Dalton Education
BY CERIFI

The Dalton Review®
Retirement Planning

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Defining Retirement

- Traditional Retirement
- Alternative Retirement

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Types of Alternative Retirement

- FIRE (Financial Independence Retire Early)
  - Lean FIRE
  - Barista FIRE
  - Fat FIRE
- Mini vacations and sabbaticals

Qualified Plan Overview
Introduction

	Pension Plans	Profit Sharing Plans	
Defined Benefit Plans	▪ Defined Benefit Pension Plans ▪ Cash Balance Pension Plans	▪ Profit Sharing Plans ▪ Stock Bonus Plans ▪ ESOPs ▪ 401(k) Plans	Defined Contribution Plans
Defined Contribution Plans	▪ Money Purchase Pension Plans ▪ Target Benefit Pension Plans	▪ Thrift Plans ▪ New Comparability Plans ▪ Age-Based Profit Sharing Plans	

Qualified Plan Overview
Pension Plans vs. Profit Sharing Plans

Characteristic	Pension Plan	Profit Sharing Plan
Legal Promise of the Plan	Paying a pension at retirement	Deferral of Compensation
In-Service Withdrawals?	Yes*	Yes (after two years)
Mandatory Funding?	Yes**	No
Investment in ER Securities	10%	100%
QJSA & QPSA?	Yes	No

* Under the PPA 2006, defined benefit pension plans **can** provide for in-service distributions to participants who are age 59 1/2 or older.

** For plan years beginning in 2008, the funding rules under IRC Section 412 have been amended by the PPA 2006.

Qualified Plan Overview
Defined Benefit vs. Defined Contribution Plans

Characteristics	**Defined Benefit**	**Defined Contribution**
What is the Annual Contribution Limit?	Not less than the unfunded current liability *	25% of Covered Compensation
Who assumes the investment risk?	Employer	Employee
How are forfeitures allocated?	Reduce Plan Costs	Reduce plan costs or allocate to other participants

* This is the annual contribution limit for 2006 and 2007. Beginning in 2008, defined benefit plans are subject to new annual contribution limits under the PPA 2006.

Qualified Plan Overview
DB vs. DC Plans (Continued)

Characteristics	Defined Benefit	Defined Contribution
Is the plan subject to Pension Benefit Guaranty Corporation (PBGC) coverage?	Yes (except professional firms with less than 25 employees)	No
Does the plan have separate investment accounts?	• No, they are commingled • Participants have accrued benefits	• Yes, they are usually separate • Participants have account balances
Can credit be given for prior service?	Yes	No

Qualified Plan Overview
Advantages of Qualified Plans

- Taxation of Contributions to Plans
  - Income Tax Deferred
  - Payroll Taxes Avoided on Employer Contributions
    - No avoidance for employee elective deferrals.
- Tax Deferral of Earnings and Income
- ERISA Protection
  - Anti-Alienation
    - Prohibits any action that may cause the plan assets to be assigned, garnished, levied, or subject to bankruptcy proceedings.
  - Protection from Employers.

Qualified Plan Overview
Advantages of Qualified Plans

- Special Taxation Options for Lump Sum Distributions
  - Pre-1974 Capital Gain Treatment *
  - 10-Year Forward Averaging *
  - Net Unrealized Appreciation

* May appear as an answer choice but will not be asked to calculate

Qualified Plan Overview
Qualification Requirements

- Plan Document - in writing by end of tax year. Funding doesn't have to occur until tax return filing plus extension.
- Eligibility (21 years old & 1 year of service or 2 years of service with 100% vesting [does not apply to 401k plans])
- Coverage
- Vesting (2 to 6 years graduated or 3-year cliff)
- Special Qualification Requirements apply to:
  - Top-Heavy Plans
  - Cash or Deferred Arrangements (CODAs) (2 to 6 years graduated or 3-year cliff)
- Limitation on Benefits and Contributions

Qualified Plan Overview
Eligibility & Plan Entrance Dates

- Eligibility
  - Age 21 and one year of service (1,000 hours worked during one plan year).
    - Special election to require two years of service – 100% vesting requirement.
      - Not available for 401(k) plans
    - Tax-exempt educational institutions can require age 26.
  - Plan Entrance Date
    - Must have at least 2 per year

Qualified Plan Overview
Eligibility Long Term PT Employees

- For plan years beginning after December 31, 2020
  - 401k must allow Long-Term Part-time Employees to participate in 401k (SECURE Act) upon the completion of:
    - 500 hours per year
    - Three continuous years
      - Years completed after 12/31/2020 will count
      - Eligibility would begin in 2024 (after the completion of 3 continuous years)

Qualified Plan Overview
Coverage Tests

- Coverage Tests
  - Can exclude:
    - Ineligible employees
      - Does not meet the 21 and 1 Rule
    - Employees covered under a collective bargaining agreement (Union)
    - Nonresident alien employees that do not perform services in the U.S.
    - Part-time employees not meeting eligibility under SECURE Act.

Qualified Plan Overview
Coverage Tests

- Coverage Tests
  - Plan must be nondiscriminatory
    - All qualified plans must pass at least ONE of the following tests:

Coverage Test	Required to Pass
Safe Harbor Test	≥ 70% of NHC Covered
Ratio % Test	$\frac{\text{% of NHC Covered}}{\text{% of HC Covered}} \geq 70\%$
Average Benefits Test	$\frac{\text{AB % of NHC Covered}}{\text{AB % of HC Covered}} \geq 70\%$ And Nondiscriminatory Test

Qualified Plan Overview
50/40 Test

Defined Benefit Plans must additionally

pass the 50/40 Test

50/40 Test	Plan must cover the lesser of: ▪ 50 employees ▪ 40% of employees

Exam Tip: "Employees" Come First!

Practice Question 1

Pear Inc has 100 eligible employees and sponsors a defined benefit pension plan. What's the minimum number of employees that must be covered by the defined benefit pension plan to conform with ERISA?

A. 40
B. 50
C. 70
D. 100

Qualified Plan Overview
Highly Compensated

- Who is a Highly Compensated Employee?
- Either of the following:
  - Any owner of >5% this year or last year, or
  - Compensation in excess of $150,000 for prior year or $155,000 (2024)
    - Unless elect and in top 20% of employees as ranked by salary.

Qualified Plan Overview
Highly Compensated Example

Employee	Salary last year	Ownership this year	Ownership last year	HC?
Jeanette	$50,000	5%	95%	
Cheryl	$50,000	95%	5%	
Delano	$160,000	0%	0%	
All of the above employees are highly compensated!				

Qualified Plan Overview
Highly Compensated Example

Employee	Salary	Ownership	HC?	HC? w/ 20%
A	200,000	65%	Yes	Yes
B	165,000	35%	Yes	Yes
C	160,000	0%	Yes	No
D	50,000	0%		
E	50,000	0%		
F	40,000	0%		
G	30,000	0%		
H	30,000	0%		
I	30,000	0%		
J	30,000	0%		

Qualified Plan Overview
Coverage Test Example

	Non-excludable EEs	Covered	AB %
NHC	75	55	6%
HC	25	21	10%
Total	100	76	

Qualified Plan Overview
Coverage Test Example, Cont.

