total cost of the option. Therefore, he must sell a total of 77 shares calculated as follows: $2,320 total cost ÷ $30 FMV of shares = 77 shares. This leaves him with 23 remaining shares of employer stock.
- When Terry sells the net amount of 23 employer shares (assuming he holds the shares for at least one year from the exercise date of the option), he will have either a long-term capital gain or loss.

TEST TIP

Recall that the bargain element is the difference between the market value of the stock at any particular time and the option's exercise price. In the taxation of an NQSO, this bargain element is taxed at the date of the option's exercise as W-2 compensation income (because the option was granted originally in lieu of salary).

PROFESSOR'S NOTE

Because ISOs and NQSOs are not ERISA retirement plans and do not provide for the deferral of income, they may be established for executives only and do not have to cover rank-and-file employees.

Comparison of ISOs and NQSOs

Date	ISOs	NQSOs
Grant date	No taxable event	No taxable event
Exercise date	AMT adjustment item to employee; no deduction for employer	Compensation income to employee; deduction for employer
Stock sale date	Long-term capital gains if meeting special holding period rules	Short- or long-term capital gains depending on holding period of the stock

Employee Stock Purchase Plans (ESPPs)

An **employee stock purchase plan (ESPP)** is an option granted by the employee's corporation that enables the employee to purchase shares in the company stock at fixed intervals (offering periods). Oftentimes, this is accomplished through taxable payroll deductions. At the end of the offering period, employees' accumulated funds are used to buy company stock, usually at a specified discount from the market value. The maximum permitted discount from fair market value is 15%. The discounted price, known as the offer or grant price, gives the employee an instant

gain at the time of purchase. Also, there is a twist. The offer/grant price is the value at the beginning of the new period during which the worker's payroll deductions are being accumulated to eventually purchase the stock. This is called the lookback period. After the stock is purchased, the company holds the stock in the employee's name until the employee decides to sell it. Only then are there any tax implications.

When the stock is sold, the discount the employee received when buying the stock is taxed as ordinary income. As with ISOs, there is a one/two-year holding period to qualify for special tax treatment. If the holding period is met, the employee pays ordinary income tax on the amount attributable to the discount (this makes sense because the discount is compensation for the employee) and any additional gains would be taxed as long-term capital gains.

> **EXAMPLE: Tax on employee stock purchase plans**
>
> Seth purchased stock in his ESPP on March 23, 2022. The stock closed at $11.16 on the offering date of January 1 and $18.65 on the purchase date of June 30. The plan gives him a 15% discount, thus giving him an actual purchase price of $9.49 (85% of $11.16 via the lookback provision).
>
> Seth will have to hold his stock at least until March 24, 2024, in order for this to be a qualifying disposition. If he does this and sells the stock in April of 2024 for $22.71, then only the discounted amount of $1.67 per share ($11.16 × 15%) will be reported as ordinary income. The difference between the actual undiscounted market price and the sale price will be counted as a long-term gain or loss. Seth will therefore have a long-term gain of $11.55 per share ($22.71 – $11.16).

If the holding period is not met, there would be a disqualifying disposition, and the difference between the discounted grant price (exercise price) and the market value on the exercise date (purchase price) would be taxed as ordinary income. Additional profit earned between the date of purchase and the date of sale would be treated as a capital gain.

> **EXAMPLE: Tax on employee stock purchase plans**
>
> If Seth sold the stock before the holding period expired, he would recognize $9.16 as ordinary income ($18.65 – the discounted purchase price of $9.49). The market price on the day of purchase ($18.65) then becomes the cost basis for the sale.
>
> In this case, the remaining $4.06 of sale proceeds (sale price of $22.71 – the market price on day purchased of $18.65) will then be taxed as a long- or short-term capital gain, depending on the length of his holding period.

Requirements of ESPPs

- As with ISOs, ESPPs must only be granted to employees.
- Also as with ISOs, ESPPs must be approved by shareholders within 12 months before or after the date the plan is adopted.

- Options must be offered to all employees with certain exceptions, such as employees who have been employed for less than two years, and employees who work 20 hours or less a week.
- Unlike ISOs, ESPPs can be offered at a discount—the option exercise price must be no less than 85% of the fair market value of the stock (up to a 15% discount). The exercise price can be based on the price on a certain date (such as the beginning of each quarter) or it can be an average. Any discounted amount will be taxed as ordinary income when the stock is sold; it is not eligible for capital gains treatment.
- Unlike the ISO maximum annual amount of $100,000 that an employee can receive or vest in annually, ESPP purchases are limited to a maximum value of $25,000 per calendar year. If an employee defers more than allowed, any excess would be returned.
- Just as with ISOs, after exercise, the acquired stock must be held for a period of two years from the date of the grant AND one year from the date of exercise, to preserve favorable tax treatment.

EXAMPLE: Employee stock purchase plans

If an employee is able to purchase company stock at a discount, any discounted amount will be taxed as ordinary income, even if the holding period requirements are met. For example, Alexis has participated in her ESPP to purchase stock at a 10% discount. Alexis purchases 10 shares at $90 per share when the stock's fair market value is $100. Alexis holds the stock for more than two years from the grant date and more than one year from the exercise date, and sells the stock for $130. She has met the holding period requirement and has a qualifying disposition. Her taxes will break down as follows:

- $10 per share ($100 on 10 shares) will be taxed as ordinary income. This is the amount of the discount Alexis received when she was granted the option (the difference between her $90 per share grant price and the $100 per share fair market value at the time). This discount is taxed as ordinary income because it is compensation for working there.
- $30 per share ($300 on 10 shares) will be taxed as long-term capital gain since she met the holding period requirement.

If the employee sells at a loss (sells at a price less than the exercise price), then the employee will have a short- or long-term capital loss depending on the holding period beginning at the date of exercise.

PROFESSOR'S NOTE

Unlike ISOs, which are designed for certain highly valued employees, ESPPs are generally intended for rank-and-file employees. Employers should benefit from their workers owning their stock because productivity should increase due to the workers also benefiting from owning the shares.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

8. Five years ago, Katie was granted 2,000 incentive stock options (ISOs) with the exercise price of $30. The stock price was $30 on that date. On February 2 of this year, she exercised all 2,000 options at $67. Katie has decided to dispose of the stock she acquired through the exercise of her ISOs on March 15th of next year. What is the tax impact of this transaction?
   A. Katie will not have any AMT income adjustment.
   B. Katie will have an AMT income adjustment of $60,000.
   C. Katie will have an AMT income adjustment of $74,000.
   D. Katie will have an AMT income adjustment of $134,000.
9. On January 2nd of Year 1, Zack was granted 10,000 ISOs to purchase his employer's stock at $5 per share. On February 14th of Year 2, he exercised the options when the stock's market price was $15 per share. On March 15th of Year 3 he sold the shares for $50 per share. What is the amount and character of gain or income of Zack's sale of the shares this year?
   A. He will have capital gain of $350,000.
   B. He will have capital gain of $450,000.
   C. He will have W-2 (compensation) income of $450,000.
   D. He will have W-2 (compensation) income of $100,000 and capital gain of $350,000.
10. Four years ago, Julie was granted an NQSO to purchase 500 shares of employer stock at $30 per share. She would like to receive as many shares of stock as she can but does not want to have to expend any cash when exercising the options. Assuming Julie exercises the option when the FMV of the stock was $40 and her marginal income tax rate was 24%, how many shares of employer stock, if any, can she receive?
   A. 0
   B. 95
   C. 405
   D. 500
11. Under the terms of an employee stock purchase plan (ESPP), the client receives options to purchase 500 shares of their employer stock at $30 per share when the FMV of the stock was $35 per share. The client exercises the options when the market price of the stock is $35 per share. Three years later, the client sells the 500 shares for $50 per share. Based on the information provided, what is the amount of ordinary income and capital gain recognized on the sale?
   A. $0 ordinary income; $10,000 capital gain
   B. $7,500 ordinary income; $2,500 capital gain
   C. $10,000 ordinary income; $0 capital gain
   D. $2,500 ordinary income; $7,500 capital gain

TOPIC 9.5: EQUITY-BASED COMPENSATION

Reading: Various Types of Equity-Based Compensation Plans

LO 9.5.1: Identify the characteristics of various types of equity-based compensations used as incentives for executives.

LO 9.5.2: Evaluate the appropriate use of various types of equity-based compensation plans used as incentives for executives.

From the employer's perspective, one of the most effective ways to compensate an executive is to align the interests of the executive with those of the company via incentive pay. Plans that tie together executive performance and company stock values are an effective means of creating this alignment of interests. These arrangements are collectively referred to as *equity-based compensation plans*. In general, when a company is successful, the compensation paid to the executives will reflect that success.

Restricted Stock Plans

A **restricted stock plan** is a form of equity compensation plan that gives an executive (or other participant) the right to receive shares of stock at some point in the future if certain conditions are met (or when restrictions have been lifted). The restricted period is called a *vesting period*. The executive's right to own the stock is restricted until the shares vest (or restrictions lapse). If the employee does not meet the requirements for restrictions to lapse, the shares are forfeited.

If the employer sells the restricted stock to the executive at a value less than its fair market value, the executive receives an immediate economic benefit. There is no current taxable event upon grant, however, because the restrictions on the stock make it subject to a substantial risk of forfeiture. Employees can opt to be taxed when the restrictions lapse (at vesting), in which case they will pay ordinary income tax plus be subject to FICA and FUTA taxation on the difference between the current price (fair market value at the time of vesting) and the amount paid for the grant, if anything. After being taxed as compensation, the normal capital gains rules apply. If the stock is ultimately sold within one year of vesting, any gain on the difference between the share price on the vesting date and the sale date will be taxed as a short-term capital gain. If the stock is not sold until after one year following the vesting date, this difference will be taxed as a long-term capital gain.