- Safe Harbor
  - 55 / 75 = 73%
  - PASS!
- Ratio %
  - (55 / 75) / (21 / 25) = 87%
  - PASS!
- Average Benefits
  - 6% / 10% = 60%
  - FAIL!
- 50/40 Test
  - Covers 76 EEs
  - PASS!

Qualified Plan Overview
Vesting

- Defined Contribution Plan
  - Noncontributory
    - 2-6 year graduated, or
    - 3 year cliff
  - Deferral (contributory)
    - 100% vested
- Defined Benefit Plan
  - 3-7 year graduated, or
  - 5 year cliff

In any case, ER can always be more generous.

Qualified Plan Overview
Top Heavy/Key Employee

- Special Plan Requirements for Top-Heavy Plans
  - Top-Heavy
    - Defined Contribution
      - >60% of account balance attributable to key employees
    - Defined Benefit
      - >60% of accrued benefits attributable to key employees
  - Key Employee
    - A greater than five percent owner, or
    - A greater than one percent owner with compensation in excess of $150,000 (not indexed), or
    - An officer with compensation in excess of $220,000 for 2024.
      - Officer determined based on all facts

Qualified Plan Overview
Highly Compensated vs Key Employee

Highly Compensated 2024	Key Employee 2024
• > 5% Owner • Compensation > $155,000 • Top 20% Election?	• > 5% Owner • > 1% Owner & Comp > $150,000 • Officer & Comp > $220,000

Testing
• Coverage Testing
• ADP/ACP Testing
	Top Heavy – Affects:
	• Funding
	  • DC – 3%
	  • DB – 2%
	• Vesting
	  • DB – 2-6 graded or 3-year cliff

Qualified Plan Overview
Top Heavy Funding Requirements

- Defined Contribution Plans
  - Employer must provide non-key employees with a contribution equal to at least 3% of employee's compensation
    - Except if key employee's contribution is less than 3%
- Defined Benefit Plans
  - Employer must provide non-key employees with a benefit equal to 2% per years of service (limit 20%) times employees average annual compensation.
  - Plans must also increase vesting to either 2-6 year graduated or 3 year cliff.

Qualified Plan Overview
Top Heavy DC Example

- Example - Minimum Funding
- of a Defined Contribution Plan

- James – compensation = $65,000
  - Not Key EE
- Plan is top heavy DC Plan
- Minimum funding for James (assuming 3% or greater contribution for Key EEs) = $65,000 x 3% = $1,950

Qualified Plan Overview
Top Heavy DB Example, Cont.

- Top Heavy DB Plan
  - Non top heavy Formula = 1.5% x avg. 3 highest years comp x years of service
- James has 10 years of service and average compensation of $100,000.
  - Under formula = 1.5% x $100,000 x 10 = $15,000
  - Under Top Heavy Formula = 2% x $100,000 x 10 = $20,000
- MUST USE TOP HEAVY FORMULA!

Qualified Plan Overview
Plan Limits

- Plan Limitations on Benefits and Contributions
  - Covered Compensation
    - $345,000 for 2024
  - Defined Benefit Plans
    - Lesser of
      - $275,000 for 2024 or
      - 100% of the average of the employee's three highest consecutive years salary

Qualified Plan Overview
Plan Limits

- Defined Contribution Plans
  - Maximum contribution for the year
    - Lesser of:
      - 100% of an employee's compensation, or
      - $69,000 for 2024
  - Limit consists of
    - Employer Contributions +
    - Employee Contributions (Deferrals of $23,000 + $7,500 for 50 and over) +
    - Any forfeitures allocated to participant's account =
    - $69,000 (per source) + $7,500 (catch up) = $76,500

Practice Question 2

Mariette, age 29, earns $220,000 per year. Her employer, Taxes Are Us, sponsors a qualified profit sharing 401(k) plan and allocates all plan forfeitures to remaining participants. If in the current year, Taxes Are Us makes a 20% contribution to all employees and allocates $6,000 of forfeitures to Mariette's profit sharing plan account, what is the maximum Mariette can defer to the 401(k) plan in 2024?

A. $4,400
B. $19,000
C. $23,000
D. $30,500

Pension Plans Types

Pension Plans (4 Types)	
Defined Benefit Pension Plans (2 Types)	Defined Benefit Pension Plans
	Cash Balance Pension Plans
Defined Contribution Pension Plans (2 Types)	Money Purchase Pension Plans
	Target Benefit Pension Plans

Pension Plans Actuary

- Actuary
  - Determine required plan funding range.
  - Assumptions
  - Required Annually
    - Defined Benefit Pension Plan
    - Cash Balance Pension Plan
  - Required at Inception
    - Target Benefit Pension Plan

Exam Tip: No other plans require an actuary.

Pension Plans
Social Security Integration

- Social Security Integration
  - Excess Method – Provides an excess benefit to those participants whose earnings are in excess of the Social Security wage base.
    - Used by both Defined Benefit and Defined Contribution Plans
  - Offset Method – Reduces the benefit to those employees whose earnings are below the Social Security wage base.
    - Used only by Defined Benefit Plans

Pension Plans
Defined Benefit Pension Plan

- Mandatory Funding
- Pension benefit based on a defined funding formula
  - Flat Amount Formula – equal dollar benefit
  - Flat Percentage Formula - % of salary
  - Unit Credit Formula –YOS x % x salary
- Commingled Accounts
- Favors Older Plan Entrants
- All plans must meet Eligibility/Coverage/Vesting Rules

Pension Plans
Cash Balance Pension Plans

- Defined Benefit Pension Plan
- Mandatory Funding
- Pension benefit based on an annual guaranteed contribution rate and guaranteed earnings on the contributions
- Quasi-Separate Accounts
  - Participant sees hypothetical account with hypothetical earnings
  - Actuarially Determined

Pension Plans
Cash Balance Pension Plans

- Favors younger plan entrants
- All Plans must meet Eligibility/Coverage/Vesting Rules
- Uses 3 year cliff vesting
  - Employer can be more generous in vesting schedule

Pension Plans
Money Purchase Pension Plans

- Defined Contribution Pension Plan
- Mandatory annual funding of a fixed percentage of total employer covered– up to 25%
- Participant bears investment risk
- Separate Accounts
- Favors younger plan entrants
- Eligibility/Coverage/Vesting
- Not likely to be established after EGTRRA 2001

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Pension Plans
Target Benefit Pension Plans

- Special type of money purchase pension plan
- Determines the contribution based on the participant's age
- Participant bears investment risk
- Favors older plan entrants
- Eligibility/Coverage/Vesting
- Requires actuary services at inception of plan

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Practice Question 3

Which of the following is not a characteristic of pension plans?

A. Mandatory funding
B. In-service withdrawals for employees under the age of 59 1/2
C. Limited investment in life insurance
D. A limit of 10 percent investment in the employer's securities

Practice Question 4

Which of the following statements is true?

A. A cash balance pension plan usually benefits older employees the most.
B. A defined benefit plan promises a contribution to a hypothetical account each year for a plan participant.
C. Cash balance pension plan participants under age 59 1/2 may take a withdrawal from the plan during employment with the plan sponsor.
D. A cash balance pension plan does not have individual separate accounts for each participant.

Profit Sharing Plans
Types of Profit Sharing Plans

- Profit Sharing Plans
- Stock Bonus Plans
- Employee Stock Ownership Plans (ESOP)
- 401(k) Plans
- Thrift Plans (after-tax)

Profit Sharing Plans
Characteristics

- Defined contribution plan.
- Established and maintained by an employer.
- Provides for employee participation in profits.
- Utilizes a definite predetermined formula for allocating the contributions to the plan.
- Must be nondiscriminatory.
- Either noncontributory or contributory.
- Noncontributory: Employee does not contribute to the plan and all contributions to the plan are from the employer.
- Contributory: Employee contributes to the plan. (Deferrals/CODA)

Profit Sharing Plans
Contributions and Deductions

- Contributions must be made by the due date of the company's income tax return.
- Contributions are discretionary, but must be "substantial and recurring."
- No requirement of company profit for contribution.
- Limited to 25% of total employer covered compensation.
- Limited to the lesser of 100% of compensation, or $69,000 for 2024 per employee per year.

Profit Sharing Plans
Allocation of Contributions (1 of 2)

- Standard Allocation
  - Equal percentage to all participants.
- Social Security Integration
  - Provides higher allocations to employees whose earnings are greater than the Social Security Wage base.
  - Profit sharing plans can only use the excess method.
- Age-Based Profit Sharing Plans
  - Use a combination of age and compensation to allocate the plan contribution.

Profit Sharing Plans
Allocation of Contributions (2 of 2)

- New Comparability Plan
  - Contribution dependent upon employee classification.
    - Owner
    - Officer
    - Rank-and-File

Profit Sharing Plans
Cash or Deferred Arrangements
(CODA or 401(k))

- Any profit sharing can have a CODA/401(k) attached.
- Most prevalent type of plan established today.
  - Predominantly funded by employee deferral contributions.
- Attaches to a profit sharing plan or stock bonus plan.
- Permits employees to defer compensation to a qualified plan.
  - Limited to $23,000 for 2024 per year, or $30,000 for 2024 for those age 50 and over.
  - Employers may (but are not required to) match the employee's deferral.
    - SECURE 2.0 Act Sec 110 effective after 2023, allows employers to making matching contributions on behalf of employees that are making payments on outstanding student loans in lieu of retirement contributions.
      - 401(k), 403(b), 457(b) or SIMPLE IRAs

Profit Sharing Plans
CODA – Eligibility & Vesting

- Eligibility (2 year not available)
- Vesting
  - Employee deferral contributions
    - 100% at all times
  - Employer matching contributions
    - Must vest at least as rapidly as
      - 2 to 6 graduated (0%, 20%, 40%, 60%, 80%, and 100%), or
      - 3-year cliff

Profit Sharing Plans
CODA – Vesting Example

- 401 (k) balance = $200,000
  - $60,000 = ER Profit Sharing Contribution
  - $40,000 = Earnings on ER PS Contribution
  - $39,000 = EE deferral
  - $21,000 = Earnings on EE deferral
  - $40,000 = ER matching contributions and earnings
- Uses 2-6 graded vesting
- After 2 years what is the vested portion?

Profit Sharing Plans
CODA – Vesting Example, Cont.

- 401 (k) balance = $200,000
  - $60,000 x 20% = 12,000
  - $40,000 x 20% = 8,000
  - $39,000 x 100% = 39,000
  - $21,000 x 100% = 21,000
  - $40,000 x 20% = 8,000

- Total Vested Balance = $88,000

Profit Sharing Plans
CODA – ADP Test

- Actual Deferral Percentage Test (ADP Test)
  - Limits the employee elective deferrals for the HC based on the elective deferrals of the NHC.
- Test ensures that HC aren’t taking too much more advantage of the plan than NHC.

Remember!

- Who is a Highly Compensated Employee?

- Either of the following:
  - Any owner of >5% this year or last year, or
  - Compensation in excess of $155,000 (2024) for the current year
  - Compensation in excess of $150,000 (2023) for the prior year.
    - Unless elect and in top 20% of employees as ranked by salary.

ACP/ADP Testing

If the ADP for NHC EEs is:	The permissible ADP for HC EEs is
0% to 2%	2 x ADP for NHC
2% to 8%	2% plus ADP for NHC
8% and over	1.25 x ADP for NHC

Profit Sharing Plans
CODA – ADP Test Example

- If the NHC EEs are contributing ____ then HC can contribute _____.

NHCEs		HCEs
1%	x2	2%
2%		4%
3%	+2	5%
4%		6%
5%		7%
6%		8%
7%		9%
8%	x1.25	10%
9%		11.25%

Profit Sharing Plans
CODA – ADP Test (1 of 2)

- If you fail the ADP Test - correct by any of these:
  - Corrective Distributions
    - Decreases ADP of HC
  - Recharacterization – change from pre-tax to after tax contributions
    - Decreases ADP of HC

Profit Sharing Plans
CODA – ADP Test (2 of 2)

- If you fail the ADP Test - correct by any of these:
  - Qualified Non-elective contributions (QNEC)
    - Increases ADP of NHC
    - 100% vested
    - Made to all eligible EEs
  - Qualified matching contributions (QMC)
    - Increases ADP of NHC
    - 100% vested
    - Made only to EEs who elected to defer in the current year

Profit Sharing Plans
CODA – ACP Test

- Actual Contribution Percentage Test (ACP Test)
  - Like ADP, but determined utilizing:
    - Employee after-tax thrift contributions, and
    - Employer matching contributions
  - Uses same scale as ADP
  - Uses same corrective procedures as ADP

Profit Sharing Plans
CODA – Safe Harbor 401k

- Safe Harbor 401(k) Plans
  - Not required to pass ADP or ACP tests.
  - Employer must provide either one of the following:
    - 3% non-elective contribution
      - To all eligible employees
    - Matching contribution
      - 100% up to 3%, and
      - 50% from 3% to 5%
  - Employer contributions are 100% vested at all times.

Exam Tip: Safe harbor employer contributions are 100% vested at all times!

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Practice Question 5

Which of the following vesting schedules may a top-heavy qualified profit sharing plan use under PPA 2006?

A. 1-5 year graduated
B. 5 year cliff
C. 3-7 year graduated
D. 4-8 year graduated

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Practice Question 6

Which of the following is true regarding CODAs?

A. A 401(k) can only be established as a stand alone plan.
B. A CODA is allowed with a profit-sharing plan, stock bonus plan, and a SEP.
C. Contributions can only be made after-tax.
D. CODAs are employee self-reliance plans.