The primary reason for compensating an executive with restricted stock of the employer corporation rather than with additional cash is to promote a beneficial result to the company (or prevent conduct that would be detrimental to the employer). The expectation is that an executive will have a greater interest in a company in which they have an ownership stake. If the executive expects to derive a benefit from the appreciation in the value of the company's stock, the executive should strive to perform at an optimum level and thus contribute toward this appreciation. Restrictions may also include incentives for the executive to remain with the company. For example, a plan may restrict the sale of stock by an employee

until they have remained with the company for a specified number of years after issuance of the stock. Additionally, restricted stock plans are attractive to employers because they require minimum cash outflow.

From the employee's perspective, restricted stock plans are attractive because they are *typically* not required to pay anything for the stock and the grant is not taxable to the employee, unless the employee makes an election under Section 83(b), until it vests.

Figure 9.6 summarizes the characteristics of restricted stock plans.

Figure 9.6: Restricted Stock Plans

	Description	Characteristics	Tax Considerations
Restricted stock plans	Shares of stock are granted to an employee at no cost or at a bargain price, subject to the restriction that they will not be sold or disposed of for a specified period.	Shares become available to employees only after a specified time elapses.	Excess of fair market value of stock over employee cost is taxable as ordinary income after period of restriction lapses.

PROFESSOR'S NOTE

The employer will not have a deductible expense for stock grants until the employee recognizes income; which is when there is no longer any substantial risk of forfeiture (upon vesting). Again, income will be equal to the value of the stock on the date of vesting (unless a Section 83(b) election is made).

EXAMPLE: Restricted stock plan

John Reiner is an executive with Redwood Corporation, a publicly traded software company. Five years ago, Redwood awarded John 1,000 shares of restricted stock when its fair market value was $30 per share. The restricted stock was nontransferable and subject to a substantial risk of forfeiture for a five-year period within the guidelines of IRC Section 409A and Section 83; specifically, if John left the company for any reason within five years from the date of transfer, he would forfeit the shares.

Five years later, the stock is worth $100 per share. The restriction has been lifted and John is vested, meaning the shares are his without any strings attached. Because there is no longer any substantial risk of forfeiture, John will be subject to income tax as well as Social Security and Medicare taxes (chances are John is already above the Social Security taxable wage base). The current fair market value is $100 per share, so John will be taxed on $100,000 (1,000 shares × $100).

John's stock was not substantially vested when it was transferred to him five years ago, so he did not have to report any income in the year he was awarded the stock.

Five years ago, John could have made an IRC Section 83(b) election and chosen to report the $30,000 value of the restricted shares as taxable income in the year of the transfer (i.e., the value of the Redwood Corporation stock at that time [1,000 shares × $30 fair market value]). If he had made this choice, any additional appreciation in value from the date of the award would not have been included as income until he sold the stock.

Assuming John had made an IRC Section 83(b) election, his basis for figuring capital gain or loss following the sale of the stock would be based on the value he was taxed on at the time of the election. Hence, any appreciation in the value of the stock after the 83(b) election was made would receive the more favorable capital gains tax treatment.

Continuing with our example, if John had paid taxes on the restricted stock when it was originally awarded to him five years ago, he would owe no taxes when he became vested. When he sold the stock, he would be taxed at the long-term capital gains rate on the difference between the sales price, and the price that his taxes were based on when he made the Section 83(b) election (in this case, $30 per share). Assuming he sold the shares at $100 per share, he would owe long-term capital gain taxes on $70,000 ($100 – $30 = $70 gain, $70 × 1,000 shares).

Once an individual makes this choice, he cannot revoke it without the consent of the IRS, and consent is typically given only if the taxpayer who made the election was under a mistake of fact as to the underlying transaction. Also, if John had left the company before five years elapsed from the date of the stock transfer, he would have forfeited the stock after having included its value in income. John does not receive any tax credit for the income tax he previously paid based on the $30,000 value when the stock was awarded for the year of his departure. This is a legally mandated gamble—an individual could end up paying taxes on something they never receive. Thus, some think of the Section 83(b) election as "the Las Vegas election."

Another scenario when the Section 83(b) election could backfire would be if the price of the stock were to fall between the time the restricted shares are awarded and the time they become vested. Returning to our scenario with John again, if the shares had fallen to $5 per share when he became vested, he would have been better off paying taxes on $5 per share ($5,000 of taxable income) rather than the $30 per share ($30,000 of taxable income) he paid five years ago when the restricted shares were awarded. The bottom line is that one should have strong expectations of the stock price rising when choosing a Section 83(b) election. Finally, the Section 83(b) election is particularly well-suited for those in a substantially lower income tax bracket when the election is made than their projected income tax bracket will be when the stock vests.

Figure 9.7: Tax Treatment of Restricted Stock Awards

Federal Income Tax Treatment	Regular Tax Treatment—No 83(b) Election	With a Tax 83(b) Election
Grant date	No current taxation—tax deferred until shares vest.	Taxpayer taxed as ordinary compensation income at grant date on spread at grant date (difference between fair market value at grant minus amount paid for stock, if any). Tax withholding and inclusion in income tax return for year of grant required.
Forfeiture	No tax consequence. No risk of paying tax and forfeiting shares without tax benefit.	Taxpayer is not permitted to claim a tax loss on the forfeiture; no recovery of taxes paid at grant date on Special Tax 83(b) election.
Vesting	Taxpayer taxed as normal compensation at the vesting date on spread on vesting date (difference between fair market value at vesting date minus amount paid for the stock, if any). Tax withholding and inclusion in income tax return for year of vesting required.	No tax consequence. Vesting does not trigger inclusion in income of any appreciation in value of shares; no further tax until sale or other disposition.
Holding period	Holding period begins at vesting date when the compensation element of restricted stock is included in income.	Holding period begins at grant date when the compensation element of restricted stock was included in income.
Subsequent sale of shares (assuming shares held as capital asset)	Taxpayer is taxed as capital gain on difference between sale price minus taxpayer's basis (the amount included in income at vesting plus the amount paid for the shares, which should be equal to the fair market value of the stock at vesting). Whether the capital gain would be short term or long term would depend on the time between the beginning of the holding period at vesting and the date of the subsequent sale.	Taxpayer is taxed on capital gain on difference between sale price minus taxpayer's basis (the amount included in income at grant date plus the amount paid for the shares, which should be equal to the fair market value of the stock at grant date). Whether the capital gain would be short term or long term would depend on the time between the beginning of the holding period at grant date and the date of the subsequent sale.

Source: "Stock Plan Services," Fidelity, 2016, http://personal.fidelity.com/products/stockoptions/rstockawards.shtml.

PROFESSOR'S NOTE

As a financial planner, you should not tell your executive client to automatically make the Section 83(b) election with respect to restricted stock. If the executive makes the Section 83(b) election and then forfeits the stock (for whatever reason), they are not allowed a deduction or refund of tax paid on previously reported income. In addition, if the executive has paid no money to acquire the restricted stock, they will not realize a capital loss when the substantial risk of forfeiture expires.

Stock Appreciation Rights (SARs)

A **stock appreciation right (SAR)** is a form of incentive or compensation that gives an executive (or other participant) the right to compensation based on the appreciation in value of a specified number of shares of stock over a specified period. A SAR is nothing more than an imaginary unit that tracks the value of the common stock of an employer. They provide a method for an employee to obtain the benefit of a stock option plan without having to make the necessary capital outlay required to purchase the stock.

SARs are granted with a set exercise price and they have a vesting period and an expiration date. Once a SAR vests, an employee can exercise it at *any time* prior to its expiration at no cost. Upon exercise, the employee will receive proceeds equivalent to the stock price increase or the net appreciation amount (market price on the exercise date minus market price on grant date). The proceeds can be paid in shares of company stock or in the form of cash. The employee does not pay any exercise price for the shares under option and the company only pays the gain or appreciation to the employee.

The amount paid is measured by the performance of the employer's stock during the designated period. As the stock increases in value, the SAR increases in value. As the stock decreases in value, the SAR decreases in value but not below the value or formula price at the grant date of the SAR. SARs are typically based on the fair market value of employer stock; however, a formula price may also be used to determine the unit value of a SAR. (Obviously, a formula price makes more sense in a closely held business than in one in which the stock value is readily identifiable.)

SARs have no special tax treatment. The value of the award is taxed as ordinary income when the SAR is exercised and, at the same time, the employer recognizes a deduction for the payment to the employee. If the award is paid in shares, the amount of the gain is taxable at exercise. Any subsequent gain on the shares is taxable as a capital gain at the time the shares are sold.

EXAMPLE: Stock appreciation rights 1

Sam is granted a SAR in the amount of 1,000 shares when the FMV of his company's stock is $10 a share. At the time Sam decides to exercise his vested SAR, the company's stock is valued at $25 a share. Sam will have a gain of $15,000 ($25 value at exercise minus the $10 value at grant, multiplied by 1,000 shares). This $15,000 will be distributed either as cash or in the form of 600 shares ($15,000 divided by the $25 FMV price at time of exercise) and will be taxable as ordinary income. If distributed in the form of shares, any subsequent gain will be taxable as a capital gain when the shares are ultimately sold (long term or short term, depending on how long the shares were held).

Unless a SAR's exercise price at the time it is granted is greater than or equal to the current fair market value, it will fall under Section 409A. However, a SAR does not provide for deferral of compensation and will not be subject to Section 409A if the following are true:

- The exercise price is not less than the fair market value of the stock when the SAR is granted.

- The exercise cannot result in a greater benefit than the difference between the fair market value at grant and the fair market value at exercise.
- The right does not include any deferred compensation feature other than the deferral of income feature (discussed previously) until the right is exercised.

SARs are cashless to the corporation when issued and do not dilute ownership because no shares are issued. They are used heavily by closely held businesses that are unable to offer traditional forms of ownership, such as limited liability companies (LLCs) and/or S corporations, which are restricted from having more than 100 shareholders/owners by law. They are also effective if a company is trying not to give away too much of the ownership to employees.