Profit Sharing Plans
Stock Bonus Plans

- Defined contribution profit sharing plans.
- Employers contribute stock to the plan.
- Contributions are discretionary but must be substantial and recurring.
- Allocations to the plan must be nondiscriminatory.
- Tax deduction for FMV of stock
  - Cashless tax deduction

Profit Sharing Plans
Stock Bonus Plans - NUA

- Net Unrealized Appreciation
- Lump sum
- In-kind distribution of employer securities.
  - Usually from ESOP or Stock Bonus Plan
- Determination of NUA:

  Fair Market Value at Date of Distribution
  <u>Less: Value of stock at Date of Employer Contribution</u>
  Net Unrealized Appreciation

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Profit Sharing Plans
Stock Bonus Plans - NUA

- Net Unrealized Appreciation
  - In year of distribution of employer stock:
    - Ordinary income
      - Value at date of Employer Contribution
    - 10% penalty if applicable
    - Deferred Long-Term Capital Gain
      - NUA
  - At date of sale of employer stock:
    - Recognize deferred long-term capital gain (regardless of holding period).
    - Any subsequent gain/loss short/long term capital gain based on holding period since date of distribution.

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Practice Question 7

Peter sells stock six months after he received it as a distribution from a qualified stock bonus plan. When the stock was distributed, he had a net unrealized appreciation of $7,500. He also had ordinary income from the distribution of $29,000. The fair value of the stock at the time of sale was $81,000. How much of the sale price will be subject to long-term capital gain treatment?

A. $7,500
B. $44,500
C. $52,000
D. $73,500

Profit Sharing Plans
Employee Stock Ownership Plans (ESOP)

- Defined Contribution Profit Sharing Plan
  - Established as a trust.
- Participant receives allocations of the employer stock from the ESOP.
- Seller can defer gains if proceeds reinvested within 12 months

Profit Sharing Plans
ESOP – Voting Rights

- Voting Rights
  - Publicly Traded Corporations
    - Participants have voting rights as regular shareholders.
    - Participants earn dividends.
  - Privately Held Corporations
    - Participants must be allowed to vote in major corporate decisions.
      - Mergers, acquisitions, consolidation, reclassification, liquidation, dissolution, recapitalization or a sale
    - Trustee of the ESOP votes in all other matters.

Profit Sharing Plans
ESOP – Contributions

- Contributions
  - Cash
    - ESOP uses to purchase employer stock, or
    - ESOP uses to pay bank debt. (Leveraged ESOP)
    - Interest on note deductible above 25%
  - Stock
    - Employer has tax deduction for the value of the stock or the cash at the date of the contribution.
    - Subject to 25% of employer covered compensation limit
    - Dividends paid are deductible

Profit Sharing Plans
ESOP – Allocations

- Allocations
  - Age-based
  - Cannot use Social Security integration

Exam Tip: Salary deferral plans, such as 401(k) plans, 403(b) plans and SIMPLEs, are also prohibited from using Social Security integration. It should be noted that many 401(k) plans have a profit sharing component, which can be integrated with Social Security. However, the CODA portion cannot.

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Profit Sharing Plans
ESOP – Distributions

- Distributions
  - Participant can demand distribution of employer securities.
  - Employer may limit.
  - Substantially equal periodic payment requirement
    - If participant elects, he may demand equal distributions from the ESOP for a period no longer than 5 years, unless his account is valued at more than $1,380,000 for 2024, in which case the distribution period may be extended one year for each additional $275,000 for 2024 of account value up to a total of ten years.
    - Not eligible for NUA.
  - Lump Sum
    - If lump sum, then NUA net unrealized appreciation

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Profit Sharing Plans
ESOP – Put Outs

- Put Option
  - Employee can require employer to repurchase stock at the fair market value on the distribution date.
    - Within 60 days after distribution, or
    - Within a 60 day period during the following plan year
  - The put option reduces the employee's risk, but increases the employer's cash requirements.

Diversification Requirement (1 of 3)

Important Rule!

- A Qualified Participant may force investment diversification within his account during the qualified election period.
  - Who is a Qualified Participant
    - At least age 55
    - Completed 10 years of participation in the plan
  - The qualified election period is the 6-plan year period beginning after becoming a qualified participant.

Diversification Requirement (2 of 3)

Important Rule!

- They may diversify 25% of their post-1986 stock balance for the first five years of their qualified election period and
- 50% of their post-1986 stock balance during their sixth and final year.
- The diversification calculation is a cumulative calculation, meaning that the stock balance consists of the number of eligible shares that have ever been allocated to a qualified participant's account less any shares previously distributed, transferred, or diversified.
- Diversification can be satisfied by a distribution, a transfer to another qualified plan, or offering three or more investment options in the ESOP (certain requirements apply).

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Diversification Requirement (3 of 3)

Important Rule!

- Note that ESOPs are not generally subject to the diversification requirements implemented under PPA 2006.
  - Exception is if the ESOP is a contributory plan or is a publicly traded business.

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Distributions from Qualified Plans
Pension Plan

- During Service with employer
  - No in-service withdrawals for participants under age 59 1/2.
  - At participant’s death:
    - Distributed to beneficiary, or
    - Participant’s estate.
    - Qualified Preretirement Survivor Annuity (QPSA)
      - An annuity benefit payable to the surviving spouse of a participant if the participant dies before attaining normal retirement age.
  - At participant’s disability:
    - Distributed to participant.

Distributions from Qualified Plans
Pension Plan

- Termination of Service before normal retirement age – pension plan.
  - Lump Sum Distribution,
  - Rollover plan assets to IRA or other qualified plan, or
  - Leave assets in plan.
    - Value must be greater than $7,000 as per SECURE 2.0 Act effective after 12/31/23

Distributions from Qualified Plans Pension Plan, Cont.

- Termination of Service at Normal Retirement Age – Pension Plan.
  - Qualified Joint Survivor Annuity (QJSA)
    - An annuity benefit payable to the participant and his spouse as long as either lives.
      - Single life annuity if QJSA is waived.
      - Signed by NON participant spouse and Notarized or witnessed by plan sponsor.
  - Lump Sum Distribution.
  - Rollover plan assets to IRA or other qualified plan.

Distributions from Qualified Plans Profit Sharing Plans

- May permit in-service withdrawals after two years of participation in the plan.
- At termination of service:
    - Lump sum distribution,
    - Rollover plan assets to IRA or other qualified plan, or
    - Purchase annuity.

Distributions from Qualified Plans Taxation of Distributions

- Ordinary income
  - Except:
    - Direct rollovers of plan assets to IRAs or other qualified plans,
    - Adjusted basis in plan,
      - Annuities (with adjusted basis)
    - Lump Sum Distribution Options, and
    - Qualified Domestic Relations Orders (QDRO) if rolled over to IRA.
- Taxable distributions are subject to 20% income tax withholding.

Distributions from Qualified Plans Taxation – Rollovers (1 of 2)

- Rollovers to IRAs
  - Causes a loss of:
    - ERISA Protection (although will be protected under federal bankruptcy law as a result of BAPCPA 2005),
    - 10-year forward averaging,
    - NUA, and
    - Pre-1974 Capital Gain Treatment.

Distributions from Qualified Plans Taxation – Rollovers (2 of 2)

- Rollovers to IRAs
  - Direct Rollover Defined
    - A distribution from a qualified plan trustee directly to the trustee of the recipient account.
    - No income tax withholding.
  - Indirect Rollover Defined
    - A distribution to the participant with a subsequent transfer to another account.
    - Mandatory 20% income tax withholding.
      - Must redeposit all, within 60 days, to avoid income taxes.