EXAMPLE: Stock appreciation rights 2

Alpha Corporation, a public corporation, grants Rashid, an important employee, 1,000 SARs with an exercise price of $100. At the date of the grant, Alpha Corporation's common stock has a fair market value of $100 per share. The plan provides that Rashid may exercise his option after two years and, for one SAR, receive one share of common stock. If he's not employed by the company at the end of two years, the SARs are forfeited. Thus, Rashid has a substantial risk of forfeiture. If, at the date of exercise, the common stock is worth $205 per share and Rashid exercises 50 SARs (from his 1,000 shares available), he will be entitled to receive 50 shares worth $10,250 (50 shares times $205/share). The exercise price is $5,000 (50 times $100) and the gain is $5,250, which represents the increased value of the stock from the date of grant to the date of exercise ($205 – $100 = $105) multiplied by the number of SARs exercised less the exercise cost. In this case there was no exercise cost. Rashid will recognize $5,250 of compensation income, and the employer will receive a $5,250 compensation deduction. Of course, Alpha Corporation will have to apply the withholding tax rules to the compensation. Notice that this SAR is not subject to Section 409A because (1) the exercise price is not less than the market price at grant, (2) there are no other deferral features, and (3) payment is made in the shares of the company's stock.

Performance Unit or Share Plan

A **performance unit** or **share plan** is a form of incentive or compensation plan that gives an executive (or other participant) the right to compensation in the form of cash, shares of stock, or other property following the satisfaction of performance-related conditions or vesting requirements. Under a performance unit program, each unit is valued at a designated amount. In a performance share program, units are valued in concert with the value of the company stock. As this is essentially the only distinction between the two plans, both will be referred to here as **performance programs**.

The goal of a performance program is usually tied to a substantial increase in earnings per share of the employer's common stock over a given period, typically

three to five years. This increase is then measured against a base period amount that is established at the time the performance period commences. To judge performance against the target, the value of each unit must be established at the commencement of the program. Most programs, therefore, will identify both the base rate of growth and the target rate of growth and subsequently apply a unit value to each rate.

Performance programs are generally structured as unfunded and unsecured promises to pay cash or stock to a select group of employees or management personnel, with the plans usually limited to senior executives. Performance programs exist primarily in publicly held corporations, although there is no reason why they cannot be used in closely held businesses as well.

EXAMPLE: Performance program

Silver Star Corporation has implemented a performance program based on growth in earnings per share from its current earnings of $2 per share. The period of measurement is three years. If the maximum growth rate is achieved, an award of 2,000 performance shares will be granted to the executive committee of the board of directors, which includes the president of Silver Star Corporation and two of its vice presidents. The current value of the common stock of the company is $40 per share. The plan provides the following growth percentages that correspond to the portion of the total award that will be distributed.

Growth	Percentage of Total Award
8%–9%	10%
9%–10%	25%
10%–11%	50%
11%–12%	80%
More than 12%	100%

At an 8% growth rate, the cumulative earnings per share over the three-year period would be $7.01 ($2.16 + $2.33 + $2.52). At a 9% growth rate, the cumulative earnings per share would be $7.15. Therefore, with cumulative earnings per share of $7.01 or more, but less than $7.15, 10% of the shares would be distributed to the executive committee. The plan would generally provide that the executive committee could take its award in stock, cash, or a combination of both.

Typically, performance program agreements are written so that they are subject to a substantial risk of forfeiture until vesting occurs (when specific performance criteria are met or the value of the stock has increased to the agreed-on amount) and are subject to income tax under IRC Section 83. Generally, performance programs with these characteristics (i.e., subject to a substantial risk of forfeiture until vested and the IRC Section 83 tax rules) are not subject to Section 409A.

The right to earn performance cash in the future (subject to a substantial risk of forfeiture until vesting occurs) will not result in the current receipt of an economic benefit. Once the cash is received, however, the employee will recognize income, and the employer will be entitled to a corresponding tax deduction.

Awards are made at the time the performance period expires, assuming the performance target was met. The payment may be deferred beyond the performance period if the plan so provides and if constructive receipt is avoided. If the award is deferred, it may be granted in the form of restricted stock or as a cash award.

PROFESSOR'S NOTE

Section 409A does not apply to performance cash plans, because these plans are not deferred compensation plans. Performance cash plan payments are subject to income tax in the year payments are made. A deferral of payments, however, would have to meet the Section 409A short-term deferral exception, otherwise the plan would be subject to Section 409A.

Phantom Stock Plans

A **phantom stock plan** is a form of long-term incentive plan used by businesses to award executives (or other participants) with potential value without stock dilution. The employer grants the employee phantom shares that resemble actual stock, but are really only a commitment to pay the employees cash on fulfillment of certain conditions, such as time of employment or growth in the value of actual company stock. This is a cashless method of providing deferred compensation through an unfunded and unsecured promise by the employer. The executive bears no risk of loss since they make no financial investment in phantom shares.

A phantom stock plan is typically initiated with a book entry made to the accounting records of the company. This entry reflects the amount of phantom stock granted to the employee based on the compensation agreement. In effect, this is an investment in some theoretical stock of the company rather than actual shares. The investment is made at the theoretical value of the stock as of the stock grant date. The investment then tracks the performance of the actual closely held stock. If the value of the real stock increases or decreases, the value of the theoretical stock likewise increases or decreases. If a real dividend is declared, the value of the dividend is added to the value of the theoretical stock. This same concept also applies to stock splits or reverse splits.

Because the shares of phantom stock held by an employee are just an unfunded and unsecured promise to pay, there is no income currently recognized by the employee; however, the employee also bears the risk that this compensation may never materialize. At the time the payment event takes place and the employee receives cash, stock, or a combination of both, a taxable event occurs. (The event or date that triggers payment to the employee usually is set by the employer, so the employee has little ability to control the exercise date.) Because the employee has no basis in the shares, the entire amount or value of property received is reported as ordinary income and is subject to normal withholding tax rules. The possibility of paying lower capital gains rates on other forms of performance incentives makes phantom stock plans somewhat less attractive.

PROFESSOR'S NOTE

Generally, phantom stock plans are used as an incentive to spur the performance of the executive-employee. These plans are used advantageously with closely held corporations because they allow executives to benefit from company growth without upsetting the structure of the company's stock ownership.

The major disadvantage of phantom stock plans is ascertaining a value for the stock at various points in time. A costly formal appraisal may be the only way to come up with a reasonable estimate of the stock's value. An additional problem arises due to the fact that the fair market value of the stock may be affected by factors other than strictly economic ones. The value of closely held stock can be impacted by considerations not applicable to large publicly held companies (e.g., family problems or the death of an important management person). Because of this, some phantom stock plans are being structured in ways that measure the amount of cash distributions payable to an employee in something other than the value of the company's stock.

A phantom stock plan may be designed so it is not subject to Section 409A. A phantom stock plan that meets the following requirements will *not* be subject to Section 409A:

- The plan must be subject to a substantial risk of forfeiture and nontransferable until vesting occurs in the future.
- The plan must be subject to income taxation under IRC Section 83.
- The plan must pay vested benefits to the executive-participant no later than two-and-a-half months after the year in which vesting occurs.

Of course, a phantom stock plan that fails to meet the Section 409A short-term deferral exception (this exception requires benefits to be paid no later than two-and-a-half months after the year in which vesting occurs) will be subject to Section 409A.

Figure 9.8 summarizes the essential characteristics of the equity-based compensation plans.

Figure 9.8: Summary of Restricted Stock Plans, SARs, Performance Share/Unit Plans, and Phantom Stock Plans

Plan	Description	Characteristics	Tax Considerations
Restricted stock plans	Shares of stock are granted to employee without costs or at a bargain price, subject to the restriction that they are not sold or disposed of for a specified period.	Shares become available to employees only after a specified time elapses, but stock can be voted when awarded. Dividend equivalents can be paid or credited to the owner's account.	Excess of fair market value of stock over employee cost is taxable as ordinary income after period of restriction lapses. Any dividends received during period of restriction are taxed as ordinary income.
SARs	Employee realizes appreciation in the value of a specified number of shares. No employee investment is required.	May be granted alone or in tandem with stock options. Distribution may be made in stock in an amount equal to the growth in value of the underlying stock.	Upon exercise, the amount received is taxable as ordinary income.
Performance share/unit plans	Awards are granted at the beginning of a specified period and then earned through attaining performance goals.	Payments are made in cash, stock, or a combination of the two.	Taxable ordinary income is recognized on the date the payments are made.
Phantom stock plans	Employee is awarded units, not representing an ownership interest, that correspond to a specific number of shares of stock. When performance goals are met or a specified time elapses, employee receives cash based on the current price of stock.	Award may be equal to the value of the shares of phantom stock or just the appreciation portion. Dividend equivalents may be credited to account or paid currently.	The value of the award paid and any dividend equivalents are taxable as ordinary income.

Junior Stock Plans

Junior stock plans provide a significant performance incentive to the recipient and are effective in deferring taxation. The company establishes the plan by creating a new class of common stock with diminished rights and hence, diminished value. For example, the junior stock may be entitled to only a small fraction of the voting, dividend, and liquidation value of the regular common stock, such as it may receive one-tenth or one-twentieth of the dividends or voting rights of the common and maybe only $1 per share at liquidation. These limited rights make the value of the stock much less, maybe one-tenth or one-twentieth the value of the common stock.

The plan is structured so that the participating employee may purchase the junior shares of the company stock at a much lower price than that of the regular common stock of the company.

The junior shares are automatically converted into regular stock after the agreed-on performance incentives are reached. Failing to achieve the established goals causes the stock to become worthless and, should the executive leave the company, the company retains a right to repurchase the shares at cost.

In the best case, no taxation occurs until the ultimate sale of common stock. However, the transaction could be viewed by the IRS as merely a bargain purchase of the stock with the resulting tax on the bargain element, much like the taxation of nonqualified stock options. There have been no clear rulings on the taxation of junior stock plans.

TEST TIP

Although both junior shares and NQSOs give employees the right to acquire company stock at a price below FMV, the employee receiving junior shares is not taxed on the date the junior shares are converted to regular common shares. Rather, taxation is deferred until the sale of the regular shares, and the difference between the sale price of the stock and the employee's basis in the stock (what was paid for the junior shares, if anything) is taxable as a capital gain.