Distributions from Qualified Plans Taxation – Plan Loans (1 of 2)

- Plan Loans
  - Permissible by any qualified plan
    - Usually only found with CODA type plans.
  - Loan may not exceed
    - The lesser of:
      - $50,000, or
      - ½ of the participant's vested account balance
    - Reduced by the highest outstanding loan balance within the previous twelve month period.

Distributions from Qualified Plans Taxation – Plan Loans (2 of 2)

- Plan Loans
  - **Exception**: when vested account balance is <$20,000, the maximum loan is limited to the lesser of:
    - $10,000, or
    - The vested account balance.
  - Reduced by the highest outstanding loan balance within the previous twelve-month period.

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SECURE 2.0 Act of 2022 Loan Provisions

- Permissible by any qualified individual in a qualified disaster area
  - Plan must have loans available
- Loan may not exceed
  - The lesser of:
    - $100,000, or
    - ½ of the participant's vested account balance
  - Reduced by the highest outstanding loan balance within the previous twelve month period.

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Distributions from Qualified Plans Taxation – Plan Loan Example

Vested Accrued Balance	Maximum Loan	
$1,000,000	$50,000	Max amount
$120,000	$50,000	
$80,000	$40,000	½ vested
$24,000	$12,000	
$18,000	$10,000	Max vested or $10,000
$9,000	$9,000	

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Distributions from Qualified Plans Taxation – Plan Loan Repayment

- Repayment of Plan Loans
  - Five years
    - Up to 30 years if loan proceeds used to purchase principal residence.
  - Substantially level amortization of the loan is required over its term.
  - Payments must be at least quarterly.
  - Plan sponsors often apply additional rules and requirements.

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Distributions from Qualified Plans
Taxation – Plan Loan

- Failure to repay the loan as prescribed will consider the value of the loan a taxable distribution.
  - Possibly subject to the 10% early distribution penalty.
- Termination from employment generally causes entire loan to become due.
- However, under TCJA 2017 terminated EEs will be permitted to rollover/repay loans until the due date of the tax return including extensions.

Distributions from Qualified Plans
Distributions Prior to 59 ½ (1 of 4)

- 10% Early Withdrawal Penalty Exceptions:
  - Qualified Plans and IRAs
    - 59½
    - Death, Disability
    - Substantially equal periodic payment (Section 72(t))
    - Medical expenses in excess of schedule A medical AGI limit for tax year (7.5%)
    - Federal Tax Levy
    - $5,000 per taxpayer for birth or legal adoption (SECURE Act)
    - Terminal illness
    - Up to an aggregate amount of $22,000 in a qualified disaster
    - Emergency personal expense up to $1,000
    - Domestic Abuse

SECURE 2.0 Act of 2022 for 2024

Distributions from Qualified Plans
Distributions Prior to 59 ½ (2 of 4)

10% Early Withdrawal Penalty Exceptions:

Qualified Plans Only

- Separation from service at age 55 or after
- Separation of service at age 50 or with 25 years of service for safety officers, firefighters and correction officers
- Qualified Domestic Relations Order

IRA Only

- Higher education costs
- Health Ins. for unemployed
- First time home purchase up to $10,000

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Distributions from Qualified Plans
Distributions Prior to 59 ½ (3 of 4)

- Substantially Equal Periodic Payments
- Requirements
  - Made at least Annually
  - For the life expectancy of the participant or joint lives of the participant and his designated beneficiary
  - After separation of service

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Distributions from Qualified Plans
Distributions Prior to 59 ½ (4 of 4)

- Method of Calculation
  - Required Minimum Distribution Method
    - Payments calculated the same as minimum distributions
  - Fixed Amortization Method
    - Payments calculated over applicable single or joint life expectancy with reasonable interest rate
  - Fixed Annuitization Method
    - Payments calculated using an annuity factor (with reasonable interest rate and mortality table)

Distributions from Qualified Plans
Required Minimum Distributions 1 of 3

- Age 72 after 12/31/2019 (SECURE Act 2019) but before 1/1/2023 (SECURE 2.0 Act of 2022)
- Age 73 for those obtaining age 72 after 12/31/22.
  - First minimum distribution must begin by April 1 of the year following the year in which the participant attains the age of 72/73 This is known as Required Begin Date (RBD)
- Those that began RMDs on or before 12/31/22 will continue them.

Watch the year on the exam!!

How Could RMD be tested?

- Wayne turned 72 on 12/1/2022….calculate his RMD, or choose the date he will need to take it.
- Oscar turned 72 on 1/5/2023… calculate his RMD (zero for 2023), or choose the date he will need to take it.
- Felix turns 73 on 1/10/2023….know he will need to continue RMDs or will need to take two in 2023 if he delayed the 2022 RMD.

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Distributions from Qualified Plans Required Minimum Distributions 2 of 3

- Exception:
  - A participant who is still employed by the plan sponsor may delay the first minimum distribution until April 1 of the year after the participant terminates employment (a >5% owner cannot use the exception).
- NOTE: This exception does not apply to SEPs or SIMPLE IRAs
- All other RMDs must occur by December 31 of each year.

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Distributions from Qualified Plans
Required Minimum Distributions 3 of 3

$$\text{Required Minimum Distribution} = \frac{\text{Fair Market Value of Participant's Account at December 31 of the preceding plan year*}}{\text{Distribution period determined based on participant's age at December 31 of the distribution year.}}$$

Exam Tip:
Look back for money – forward for life expectancy.

Distributions from Qualified Plans
Required Minimum Distributions Example

- FAST FORWARDING – no first-time distributions will be made for 2023 due to RMD Age changes.
- Facts:
  - Account Balance on Dec 31, 2023 = $400,000
  - Age 73 on January 12, 2024
  - Age on Dec 31, 2023 = 73 (factor of 26.5)
- Distribution required FOR 2024 (by April 1, 2025)
  - $400,000 / 26.5 = $15,094.34
- Distribution required IN 2024
  - $0 – it is required by April 1, 2025

Distributions from Qualified Plans
Required Minimum Distributions Example, Cont.

- If the account balance was $480,000 on Dec 31, 2024 (age factor of 25.6)
- Distribution FOR 2025 (by Dec 31, 2025)
  - $480,000/25.6 = $18,750
  - This would be in addition to the 2024 distribution if delayed

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Distribution due to QDRO

- A QDRO is an order under state law recognizing the right of a former spouse to benefits under the participant's qualified plan
  - Former spouse is an alternate payee
  - Describes the spouse's interest in the plan benefits
  - Cannot override plan rules (e.g. if QDRO calls for lump sum distribution but plan does not allow lump sum distributions)

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Portfolio withdrawal Strategies

- Flat amount of income
  - Fixed dollar income throughout entire lifetime
- Inflation-adjusted income
  - Annual income increased based on prior year inflation or a flat pre-selected inflation amount
- Performance-based income
  - Annual income determined by performance of the investment portfolio
- Combination

Sustainable Withdrawal

- Historical studies have shown that, with a portfolio of 50% bonds and 50% stocks, a withdrawal rate of 3 – 4 % could be relied on to provide income for a 35 - 50 year time frame
- Later studies have demonstrated that the addition of an annuity for a portion of the income may allow for a higher sustainable withdrawal rate
- Keep in mind when dealing with Capital Preservation as a retirement funding strategy.