Using an ISO to purchase junior stock appears to lift the clouds from the junior stock transaction because the transaction then becomes an ISO transaction for which the taxation rules are clear. Also, the low price of the junior stock allows the ISO to gain leverage to acquire ultimately far more than the $100,000 worth of stock allowed by the ISO.

Severance plans

Severance plans are employer-sponsored arrangements that provide unemployment benefits or layoff allowances to former employees who lose their jobs through no fault of their own. Payments are usually based on an employee's length of employment as of the date employment is terminated. Severance pay is based on an agreement (contract) between an employer and an employee (or the employee's representative) and the law does not require that such a plan be provided to employees.

Under ERISA regulations published by the Department of Labor (DOL), a severance pay arrangement will be deemed not to be an employee pension plan, and will not be subject to the requirements of an ERISA pension plan, if the following requirements are met:

- The severance payments are not contingent, directly or indirectly, on the employee's retiring.
- The total amount of payments does not exceed the equivalent of twice the employee's annual compensation during the year immediately preceding the termination of his service.
- The severance payments must be distributed within 24 months after the termination of the employee's service.

Severance pay is a key consideration in any executive compensation package. Important executives are often concerned about what might happen to their roles in the event of a corporate takeover or merger, or simply a shift in management control through stock sales or family inheritance. The ability to weather a potential financial storm is especially important to an executive in these times, when such transactions are becoming commonplace.

Severance plans may either be unfunded or informally funded. Under an unfunded severance plan, assets may or may not be earmarked by the employer/plan sponsor to pay for severance benefits in the future. If assets are contributed to an informal funding arrangement to pay future benefits, they will remain subject to the claims of the employer's creditors so as to prevent the employee-participants from being taxed immediately on the plan benefits under the constructive receipt doctrine. Severance benefits are taxable to an executive when they are paid or become payable under the terms of the plan.

Various types of severance programs are available; the type depends on the rank of the employee who the plan is covering. ERISA's participation rules do not apply to certain types of welfare plans such as top hat welfare plans (i.e., severance plans sponsored by an employer for the purpose of providing benefits for a select group of management or highly compensated employees). Hence, high-level executives typically have extensive severance programs, while middle management and other employees have much more limited severance packages.

Types of Severance Plans

A **golden parachute** is an agreement between an executive and their company requiring the company to pay certain benefits in the event of a change in control of the company. The agreement, therefore, provides a guarantee of financial security to the executive in the event of a takeover. Because this type of agreement typically provides a substantial amount of severance pay, a financial adviser may find their services requested regarding an appropriate investment of such a large lump sum.

Payments take the form of cash, stock, compensation, extra pension benefits, medical and life insurance, other fringe benefits, and various combinations of all of these benefits. In each situation, the parachute opens when there is an employment termination or transfer on a change in corporate control. The agreement protects the executive's financial position in the event of a takeover and it is justified from the company's standpoint as assisting in the retention and recruiting of valuable top management.

Under the golden parachute tax rules, a safe harbor is established that protects all payments contingent on a change in control where the aggregate present value of those payments is less than three times the base amount. The base amount is the average compensation received over the prior five years (if applicable) with the company. If the severance payment is less than three times the base amount, none of the payment is a parachute payment. If the payment is equal to or more than three times the base amount, then the entire payment *is* a **parachute payment**. Once a payment is determined to be a parachute payment, the excess parachute payment is calculated. The allocable base amount is subtracted from the entire

parachute payment and the remainder is the **excess parachute payment**. Excess parachute payments are subject to a 20% excise tax for the employee, and the employer cannot take an expense deduction for the excess parachute payment.

> **EXAMPLE: Severance plan**
>
> Joan, CEO of the SLH, Inc., received a severance payment of $700,000. The applicable base amount is $200,000. Clearly, the payment is more than three times the base amount. Sec. 280G(b)(1&2) defines "excess parachute payment" as the excess of any parachute payment ($700,000) over 3 times the base amount (3 × $200,000). $700,000 – $600,000 = $100,000. So penalty is 20% of 100,000 or $20,000. Joan must pay this penalty (in addition to being income taxed as compensation on the entire $700,000). Finally, SLH, Inc. cannot deduct the $100,000 excess parachute payment.

Tin parachutes apply to middle-management employees, as opposed to the golden parachutes applicable to upper-management executives. While tin parachutes carry the same potential tax disadvantages as golden parachutes, these rules are much more rarely invoked. Obviously, this is because middle-management employees are generally not considered valuable enough to warrant extensive severance packages. Tin parachutes are employed on a basis similar to that of golden parachutes, only on a much smaller scale.

Voluntary severance retirement plans (VSRPs) are a popular tool used by companies not only to reward long-term employees, but also to reduce the companies' compensation costs in the long run. These plans, which allow employees to retire early, have become popular in recent years as a means of transitioning older employees of the company into retirement. The opportunity of an attractive severance benefit package provides considerable incentive for an employee to retire early and still receive an adequate income stream. From the employer's standpoint, the cost of the employee has been fixed at this point. Thus, no raises or promotions need to be considered in the future. In addition, employer costs relating to payroll, insurance coverage, and other employee benefits are no longer incurred, which often makes these plans a viable alternative for the company. Companies that offer a VSRP are likely to offer another one in the future if there is a need to lower the employee headcount later on.

While all VSRPs are legally voluntary for the workers, there can be an implied threat that layoffs are coming if the VSRP does not produce enough savings. Thus, currently eligible workers need to factor their chances of a layoff into their decisions. Also, workers who are younger than the current VSRP need to view the first VSRP as a warning shot. Thus, they should accelerate their retirement preparations in case the next VSRP comes before their personal retirement date.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

12. Select the CORRECT statement(s) regarding a Section 83(b) election on restricted stock.
    I. An employee who receives restricted stock may elect under Section 83(b) to recognize the income immediately rather than wait until the substantial risk of forfeiture expires.
    II. The Section 83(b) election must be made within one year of receiving the restricted stock.
    III. If the election is made, the employee immediately includes the FMV of the stock at time of receipt as long-term capital gain, less any amount paid for the stock.
    IV. If the employee makes the election and then forfeits the stock, the employee is not allowed a deduction or refund of tax on previously reported income.
    A. I only
    B. I and IV
    C. I, III, and IV
    D. II, III, and IV

13. A phantom stock plan
    I. is a type of unfunded deferred compensation plan.
    II. pays benefits in cash.
    III. is based on the value and transactions of an imaginary stock which mirrors the value and transaction of the employer's stock.
    IV. has an exercise date that is controlled by the employer.
    A. III only
    B. I and IV
    C. I, II, and III
    D. I, II, III, and IV

14. Identify the statement that is NOT a characteristic of junior class shares.
    A. Voting rights are subordinate to the regular class of common stock issued by the corporation.
    B. Dividend rights are subordinate to the regular class of common stock issued by a corporation.
    C. Junior class shares are typically convertible into regular shares on certain specified events.
    D. Junior class shares are taxable as ordinary income.

MODULE 9 ANSWER KEY FOR PRACTICE QUESTIONS

1. **A** A major advantage of a nonqualified plan is that it does not have to comply with the general nondiscrimination rules that apply to qualified plans. In addition, nonqualified deferred compensation (NQDC) is not subject to all the reporting and disclosure rule requirements that pertain to qualified plans. Generally, nonqualified plans benefit highly-paid executives to the exclusion of rank-and-file employees. In a nonqualifed plan, the promise made by the employer is unsecured.

2. **A** A major advantage of a nonqualified plan is that it may discriminate in favor of select executives. In addition, NQDC plans are not subject to the reporting and disclosure requirements that apply to qualified plans. Generally, nonqualified plans are used to benefit both the businessowners and selected, highly-paid executives. Fund earnings are currently taxable to the employer in most cases.

3. **D** There are only two potential beneficiaries who can receive a payment from a rabbi trust: the employee and the creditors of the company. The fact that creditors may get to the money rather than the employee enables the employee to defer taxation, but the trust is irrevocable to protect against a change of control, such as a hostile takeover, that might void the plan.

4. **A** A secular trust does not allow deferred compensation. The executive is income taxed when the money goes into the trust.

5. **A** A top hat plan is a type of supplemental plan. In a supplemental plan, the employer makes a commitment to provide a specific benefit, but the employee does not forgo current compensation to fund this benefit. A top hat plan is always unfunded.

6. **B** The death proceeds from a life insurance policy as part of a DBO plan are taxable as compensation income to the heirs of the insured executive.

7. **C** Constructive receipt is not the same as the economic benefit doctrine. The economic benefit rule is triggered if there is an irrevocable transfer of funds made on the executive's behalf that provides a benefit to the executive. There is no constructive receipt if income is available only on surrender of a valuable right or if there are limits on the right to receive the income.

8. **C** The bargain element, $67 – $30 = $37, will be an AMT adjustment. Multiply $37 by 2,000 options to arrive at $74,000. This sale of the ISO stock is made after both ISO holding periods are met. First, the sale was more than two years after the ISO was granted. Second, the sale was more than a year after the exercise date.

9. **B** For regular income tax purposes, there is no gain at the time of exercise of the ISO. As a result, Zack's taxable basis equals the exercise price of $5 per share. Therefore, Zack will have a capital gain of $450,000 [($50 – $5) × 10,000 shares] at the time of sale of the shares. Both the two years from the date of the grant of the ISOs and the one year since the exercise of the ISO holding period requirements applying to ISOs were met, thereby, permitting this tax treatment.

10. **B** Julie will receive a net amount of 95 shares of stock calculated as follows.

    The exercise cost of the NQSO is $15,000 (500 shares × $30 per share). She will have to pay ordinary income tax of $1,200 on the bargain element [($40 FMV – $30 exercise price) × 500 shares × 0.24], so Julie's total cost of exercising the option and paying the income tax is $16,200.

    To cover the cost of the option, 405 shares of the stock must be sold ($16,200 ÷ $40 FMV). This leaves a net amount of 95 shares (500 – 405) that Julie will receive.

11. **D** When the client sells the shares, they will have a total gain of $10,000, which equals $25,000 FMV ($50 × 500 shares), less the option price of $15,000 ($30 × 500 shares). Because the shares were purchased under an ESPP, the $10,000 gain will be considered $2,500 ordinary income and $7,500 capital gain. The ordinary income portion is $2,500, which equals the FMV of the stock at the grant date less the option price [$17,500 ($35 × 500 shares) FMV at grant date minus the $15,000 exercise price ($30 × 500 shares)]. The remaining portion represents the capital gain of $7,500 ($10,000 – $2,500).

12. **B** The Section 83(b) election must be made within 30 days of receiving the restricted stock. The employee recognizes ordinary income and not long-term capital gain when the election is made.

13. **D** All of these statements are correct.

14. **D** Junior class shares taxation defers until the sale of the regular shares, and the difference between the sales price of the stock and the employee's basis in the stock (what was paid for the junior class shares, if anything) is taxable as a capital gain.

MODULE 10

Case Study

Case studies are a principal part of the CFP® Certification Examination. The Madison case study, described next, will allow you to become familiar with the presentation and layout of a case study. The questions and answers following this case study will give you a sampling of the General Financial Planning Principles, Professional Conduct, and Regulation subject matter that may be tested on the exam.

The Madison case study will be presented in all six education courses, FP511 through FP516. Questions and answers presented in each course will focus on the particular subject matter of that course. After studying the Madison case in all six education courses, you should be well prepared for the FP517 course, *Financial Plan Development*, a CFP Board requirement for all students.

CASE STUDY APPROACHES

Generally, there are two approaches you can use for case studies: the case facts analysis approach and the question review approach.

Case Facts Analysis Approach

Read the case carefully and slowly, making sure that you pay attention to detail. Focus on elements that CFP Board refers to as "Contextual Variables," these include, age, marital status, number of children and grandchildren, net worth, special circumstances, and income levels. These variables will give you a good idea of what the case is about. Anticipate questions and make notes. When a topic is presented, make a mental or written note of that topic. When additional information is provided on that topic later in the case, a question regarding that topic usually appears unless the additional information negates the question.

Read each question and the answers provided. Answer the easy questions first, followed by the more complex questions. Calculation questions (e.g., probate estate, education funding, capital needs analysis, required minimum distributions (RMDs), and mortgage qualification) can be time consuming. Go back to them later.

Question Review Approach

Read the questions quickly. Make notes. Answer any questions that do not require reading the case, then read the case, looking only for the answers to the questions asked.

Follow these steps:

Step 1: Read the last line of the question.

Step 2: Make notes.

Step 3: Answer all questions that can be answered without reading the case. Record your answers. Eliminate any answers to questions that cannot be a part of the answer.

Step 4: Read the case to answer the questions that involve specific case facts. Record your answers.

Step 5: Make sure all questions are answered.

Step 6: Review the answers.

This case is for practice purposes only. For your module case study quiz, please download the case study facts available via your case study quiz launch page in your course.

NICHOLAS AND KATIE MADISON CASE STUDY

Nicholas and Katie Madison have come to you, a financial planner, for help in developing a plan to accomplish their financial goals. You are a Series 7 general securities representative and hold insurance licenses for life and health insurance and variable contracts.

The Madisons have been reading about various financial planning services and want to coordinate a "fee-only" compensation arrangement for your services. They ask if you are a fee-only planner, and ask if you can work with them on that basis. The Madisons are generally optimistic about their future; however, after having a conversation about investing with one of their neighbors, they have been feeling less financially secure. Assume today is January 1st of this year.

Personal Background and Information

The Madisons

Nicholas and Katie have been married for 12 years. They have two children, Jude and Ellie. Nicholas has a son, Ben, and a daughter, Megan, from a previous marriage.

Nicholas Madison (Age 45)

Nicholas is a vice president of Asher Bank and Trust. He has been employed there for 12 years and has an annual salary of $70,000.

Katie Madison (Age 40)

Until Ellie was born, Katie was an architect with a local design firm. She had been uncertain about re-entering the workforce until recently. While at a town hall meeting, a partner in the top architecture firm in the city, Wright and Associates, approached her about joining the firm as a part-time independent contractor. Katie has a high level of skill using architectural design software and Wright and Associates wants her to help with high-end design projects. Her annual earnings from the part-time work are expected to be at least $50,000. She is excited to accept the position because she feels she now has the time, with Ellie attending school all day.

Family

- Ben, 20 years old, is a sophomore at State University on a partial scholarship, located 25 miles from Nicholas and Katie. When not boarding at school, he lives with Nicholas and Katie. During the summers, Ben works at Asher Bank and Trust as an intern. Nicole and Nicholas have agreed that Nicholas will claim Ben as a dependent.
- Megan, 16 years old, lives in another state with her mother and attends public school. She has aspirations to study at a prestigious dance academy upon graduation and has applied for a scholarship. She is Nicole's dependent for income tax purposes.
- Nicole, Nicholas's ex-spouse, who lives in another state, is an attorney for the Department of Justice. There is currently no child support agreement for Megan.
- Jude, 10 years old, is in the fifth grade at Woodridge Academy, a private school. He plays the trombone in the school band and attends band camp every summer. Jude also plays on the school's basketball team.
- Ellie, 7 years old, is in second grade at Woodridge Academy. She meets with a private tutor once a week to get help with her reading skills.
- Ruth, Nicholas's mother, died within the past month at the age of 70, and her estate is currently in probate. She had been in poor health and living with Nicholas and Katie the past two years and had been using her investments to meet her living expenses. Nicholas is the sole beneficiary and executor of Ruth's estate. Nicholas's father passed away five years ago.
- Grant and Janet, Katie's parents, are in good health and have agreed to pay for Jude and Ellie's private school tuition through the eighth grade. They are retired and travel year-round. Katie is their only child. Katie mentions to you that her parents want to know if there are any gift tax consequences for them paying the tuition for Jude and Ellie. They are also interested in making additional gifts for education, and Katie asks you what she should tell her parents.

In addition to addressing their specific goals and concerns shared in your meetings, the Madisons have asked you to comment and offer recommendations on any area of their current finances that you feel has a weakness or vulnerability, or that presents an opportunity for improvement in reaching their goals.

Economic Information

The Madisons expect medical inflation to be 5% annually and the annual general inflation rate to average 3% over both the short and long terms. The present average interest rate on their credit cards is 16%. The risk-free rate is 3.25%, and the Madisons' required rate of return on investments is 8%.

Current mortgage rates are 6% for 30-year fixed mortgages and 5.5% for 15-year fixed mortgages. Closing costs will approximate 3% of any mortgage refinanced and will be paid from separate funds. Nicholas and Katie feel this is an opportune time to refinance their home mortgage. Given their goals, they have asked you to evaluate available mortgage options and make a recommendation. Their credit score is good, but they are concerned about whether they will be able to meet the standard financial ratio tests required to qualify for a new mortgage.

The current GDP has been growing at 3%. There has been a lot of speculation about the Federal Reserve raising interest rates to be better prepared to fight a future recession. Also, Asher Bank and Trust has failed to meet some of its economic projections for the last few years. There is talk about job cuts, but so far, these have only been rumors.

Insurance Information

Health Insurance

The entire family is insured under Nicholas's company plan, which is a major medical plan with a $500 per person deductible, an 80/20 coinsurance clause, and a family annual stop-loss limit of $2,500. Nicholas's employer pays 100% of the health insurance premium.

Life Insurance

Nicholas has a group term life insurance policy with a face amount of $60,000 provided by his employer. Nicholas is not a highly compensated employee. The policy beneficiary is Katie. The premium of $9 per month is paid by his employer. The Section 79 table cost per $1,000 of protection is $0.15 per month for Nicholas's age. Recently, one of their neighbors, who was the same age as Katie and had three very young children, died prematurely at age 38. After the Madisons saw firsthand the financial stress of the surviving spouse, they decided it was time to request a life insurance needs analysis. The Madisons want to know what type of information you need to prepare your life insurance recommendations.

Disability Insurance

Nicholas has a private disability income insurance policy with an own-occupation definition of disability and a 30-day elimination period. Based on the policy's provisions, in the event Nicholas is totally disabled, he will receive a monthly benefit of $2,700 until his normal retirement age, defined as his retirement age under the Social Security Act on the date of his disability. The annual premium is $761 and is fully paid by Nicholas. Nicholas has asked you to explain the tax treatment of the disability insurance benefits in the event he becomes disabled.

Homeowners Insurance

The Madisons have an HO-3 policy with a dwelling extension and replacement cost on contents. The policy has a $1,000 deductible. The annual premium is $950. Coverage A (Dwelling) is $150,000.

Automobile Insurance

The Madisons have automobile liability and bodily injury coverage of $100,000/$300,000/$100,000. They have both comprehensive coverage (other than collision) and collision coverage. The deductibles are $250 (comprehensive) and $500 (collision), respectively. The annual premium is $900.

The Madisons are not entirely happy with their auto and homeowners insurance carrier due to a dispute over hail damage last year. Nicholas has asked you what you think of their carrier and if you can secure a better rate on their coverages.

Investment Information

The only investments the Madisons have outside of the retirement plan are the ABC stock inherited by Katie from her grandmother in 2020 and the college fund certificates of deposit (CDs).

The Madisons have had little investment experience but consider themselves to have a moderate risk tolerance (7 on a scale of 10), given their ages and long-term goals.

ABC stock has paid a steady dividend of $3.50 per share. The dividend is expected to grow at a constant rate of 5% per year into the foreseeable future. Given the Madisons' required rate of return, they have asked you to determine if the stock is overpriced or underpriced in the secondary market.

The Madisons are concerned that ABC stock may substantially decline in price in the near future. They want to know which investment strategies would best protect their position in ABC over the next 60 days. Also, they have asked you to determine the tax that would be incurred if they choose to sell the stock at the current FMV.

The correlation efficient of ABC stock to the S&P 500 is 0.90.