Distributions Due to Death

- Pass to a named beneficiary (outside of probate)
  - Spouse
  - Non-spouse
  - Charity
- Pass to the estate if no named beneficiary (probate)

Distributions Due to Death – SECURE Act

- Distributions are based on the beneficiary type

Designated Beneficiary	Eligible Designated Beneficiary	Non-Designated Beneficiary
Any individual designated as a beneficiary by the employee, that is not an Eligible Designated beneficiary	• Surviving spouse • Child of IRA owner who has not reached majority (At age of majority becomes a Designated Beneficiary) • Disabled* or Chronically ill individual • Any other individual who is not more than ten years younger than the employee or IRA owner	No listed beneficiary

	Designated Beneficiary based on owner's death		
	Eligible Designated Beneficiary	**Designated Beneficiary (Ineligible)**	**Non-designated beneficiary (including an estate, charity, or some trusts)**
Owner dies prior to entire distribution	May be distributed over the life expectancy of the eligible designated beneficiary, beginning in the year following the year of death. Spouse can roll to their IRA If child beneficiary is a minor at the time of account owner death, the child become a Designated Beneficiary when they reach the age of majority.	Balance must be paid out within 10 Years (SECURE Act)	Follows pre-SECURE Act rules After RMD • Use owner's age as of birthday in year of death • Reduce beginning life expectancy by 1 for each subsequent year • Can take owner's RMD for year of death Before RMD • Take entire balance by end of 5th year following year of death.

IRAs
Limits

- Contribution Limits for Traditional and Roth
- Generally,
  - Lesser of
    - $7,000 ($8,000 for age 50 and over - 2024) or
    - Individual's earned income.
- Subject to limitations.
  - Roth for contributions
  - IRA for deductions
- Catch up for individuals age 50 and above
  - $1,000
    - SECURE 2.0 Act indexes this limit and is effective after 12/31/23.

IRAs
Earned Income

- What is earned income?
  - W-2 income
  - Schedule C net income
  - Income as a general partner
  - Alimony (divorces on or prior to 12/31/18)
- Exceptions:
  - Spousal IRA – spouse of account owner has sufficient earned income

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IRAs
Excess Contributions

- Contributions in excess of the contribution limit.
  - Subject to a 6% excise tax for each year that the excess contribution remains in the account.
  - Avoid the excise tax by withdrawing the excess contribution and the attributable earnings before April 15th of the following tax year, plus extensions.
  - SECURE 2.0 Act of 2022 will waive the 10% early withdrawal penalty (under age 59 ½) for corrective distributions made within the correction window.

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IRAs
Contribution Due Date

- Contributions must be made by the due date of the individual’s income tax return (without extensions).
  - Usually April 15th of the following tax year.
    - Jan – April 15^{th} can be current or prior year contribution

IRAs
Deductible Traditional IRAs

- No age limits on contributions but must have earned income (SECURE Act)
- Deductibility of traditional IRA contributions based on AGI and qualified plan status
- Deduction FOR AGI – Schedule one of the Form 1040

IRAs
Deductible Traditional IRAs

- CFP Board provided numbers (2024)

Taxpayer and spouse are not active participants	Taxpayer(s) is/are an active participant in a qualified plan		Taxpayer is NOT an active participant, but taxpayer's spouse is active
No AGI Limit	Single	AGI Phaseout	AGI Phaseout
		$77k - $87k	$230k - $240k
	MFJ	AGI Phaseout	
		$123k - $143k	

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IRAs
Traditional IRA - Active Participant

- Active Participant Status
  - Limits deductibility of traditional IRA contributions.
  - Individual is considered an active participant if:
    - Defined Benefit Plan
      - Participates or meets the eligibility requirements of the plan.
    - Defined Contribution Plan
      - Receives a contribution to the qualified plan on his behalf for the year (including forfeitures), or
      - Defers compensation to a CODA plan.

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IRAs
Nondeductible Traditional IRA Contributions

- Nondeductible IRA contributions.
  - Tax-deferred growth
  - Creates adjusted basis in IRA.
    - Distributions will be partially return of capital and partially earnings.
  - Nondeductible IRA contributions are not limited for active participants of qualified plans.
  - File Form 8606 with Form 1040 to track the adjusted taxable basis of an IRA.
  - CAN be funded at any age with earned income.

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IRAs
Nondeductible Traditional IRA Contributions

- Distributions from traditional IRAs with nondeductible contributions: Ordinary Income
  - Except:
    - Distributions of adjusted basis (cumulative nondeductible amount)

$$\text{Ratio of ATB} = \frac{\text{ATB before withdrawal}}{\text{FMV of account at withdrawal}}$$

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IRAs
Distributions prior to 59 1/2

- 10% early withdrawal penalty exceptions - Qualified Plans and IRAs
  - 59½
  - Death, Disability
  - Substantially equal periodic payment (Section 72)
  - Medical expenses in excess of schedule A medical AGI limit for tax year – 7.5% based on TCDTR Act)
  - Up to $5,000 for birth or legal adoption, within 12 months of birth or adoption
  - Federal Tax Levy
  - Terminal illness
  - $22,000 aggregate for federal disasters
  - Emergency funds up to $1,000 once every three years
  - Domestic abuse

IRAs
Distributions prior to 59 1/2

<u>Qualified Plans Only</u>
- Separation from service after age 55 (50 safety/fire/corrections)
- Qualified Domestic Relations Order

<u>IRA Only</u>
- Health Ins. for unemployed
- Higher education costs
- First time home purchase up to $10,000

IRAs
Roth IRAs

- Roth IRAs
  - Created by the Taxpayer Relief Act of 1997
  - Nondeductible Contributions
  - Qualified Distributions are income tax-free
  - Owner may fund at any age with earned income
  - Not subject to required minimum distribution rules during the life of the account owner
  - Share contribution limit with Traditional IRA
  - Contributions may be limited based on AGI
    - Without regard to active participant status

IRAs
Roth IRA - Contributions

- Roth IRA Contributions:
- Cash
  - Limited to lesser of earned income or $7,000 ($8,000 if age 50 and over for 2024)
    - Combined Limit with Traditional IRA
  - Availability phased-out based on AGI (provided numbers)

Contribution AGI Phase-out Limit (2024)	
Single	$146,000 - $161,000
Married Filing Jointly	$230,000 - $240,000
Married Filing Separate	$0 - $10,000

IRAs
Roth IRA – Conversions and Recharacterizations

- Convert Traditional IRA to Roth IRA
  - No AGI limit for conversions in 2010 and after
- Recharacterized Contributions
  - Change contributions for the year from one type to another. Must complete by due date of return (including extensions)
  - TCJA has limited recharacterizations once the decision to convert an IRA to a Roth IRA is made, no recharacterization for years after 2017

IRAs
Roth IRAs - Qualified Distributions

- Qualified Distributions from Roth IRAs are income tax-free.
- Qualified Distributions from Roth IRAs are not subject to 10% early withdrawal penalty.
- Qualified Distribution:
  - The distribution is made after a five taxable year period (which begins Jan 1 of the tax year for the first contribution), AND
  - The distribution is on account of the owner attaining age 59½, the owner's death, disability, or first-time home purchase (maximum $10,000).