Nicholas has his 401(k) invested in a 2040 target date fund. It has a beta of 0.85 when compared to the S&P 500 Index. The fund has a standard deviation of 12% and an average return for the last 10 years of 10%. The returns for the last four years have been –6%, 18%, 8%, and 3%. The Madisons have read the fund has a Jensen's

alpha of –0.9. It also has a Sharpe ratio of 0.26 and a Treynor ratio of 7.22, but they are not sure what these measurements mean.

Income Tax Considerations

The Madisons tell you that they are in the 12% federal income tax bracket. They pay $1,320 annually in state and local income taxes. The Madisons want to know the income tax implications of Katie returning to work as an independent contractor. Most of Katie's work will be done at home and the Madisons are currently remodeling a guest bedroom to function as a home office. Katie has asked if there are any tax benefits associated with maintaining a home office. The Madisons are also considering selling their home is a few years. They are interested in what they might owe in income taxes if they were to sell their home.

The Madisons have also asked you if there are any income tax consequences related to the life insurance and health insurance for which Nicholas's employer pays the premiums.

Katie is considering buying an advanced 3D printer for her business. It would cost $5,000 after taxes. She projects it would last four years before she would need to upgrade it. Her projected after-tax cash flows at the end of each year are as follows: –$2,000 for Year 1; breaking even in Year 2; making $3,000 extra in Year 3; and in Year 4, the printer should enhance her income by $6,500, but she would need to replace it. She estimates she could sell it for $500 after taxes at the end of Year 4. Her required rate of return for this expenditure is 12%.

Retirement Information

Nicholas wants to retire at age 62 with income equal to 80% of his preretirement income. He expects to receive Social Security benefits of $24,000 (in today's dollars) for himself and $12,000 for Katie (in today's dollars) at the full retirement age, 67. The Madisons are aware that Social Security retirement benefits are reduced if claimed before their full retirement age, but they have asked you to determine the approximate benefit if Nicholas retires at age 62. With Katie returning to work, she may earn a higher benefit on her own work record. The bank offers a Section 401(k) plan in which Nicholas is an active participant. The bank matches contributions dollar for dollar up to 3% of Nicholas's salary. Nicholas currently defers 3% of his salary.

The Madisons want to know the amount of required capital, after considering Social Security, to support their retirement goal.

Katie wants to know what type of retirement plan would allow her to contribute the most for retirement on a tax-favored basis if her work with Wright and Associates generates sufficient income.

The Madisons have heard about traditional and Roth IRAs. They are wondering what their options are with IRAs since Nicholas is already getting the full match in his 401(k).

Education Information

Jude is 10 years old and currently attending fifth grade at Woodridge Academy, which he will attend through high school. Nicholas and Katie have $2,500 in CDs that they contribute to once a year ($500 each year) for Jude. This account will be used for college and is in Jude's name as a Uniform Transfers to Minors Account (UTMA).

Ellie is 7 years old. She is in second grade at Woodridge Academy and will attend the academy through high school. Nicholas and Katie have $1,000 in CDs to which they contribute once a year ($500 each year) for Ellie. This account will be used for college and is in Ellie's name as an UTMA.

Nicholas and Katie invested in CDs for Jude and Ellie's college educations; the CDs are owned by Nicholas and Katie. The rate of return on this college fund is 2%, and the current balance is $15,000. It looks like Ben will take five years to complete his college education. Thus, Nicholas and Katie would like to send their children to school for five years instead of the traditional four years. If Jude or Ellie can complete their education in four years, the extra year could be used to pursue a graduate degree.

The current cost of college (including room, board, tuition, and books) is $20,000 per year per child. The Madisons expect their children to start college at the age of 18, and they expect an educational inflation rate of 5%.

The Madisons intend to assist Ben and Megan using their current cash flows and want to understand the best way to do so from a tax perspective. Also, they are interested in discovering other college funding sources that may be available. Additionally, they would like to know the amount of annual savings required to provide for college for Jude and Ellie. The Madisons are open to your ideas regarding any investment alternatives they should consider for their existing college savings currently invested in CDs.

Gifts, Estates, Trusts, and Will Information

Nicholas's will leaves everything to Katie conditioned on a six-month survivorship clause—otherwise, equally in separate trusts for the four children.

Katie does not have a will. The Madisons want to know the next step to take to begin basic estate planning and what areas are critical to include in the plan at this time.

Grant and Janet both have wills. They also have two trusts: a revocable living trust and an irrevocable life insurance trust (ILIT) with a $1 million life insurance policy. The surrender value of the policy is $125,000. Katie is the beneficiary of the ILIT. Katie's uncle, Russ, is the trustee. The premiums for the ILIT are $25,000 per year. Grant and Janet have told the Madisons that their wills and trusts are all the estate planning documents they need. The Madisons are wondering if there are any other estate planning documents that might be missing from Grant and Janet's situation.

Nicholas has questions regarding several assets in Ruth's estate:

- *A nonqualified variable annuity consisting of an initial investment of $50,000 made 14 years ago*. The current value of the annuity is $126,000 and Nicholas is the sole primary beneficiary. Nicholas would like to know the tax consequences associated with taking the entire $126,000 in a lump-sum distribution to help refinance the mortgage.
- *A universal life insurance policy with a face amount of $100,000*. The policy had a cash surrender value of $18,000 and Ruth had paid total premiums of $15,000. Ruth had elected death benefit option B at the time the policy was issued. Nicholas wants to know the amount he will receive from the policy after taxes.
- *A nonqualified fixed annuity in which she had invested a total of $40,000*. This contract was purchased 21 years ago and has a current value of $93,000. Nicholas is the sole beneficiary. He decided to take the life income option on this portion of his inheritance to help out with the entertainment section of the budget. Nicholas's life expectancy is 35 years and he is to receive $500 per month for the rest of his life. He has asked how much of this monthly distribution is taxable.
- *A Roth IRA with an account balance of $50,000 into which contributions of $30,000 had been made over the past 10 years*. Nicholas would like to make this account part of their retirement savings and has asked about his options regarding this account and the respective income tax treatment of those options.
- *A mutual fund valued at $30,000 at the time of Ruth's death*. Ruth invested $10,000 initially in the mutual fund, and the fund had generated $5,000 in dividends and capital gains (all reinvested in the fund) over her 10-year holding period. Nicholas is considering liquidating the fund once ownership is established in his name and wants to know the tax consequences of this transaction.
- Nicholas also has asked you to brief him on the general responsibilities he has as executor of his mother's estate.

STATEMENT OF CASH FLOWS
Nicholas and Katie Madison
For this Year (Expected)

INFLOWS			
Salary and Schedule C income			
Salary—Nicholas	$70,000		
Schedule C income—Katie (projected)	50,000		
Total salary and Schedule C income		**$120,000**	
Investment income			
Interest (taxable)	$450		
Dividends	150		
Total investment income		**$600**	
TOTAL INFLOWS			**$120,600**

STATEMENT OF CASH FLOWS Nicholas and Katie Madison For this Year (Expected) (continued)			
OUTFLOWS			
Savings			
Reinvestment interest/dividends	$1,050		
Section 401(k) plan elective contribution	2,100		
College fund CDs	1,000		
Total savings		**$4,150**	
Ordinary living expenses			
Food	$9,000		
Clothing	6,600		
Child care	1,600		
Entertainment	4,814		
Utilities	6,600		
Auto maintenance	3,000		
Church contributions	7,500		
Total ordinary living expenses		**$39,114**	
Other payments			
Credit card payments[1]	$960		
Mortgage payments[2]	21,954		
Boat loan[3]	3,040		
Total other payments		**$25,954**	
Insurance premiums			
Automobile	$3,000		
Disability	761		
Homeowners	1,500		
Total insurance premiums		**$5,261**	
Tuition and education expenses		**$1,000**	
Taxes			
Federal FICA, SECA, and withholding	$12,993		
State and city income tax	1,320		
Property tax (principal residence)	2,000		
Total taxes		**$16,313**	
TOTAL OUTFLOWS			**$91,792**
NET CASH FLOW (SURPLUS)			**$28,808**

[1] Credit card payments: principal $345; interest $615

[2] Mortgage payments: principal $1,234; interest $20,720

[3] Boat loan payments: principal $1,493; interest $1,547

STATEMENT OF FINANCIAL POSITION Nicholas and Katie Madison January 1st of this Year		
ASSETS[1]		
Liquid assets		
JT checking account	$1,500	
JT savings account	1,000	
Total liquid assets		$2,500
Investments		
S2 ABC stock (100 shares)[2]	$13,000	
JT CDs (college fund)	15,000	
S1 Section 401(k) vested plan balance	43,000	
Total investments		$71,000
JT personal real estate—residence[3]		$250,000
Other personal assets		
JT automobiles	$15,000	
JT boat	20,000	
JT jewelry	13,500	
JT furniture and household	60,000	
Total other personal assets		$108,500
TOTAL ASSETS		$432,000
LIABILITIES[4] AND NET WORTH		
Current liabilities		
JT credit cards		14,000
Long-term liabilities		
JT mortgage on residence[5]	197,888	
JT boat loan	13,559	
Total long-term liabilities		$211,447
TOTAL LIABILITIES		**$225,447**
MADISON FAMILY NET WORTH		$206,553
TOTAL LIABILITIES AND NET WORTH		$432,000

S1—Nicholas Madison; S2—Katie Madison; JT—jointly owned by Nicholas and Katie Madison

Other notes to the statement of financial position:

[1] Assets are stated at fair market value.

[2] The ABC stock was inherited from Katie's grandmother on November 15, 2020. Her grandmother originally paid $20,000 for it on October 31, 2018. The fair market value at her grandmother's death was $12,000.

[3] The replacement value of the Madisons' home is $225,000.

[4] Liabilities are stated at principal only.

[5] Note that some statements of financial position may show the current year's mortgage liability as a current liability. However, the total liability may also be listed as a long-term liability, as done in this case.

PRACTICE QUESTIONS

Choose the best answer for the following questions. The answers can be found at the end of this module.

1. Nicholas and Katie are committed to reducing living expenses to be able to save more for retirement. The couple is not counting any possible income from any potential part-time earnings for Katie because that income is not yet realized. Assuming they create the necessary discretionary income, what is the total maximum deductible contribution they can make to a traditional IRA together for 2023?
   A. $0
   B. $6,500
   C. $9,750
   D. $13,000
2. Nicholas's employer, Asher Bank and Trust, is considering making an additional profit-sharing contribution to the bank's Section 401(k) plan for 2023. What is the maximum amount of additional profit-sharing contribution the bank could make on behalf of Nicholas for 2023?
   A. $18,400
   B. $22,500
   C. $61,800
   D. $66,000
3. A rival bank across town has been aggressively recruiting Nicholas. Assume that Nicholas had a retirement plan loan from his Section 401(k) plan with a balance of $10,000. If Nicholas leaves Asher Bank and Trust, which of the following statements regarding his outstanding loan from his Section 401(k) plan is CORRECT if Nicholas cannot arrange to pay off the loan all at once as he is leaving?
   I. The loan balance continues to be tax free because Nicholas is essentially borrowing from himself.
   II. Nicholas is not eligible to use a qualified plan loan offset (QPLO) for up to the outstanding loan to replace some or all of the plan loan in an IRA or his new employer's retirement plan.
   III. The outstanding loan is subject to income tax if not repaid in a timely manner.
   IV. The outstanding loan may be subject to an additional 10% excise penalty.
   A. I and II
   B. II and III
   C. II and IV
   D. III and IV

4. If Nicholas should leave Asher Bank and Trust and elect to take a lump-sum distribution of his Section 401(k) balance, which of the following statements is CORRECT?
   A. Nicholas may elect to roll over the lump-sum distribution and the outstanding loan to an IRA and continue to make loan payments as before to eventually repay the loan.
   B. Nicholas may elect a tax-free direct transfer of the lump-sum distribution to an IRA, less the 20% mandatory withholding.
   C. Nicholas may take receipt of the lump-sum distribution, and as long as he rolls over the distribution within 60 days to an IRA, the rollover is tax free and not subject to the 20% mandatory withholding.
   D. If Nicholas's new employer's qualified plan allows, he may be able to directly transfer the lump-sum distribution to the new plan without being subject to the mandatory 20% withholding.
5. If Nicholas died today, which family members may be eligible for Social Security survivor benefits based on Nicholas's PIA, assuming he is fully insured?
   A. Katie, Jude, Ellie, and Ben
   B. Jude and Ellie
   C. Jude, Ellie, Ben, and Megan
   D. Katie, Jude, Ellie, and Megan
6. Assuming Nicholas's income increases by 3% per year between now and age 62, what lump sum (+/–$20) will be necessary at the date of retirement to provide Nicholas's goal of 80% of preretirement income of $70,000 per year now for 25 years in retirement without considering Social Security? Assume the Madisons' required rate of return in the calculation.
   A. $839,790
   B. $1,388,038
   C. $1,400,000
   D. $2,313,975

7. Nicholas and Katie have been working with you, a CFP® professional, for some time on their financial plans for retirement. You have presented your recommendations to the Madisons and a timeline for implementation has been created. The Madisons now inform you that Katie is considering working as a part-time independent contractor providing architecture consulting to Wright and Associates. She feels this would be a good way to increase the amount they save for retirement. Katie is considering adopting a qualified profit-sharing plan as a self-employed individual. What do you do next to assist the couple in their retirement planning and the potential changes?
   A. You discuss and evaluate the effects this possible new employment will have on the recommendations already implemented.
   B. You must return to the developing the financial planning recommendation(s) phase of the planning process because the Madisons' circumstances will change.
   C. Katie's plans have no effect on any retirement planning already accomplished because it will only add to the couple's retirement assets.
   D. You should recommend she establish a defined benefit plan instead of a profit-sharing plan.
8. Nicholas is considering executing a loan from his Section 401(k) plan. What is the maximum loan amount he could currently borrow?
   A. $10,000
   B. $14,500
   C. $21,500
   D. $43,000
9. Nicholas is considering a part-time job teaching at a community college. The college offers a Section 403(b) plan. Assuming Nicholas would earn $35,000 per year teaching, what is the maximum elective deferral he could make to the Section 403(b) plan in 2023?
   A. $15,500
   B. $20,400
   C. $25,500
   D. $30,000
10. If Nicholas died today, what is the total lump-sum death benefit that Social Security will pay to his family?
   A. $255
   B. $510
   C. $1,020
   D. $1,275

MODULE 10 ANSWER KEY FOR PRACTICE QUESTIONS

1. **D** The maximum deductible contribution for the Madisons to a traditional IRA for 2023 is $13,000 ($6,500 each). Nicholas is an active participant in a qualified plan, but his AGI is below the MFJ phaseout of $116,000. If Katie has no earned income in 2023, she can make an IRA contribution based on Nicholas's earned income, and her AGI for these purposes is below the nonparticipant spouse AGI limit of $218,000.

2. **C** The maximum additional profit-sharing contribution the employer could make for Nicholas in 2023 is $61,800. The maximum annual additions limit in 2023 is $66,000. The annual additions limit includes employer contributions and employee elective deferrals. Nicholas makes elective deferrals of 3% ($2,100), and the employer matches this amount 100% ($2,100). The total elective deferrals and employer contributions is $4,200, so the employer could make an additional profit-sharing contribution of $61,800 ($66,000 – $4,200).

3. **D** The loan becomes fully taxable if not repaid and may be subject to an additional 10% excise penalty. Because of the TCJA and the fact that Nicholas must repay his retirement plan loan early due to separation from service, Nicholas would have up to the due date of his income tax return for the year the loan terminated (plus extensions) to replace some or all of the loan amount that was terminated. Whatever amount he can get into an IRA or his new employer plan will be coded as a "qualified plan loan offset" (QPLO). This is different than a "deemed distribution." Doing a plan loan offset is similar to a transfer. A deemed distribution is not eligible to be moved into another retirement account. In all, Nicholas would have a chance to decrease the amount he was subject to income taxes and the 10% EWP from when the loan was terminated. As a QPLO, Nicholas has until the due date of his tax return (including extensions) for the year the retirement plan loan was terminated to fund up to the defaulted amount of the loan. This is because a QPLO investment into his new employer's retirement account and/or his IRA is counted as a rollover contribution. While normal rollovers only have 60 days to complete the transaction, QPLO contribution rollovers give people much longer to offset some or all of the defaulted loan amount. This can be great news for the individual's income taxes for the year of the default. However, it may be even better news at retirement because the QPLO rollover amounts can compound until withdrawn in retirement. You have the ability to calculate that extra amount at retirement under different growth rate assumptions.

4. **D** Answer A is incorrect because a Section 401(k) loan cannot be rolled over to an IRA and continue to make the loan payments. This option of essentially transferring the loan to the new employer's retirement plan, would be available if his new employer plan document allowed it, but it is not available for an IRA. He would only have until the due date of his income tax return (including extensions) to make qualified plan loan offsets into the IRA or employer retirement plan. This is different

from continuing to make loan payments. Answer B is incorrect because if a direct transfer to an IRA is elected, the distribution is not subject to 20% mandatory withholding. Answer C is incorrect because even if the distribution is rolled over into an IRA within 60 days, the 20% mandatory withholding still applies if Nicholas takes receipt of the distribution before the rollover.

5. **D** Katie, Jude, Ellie, and Megan are eligible for benefits. Ben is not eligible because he is over age 18. Katie is his widow caring for at least one child who is under 16. Jude, Ellie, and Megan are his children under 18 or under 19 if still in high school.

6. **B** This lump sum is needed at the date of retirement to support Nicholas's goal (without considering Social Security).

   Step 1:

   $70,000 × 80% = $56,000

   $56,000, +/-, PV

   17, Shift, N (62 – 45) You will see "17.0000" if your calculator is set to one payment per year. For the TI BA II Plus, 17, 2ND, xP/Y, N

   3, I/YR For the TI BA II Plus, I/Y

   FV For the TI BA II Plus, CPT, FV

   $92,559.4674

   Step 2:

   Ensure you are in the Begin Mode.

   For the HP-10bII, hit +/- once then hit +/- a second time to return $92,559.4671 to a positive number, then hit PMT. For the TI BA II Plus, simply hit, PMT.

   25, Shift, N You will see "25.0000" as N if your calculator is set to one payment per year. For the TI BA II Plus, hit 25, 2ND, xP/Y, N to get the N to be 25.0000.

   [(1.08 ÷ 1.03) – 1 × 100] = 4.8544 I/YR For the TI BA II Plus, I/Y

   0, FV

   PV For the TI BA II Plus, hit CPT, PV

   –$1,388,038 (+/–$20) The +/- $20 depends on the number of decimals used when compounding. If the calculator computes a number, the result is actually used out to nine decimal places, even if it only displays four. Thus, if a number is manually entered with less than nine decimals places a small difference will be calculated. The bottom line is that the number calculated either way will be sufficiently accurate for planning purposes because the actual variables experienced will differ from the variables entered. For example, what if inflation in this problem turned out to average 3.2% or 2.7%? Also, the plan should be updated every year. The key is that the numbers computed are reasonable goals.

7. **A** You should discuss and evaluate the effects this possible new employment will have on the recommendations already implemented. The monitoring progress and updating phase of the financial planning process is when changes in a client's circumstances are evaluated and the plan is changed to accommodate the new circumstances. It would be inappropriate for a new, small business to take on the obligations of a defined benefit plan.

8. **C** Nicholas would be eligible to make a loan from his Section 401(k) account in the amount of 50% of his vested account balance ($21,500). This amount would be reduced by the highest loan balance in the previous 12 months, but there is no evidence that he has taken out a loan in the last year.

9. **B** The elective deferral limit in a Section 403(b) plan is $22,500 (2023), but Nicholas already defers $2,100 into his Section 401(k) plan at Asher Bank and Trust. The combined elective deferral limit between plans is $22,500, so the most Nicholas could defer into the Section 403(b) plan is $20,400 ($22,500 – $2,100).