Roth Triggers vs. Penalty Exceptions

Roth Qualified Distribution Triggers	IRA Penalty Exceptions
1. Age 59 ½ 2. Death 3. Disability 4. First time purchase (up to $10,000)	1. Age 59 ½ 2. Death 3. Disability 4. First time purchase (up to $10,000) 5. Medical Insurance premiums while unemployed 6. Substantially equal periodic payments 7. Higher education expenses 8. Medical expenses in excess of 7.5% floor 9. Birth or Legal adoption ($5,000) 10. Federal Tax Levy 11. Terminal illness 12. $22,000 aggregate for federal disasters 13. Emergency funds up to $1,000 once every three years 14. Domestic abuse

IRAs
Roth IRAs – NON-Qualified Distributions

	Subject to Taxation?	Subject to 10% Penalty
Contributions	No	No
Conversions	No	Yes, within five years of conversion*
Earnings	Yes	Yes*

* No penalty if penalty exceptions applies.

* Exceptions to the 10% early withdrawal penalty are the same as the exceptions for Traditional IRA distributions.

Roth 401k vs Roth IRA

Roth 401K/403b	Roth IRA
Contribution = 23,000 Catch up = 7,500 No phase out	Contribution = 7,000 Catch up = 1,000 With phase out
Qualifying Distribution 5 years – start Jan 1 for year of contribution Plus 59 ½ , disabled, death	Qualifying Distribution 5 years – start Jan 1 for year first contribution was made for Plus 59 ½ , disabled, death 1st time home purchase
RMD – Yes/No** (SECURE 2.0 Act)	RMD – No
Non Qualifying Distribution Prorata – use exclusion ratio	Non Qualifying Distribution Best out first -Basis -Conversions -Earnings

IRAs
Roth vs. Traditional

- Comparing Roth IRAs to Traditional IRAs
  - Under SECURE Act, both can contribute at any age if they have earned income.
  - Roth IRAs are not subject to the minimum distribution rules, unlike Traditional IRAs.

IRAs
Permitted Investments

- Permitted investments for IRAs:
  - Cash
  - Stocks
  - Bonds
  - Options (Often limited by custodians)
  - U.S. Gold, Silver, and Platinum Coins (Eagles)
- Investments not permitted for IRAs:
  - Life Insurance
  - Collectibles
  - Other Coins (Krugerrands, Maple Leaf, Pandas)

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IRAs
Sample Question

Which of the following is not a permissible investment inside an IRA?

A. **Gold Eagle Coins**
B. Stocks
C. Gold Maple Leaf Coins
D. Options

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IRAs
Rollovers from Qualified Plans to IRAs

- Rollovers from Qualified Plans to IRAs
  - Lose Lump Sum Distribution Taxation Options (10-year Forward Averaging, Pre-1974 Capital Gain Treatment, NUA)
  - Loans Not Permitted
  - May be rolled back to Qualified Plan that permits
  - Lose ERISA Protection
    - However, will have full protection under federal bankruptcy law if clearly marked rollover and not contaminated, otherwise 1 million.

Simplified Employee Pensions (SEPs)
Characteristics

- Small Business Retirement Plan
- Tax-deferred growth of Contributions
- NOT a qualified plan, but has similar characteristics with unique rules:
  - More liberal coverage requirements.
  - Can be established as late as the extended due date of the income tax return.
  - Unique contribution, vesting, and distribution rules.
- Established utilizing Traditional IRA Accounts

Exam Tip: No longer the only plan eligible to be established after the calendar year has ended

Simplified Employee Pensions (SEPs)
Eligibility

- Employers that sponsor SEPs must provide benefits to all employees who meet the following requirements:
  - Attainment of age 21 or older, and
  - Performance of services for three of the last five years, and
  - Received compensation of at least $750 (2024) during the year.
- SECURE 2.0 Act of 2022 made SEP plans available to domestic employees (ie nannies) beginning with the 2023 tax year.

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Simplified Employee Pensions (SEPs)
Establishment

- Employer must complete the following three steps by the extended due dates of the tax return.
  - Complete a formal written agreement.
    - Form 5305-SEP
  - Give eligible employees notice.
  - Open a SEP-IRA account for each eligible employee.
- SECURE 2.0 Act of 2022
  - Employees can direct all or a portion of employer contributions to a designated Roth account.
    - Contributions will be taxable to the employee

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Simplified Employee Pensions (SEPs)
Contributions

- Employer Funded Only
- Contributions are discretionary
  - Must be made to all employees eligible during the year – even if dead or no longer employed at time of contribution
- Contributions are limited to the lesser of:
  - 25% of an employee's covered compensation, or
  - $69,000 for 2024
- Can utilize pro-rata, flat dollar and Social Security Integration

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Self-Employed Individual
Noncontributory Contributions

Self-Employed Individuals will be subjected to the special contribution calculation as detailed below:

$$\text{Self-Employed Contribution Rate} = \frac{\text{Contribution rate to other participants}}{1 + \text{Contribution rate to other participants}}$$

Exam Tip: Applies to all self-employed plans.

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Simplified Employee Pensions (SEPs)
Vesting and Distributions

- Employees are 100% vested in their account balance at all times.
- Withdrawals are treated just as withdrawals from IRAs.
  - Ordinary Income
    - Subject to 10% early withdrawal penalty unless excepted under IRA penalty exceptions.

SIMPLEs
Characteristics

- Savings Incentive Match Plans for Employees (SIMPLEs).
- Retirement plans for small employers.
- Easy to establish.
- Easy to maintain.
- Similar tax advantages to qualified plans.
- Employee elective deferral contributions.

SIMPLEs
Types

- SIMPLE IRA
  - Utilizes an IRA account as the funding vehicle.
- SIMPLE 401(k)
  - Utilizes a 401(k) plan as the funding vehicle.
- SECURE 2.0 Act of 2022 allows for SIMPLE Roth contributions for both employer and employee contributions (in whole or part)
  - Employee is taxed on the Roth contributions.

SIMPLEs
Establishment

- Can only be established by small employers.
  - A small employer is an employer who has 100 or fewer employees who each earned at least $5,000 of compensation in the preceding calendar year.
- Must be a calendar year plan.
- To establish complete and provide participants with either:
  - Form 5304-SIMPLE, or
  - Form 5305-SIMPLE.
- Provide participants with 60-day period to elect deferral.
- Employer cannot maintain a qualified plan.

SIMPLEs
Eligibility and Vesting

- Employees are eligible if they earned at least $5,000 in any two preceding years from the employer and is expected to earn $5,000 in the current year.

Exam Tip: $5,000 of earnings for eligibility

- The participant is 100% vested in all their contributions to either a SIMPLE IRA or 401(k) and employer contributions if the plan is a SIMPLE IRA.