10. **A** This is the total lump-sum death benefit payable by Social Security. The amount is fixed and is not based on the number of family members eligible for survivor benefits.

INDEX

$15,000 lifetime special catch-up amount, 87
1% owner, 11
5% owner, 11
5-year rule, 159
10% early distribution penalty, 88
10% early withdrawal penalty, 51
10% premature distribution penalty, 163
10% premature withdrawal penalty, 115
10-year forward averaging, 79, 98, 137
15 years of service, 89
21-and-1 rule, 10
50/40 test, 13
50% penalty tax, 140
59½, 107, 111
83(b) election, 247
100 times test, 203

A

ACP, 65
  rules, 67
  tests, 62, 67, 89
active participation, 12, 84, 93, 99
actual contribution percentage test, 65
actual deferral percentage test, 65
ADP, 65
  rules, 66
  test, 62, 89
advance determination letter, 24
after-tax contributions, 132
age-based profit-sharing plan, 53
AIME, 173
allowable rollovers, 132
alternative minimum tax (AMT), 249
American Jobs Creation Act (AJCA) of 2004
  requirements of 409A, 227
amortization method, 107
annual additions limit, 19
annuity, 127, 128
  contract, 86
annuity method, 107
April 1, 138
assignment of income doctrine, 246
automatic enrollment, 62
  notice, 62
average benefits percentage test, 12
average indexed monthly earnings, 173

B

backdoor Roth IRA, 109
bargain element, 251
beneficiary, 148
bridge employment, 216

C

capital needs analysis, 207
capital preservation approach, 208
capital utilization approach, 208
career average method, 35
cash balance pension plan, 39
catch up, 108
catch-up contribution, 19, 61
CODA, 60
collectibles, 84
compensation, 97
contributory plan, 20
controlled group rules, 14
corporate-owned life insurance (COLI), 233
covered, 12
cross-tested plan, 53
currently insured, 172

D

DB(k) plan, 37
death, 107, 144
  occurring after the required beginning date, 152, 159
  occurring before the required beginning date, 151, 159
death-benefit-only (DBO) plan, 244
deductibility rules for a traditional IRA, 98
defined benefit pension plan, 5, 32
defined contribution plan, 22, 49
definitely determinable benefits, 28
Department of Labor (DOL), 4, 88
dependent benefit, 172
dependent parent benefit, 172
designated beneficiary, 148
direct transfer, 127, 129
disability, 107, 111, 144
disability benefit, 176
disabled widow(er), 175
distribution, 125

E

early distribution penalty, 144
elective deferral, 60
  limit, 91
elective nonqualified deferred compensation plan, 238
eligibility, 10
eligible designated beneficiary (EDB), 148
Employee Retirement Income Security Act (ERISA), 3, 88, 95
  reporting and disclosure requirements, 88
employee stock ownership plan, 57
employee stock purchase plan (ESPP), 253
  requirements, 254
ESOP, 57
estate as beneficiary, 157
excess benefit plan, 239
excess method, 22
excess parachute payment, 269
executive compensation plans, 224
  qualified and nonqualified plans, 224
executive incentive plans, 264
  phantom stock plan, 264

F

Federal Insurance Contributions Act (FICA), 60, 81, 85, 168
fiduciary, 26, 27
final average method, 35
financial needs test, 50
first-time homebuyer costs, 144
five-year holding period, 111
flat amount formula, 35
flat percentage formula, 35
forfeitures, 19, 45
FRA, 173, 178
full retirement age, 173, 178
fully insured, 171
FUTA, 60, 81, 85

G

golden parachute, 268
Government Pension Offset, 180
greater than 5% owner, 10

H

hardship withdrawal, 50
health insurance premiums, 107

higher education costs, 107, 144
highly compensated employee (HCE), 10, 66

I

incentive stock option (ISO), 248, 249
includible compensation, 18
income in respect of a decedent, 138
individual retirement account (IRA), 95, 97, 117, 138, 144, 148
  deductibility, 93
individual retirement annuities, 97
informally funded plan, 232, 234, 235
  escrow accounts and sinking funds, 235
  surety bond, letters of credit, and indemnity insurance, 234
inherited IRA, 104, 155
in-service distributions, 50
integrated, 59
integrated plan, 22
integration level, 22
interest rate credit, 39
Internal Revenue Service (IRS), 3
investment risk, 189

J

junior stock plan, 266

L

LESOP, 57
level payment approach, 211
leveraged ESOP, 57
life expectancy method, 107
life insurance, 84
liquidity, 201
LLC, 71
lump-sum death benefit, 172
lump-sum distribution, 127

M

MAGI, 109, 179
mandatory 20% withholding, 88
maximum elective deferral, 61
maximum family benefit, 176
medical expenses exceeding 7.5%, 144
Medicare, 168
minimum distribution rules, 69, 97
modified adjusted gross income, 109, 179
money purchase pension plan, 42
mutual fund, 86

N

negative election, 62
net unrealized appreciation (NUA), 55, 58, 79, 98, 137
new comparability plan, 53
noncontributory plan, 20
nondiscrimination, 79
  rules, 78
non-elective, 239
non-elective nonqualified plan, 239
nonhighly compensated employees (non-HCE), 11
nonqualified, or regular, stock option, 251
nonqualified plan, 8, 79, 238
  types used for retirement funding, 238
non-top-heavy, 14
normal retirement age, 177

O

offset method, 22
old age, survivors, and disability insurance program (OASDI), 168
ordering rules, 113
ordinary income recognition, 55
other executive benefits
  death-benefit-only plan, 244
other stock plans, 257
  junior stock plan, 266
  performance unit or share plan, 262
  phantom stock plan, 264
  SAR, 261

P

parachute payment, 268
party in interest, 27
Pension Benefit Guaranty Corporation (PBGC), 4
Pension Protection Act of 2006 (PPA), 35, 62
percentage test, 12, 203
performance program, 262
performance unit, 262
periodic payment, 128
permitted disparity rules, 22
phantom stock plan, 264
PIA, 173, 177
pre-1974 capital gain, 98
  treatment, 79
primary insurance amount, 173
profit-sharing plan, 49, 52
prohibited transaction, 27, 101
  rules, 4
prohibited transaction exemption (PTE), 4
provisional income, 179
pure protection cost, 203

Q

qualified automatic contribution arrangement (QACA), 62
qualified charitable distribution (QCD), 117
qualified default investment notice, 62
qualified distribution, 110, 111
qualified domestic relations order (QDRO), 132, 162
qualified joint and survivor annuity (QJSA), 129, 161
qualified matching contribution, 67
qualified nonelective contribution, 67
qualified plan, 8, 132
qualified preretirement survivor annuity (QPSA), 129, 161
qualifying charity as beneficiary, 156
qualifying public charity, 156
qualifying trust, 156

R

rabbi trust, 233
rate of inflation, 205
rate of investment return, 205
ratio test, 12
required beginning date (RBD), 138, 151
required minimum distribution (RMD), 109, 117, 132, 139, 148
resources test, 50
restricted stock plan, 257
retirement benefits, 174
retirement needs analysis, 205
retirement savings need, 189
rollover, 127, 130
rollover IRA, 104
Roth 401(k) plan, 60, 69, 92
Roth contribution, 88
Roth IRA, 95, 98, 108, 115, 117, 133, 163

S

safe harbor Section 401(k) plan, 60, 62
salary reduction plan, 238
salary reduction SEP (SARSEP), 85
  plan, 92
savings incentive match plan for employees (SIMPLE) IRA, 80
savings/thrift plan, 70
SECA, 169
Section 401(k) plan, 60, 61, 69, 88, 89, 92, 116
Section 403(b) plan, 86, 87, 88, 92, 99, 116, 132, 138
Section 412(e)(3) plan, 41

Section 415, 34
Section 457 plan, 89, 91, 93, 99, 116, 138
Section 501(c)(3), 88
secular trust, 236
Self-Employment Contributions Act, 169
self-employment tax, 169
separation from service, 144
SEP IRA, 99
serial payment approach, 212
severance plans, 267, 268, 269
  golden parachute, 268
  tin parachute, 269
  voluntary severance retirement plan (VSRP), 269
share plan, 262
SIMPLE, 68, 79
  401(k), 60, 68, 79, 80, 92
  IRA, 68, 79, 80, 92, 99, 132
simplified employee pension (SEP), 82, 84
  plan, 82
Social Security, 167, 168
solo 401(k), 70
special catch-up, 87
Spousal IRA, 98
spousal retirement benefits, 172
stock appreciation right (SAR), 261
stock bonus plan, 54
stock option, 248
  employee stock purchase plan (ESPP), 253
stock options, 248
stretch IRA, 103, 106
substantial and recurring basis, 49
substantially equal periodic payment, 107, 144
summary of material modification (SMM), 25
supplemental executive retirement plan (SERP), 241, 242
  top hat plan, 242
supplemental nonqualified plans, 239
surety bond, 234
surviving spouse
  benefits, 172
survivor benefits, 175

T

Table 2001 cost, 203
tandem plan, 44
target benefit pension plan, 43
taxable wage base, 169
tax-advantaged, 78
tax rules, nonqualified plan, 225, 227, 246, 247
  assignment of income doctrine, 246
  economic benefit doctrine, 227
  Section 83, 247
tax-sheltered annuity (TSA), 86
tin parachutes, 269
top hat plan, 242
top-hat plan, 79
top-heavy
  defined benefit plan, 16
  plan provisions, 63
  rules, 79, 83
traditional IRA, 97, 106, 108, 115
traditional Section 401(k) plan, 60
trigger year, 139

U

unfunded plan, 231
Uniform Lifetime Table/Table III, 140
unit benefit formula, 35
unreimbursed medical expenses, 107
unrelated business taxable income (UBTI), 202

V

vesting, 14, 60
voluntary severance retirement plan (VSRP), 269

W

W-2 income, 71
wage replacement ratio (WRR), 207
Windfall Elimination Provision, 180
withdrawal penalty, 115

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