SIMPLE IRAs
Contribution Limits

- Employee Elective Deferrals
  - Maximum $16,000 (2024), plus $3,500 (2024) as catch-up contribution for those age 50 and over.
    - Contribution limit (and catch-up) increased to 110% of the regular contribution limit after 12/31/23.
  - Roth contributions for allowed for taxable years after 12/31/22.
- Employer Contributions (they choose one)
  - Employer Matching Contributions
    - Dollar-for-dollar match up to 3% of all compensation.
    - May be reduced under special circumstances.
  - 2% Non-elective Employer Contributions
    - 2% of **covered** compensation contribution to each eligible employee.

SIMPLEs
Contributions

- Contributions to SIMPLEs:
  - Tax deductible
  - Tax-deferred growth
  - Employer contribution must be made by the due date of the employer's income tax return filing deadline (including extensions).
  - Employee deferral contributions are subject to payroll taxes.
    - Employee Designated Roth contributions are subject to payroll, Federal and State taxes
  - Additional non-elective contributions for taxable years after December 31, 2023
    - lesser of: up to 10 percent of compensation or $5,000 (indexed beginning in 2025)
    - Cover comp limit for non-elective contributions.

SIMPLEs
Distributions

- Withdrawals and Distributions
  - Ordinary income to recipient.
  - May be rolled over to an IRA or other qualified plan.
  - May be subject to early withdrawal penalties.
    - 25%, rather than 10%, penalty if the withdrawal is completed within the first two years of the employee's participation in the plan.
    - Subject to IRA early withdrawal penalty exceptions.

SIMPLE IRA Replacements

- SIMPLE IRA plan can be replaced by a SIMPLE 401(k) plan or other 401(k) plan that requires mandatory employer contributions during a plan year.
  - 2-year 25% penalty withdrawal rule waived.
  - Effective for plan years beginning after December 31, 2023

SIMPLEs
SIMPLE 401(k)

- SIMPLE 401(k) Plans
  - Similar to SIMPLE IRAs.
  - Participants may take loans from SIMPLE 401(k)s.
  - Very few established.
  - Covered Comp rules apply

403(b) Plans or Tax
Sheltered Annuities (TSAs)

- Retirement plan for the following:
  - Public schools or educational organizations, and
  - Tax-exempt Organizations under IRC Section 501(c)(3).

403(b) Plans
ERISA

- ERISA applies to:
  - Employee benefit pension plans of 501(c)(3) organizations.
    - Unless employer involvement is minimal.
      - Employer only provides salary reduction agreement.
- ERISA does NOT apply to:
  - Governmental 403(b)s
  - Church Related 403(b)s

403(b) Plans
ERISA

- When ERISA applies:
  - Plan must meet the following tests:
    - Nondiscrimination test
    - Matching contributions must satisfy ACP test
  - Plan must offer the following distribution options:
    - Preretirement Joint and Survivor Annuity
    - Qualified Joint and Survivor (QJSA)

403(b) Plans
Eligibility

- Plan may require employees to meet the general eligibility requirements of:
  - Age 21 and one year of service.

403(b) Plans
Contributions

- Contributions to 403(b) Plans
- Employee elective deferrals:
  - Tax deductible
  - Subject to payroll taxes
  - Limited to $23,000 per year for 2024, plus $7,500 for 2024 for catch-up (50 and over)
    - Combined limit with other CODA plans
- Employer may match or provide non-elective contribution

403(b) Plans
Vesting

- The participant is 100% vested in all employee contributions to a 403(b) plan.
- If the employer contributes, then the employer can require vesting on their contributions.

403(b) Plans
15-year Catch Up – HER Organization

- 15-year catch-up contributions
  - Permits up to an additional $15,000 (maximum $3,000 additional per year) of contributions to the 403(b).
  - Participant must have completed 15 years of service with the employer and have unused deferral.
  - Only applies to HER organizations (Health, Education, Religious)

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403(b) Plans
15-year Catch Up – Example

- For 2024, maximum deferral contribution would be $33,500 for an individual over the age of 50.
  - $23,000 – Employee Deferral
  - $7,500 – Age 50 and over catch-up
  - $3,000 – 15-Year Catch-Up

Exam Tip: Max either be $23,000, $26,000, $30,500, or $33,500!

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403(b) Plans
Investment Choices

- Funds within a 403(b) account can only be invested in either of the following:
  - Insurance Annuity Contracts
  - Mutual Funds
  - SECURE 2.0 Act of 2022 allows for investment in Collective investment trusts. SEC rules need to be modified to have this available.

403(b) Plans
Loan Availability

- Loans from 403(b) plans:
  - Only permissible from ERISA plans
  - Subject to same rules as loans from 401(k) plans

403(b) Plans
Distributions

- 403(b) plans are subject to the same required minimum distribution rules as IRAs and Qualified Plans.
- Distributions follow penalty exceptions of qualified plans.

457 Plans
Types

- Nonqualified Deferred Compensation Plan
  - Eligible tax-exempt entities
  - Eligible governmental entities
- Employee elective tax-deferred savings
- Designated Roth contributions

457 Plans
Public vs. Private Plans

	Public 457(b) Plans	Private 457(b) Plans
Eligible/Ineligible	Eligible	Eligible
Employer/Sponsor	Government	Tax-Exempt – 501(c)
Assets in Plan	Protected by Trust	Not Protected
Contribution Limits	$23,000 (2024)	$23,000 (2024)
Participants	All Employees	Key Management and HC for tax-exempt; all employees for church-related
Pretax and Tax Deferral	Yes	Yes
Catch-Up Available 50 and older	Yes	No
Rollovers	Permitted to 401(k), 403(b), 457(b) or IRA Plans	Only to other 457(b) Plans

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457 Plans
Special Catch Up

- Three years prior to normal retirement age an employee may defer an additional $23,000 for 2024 to the 457(b) plan.
  - Public and private eligible.
  - Limited to prior unused deferral amounts.
  - Maximum contribution equals $46,000 for 2024.
    - $23,000 for 2024 deferral contribution + $23,000 for 2024 catch-up contribution (prior unused contributions).
  - Cannot include 50 and over catch-up contribution when determining the 3-year catch-up (or for Private 457).

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457 (f) Plans

Eligible/Ineligible	Ineligible
Employer/Sponsor	Governmental and Tax-Exempt 501(c)
Assets in Plan	Not Protected by Trust
Contribution Limits	No Limit
Participants	Key Management and HC
Pretax and Tax Deferral	Yes
Catch-Up Available	No
Rollovers	Not Permitted

Deferred Comp and Nonqualified Plans
Why offer deferred compensation?

- To provide benefits to a select group of employees without the limitations of qualified plans.
- To discriminate the provision of benefits to key employees.
- Qualified plans cannot provide sufficient retirement resources for key executives who earn in excess of the covered compensation limit of $345,000 for 2024.

Deferred Comp and Nonqualified Plans
Characteristics

- Do not have the tax advantages of qualified plans.
- Usually involve deferral of income by the executive.
- No mismatch of tax deduction and taxable income.
- Generally, employee must have substantial risk of forfeiture, and must not have constructive receipt of the funds.

Deferred Comp and Nonqualified Plans
Economic Benefit Doctrine

- An employee will be taxed on funds or property set aside for the employee if the funds or property are unrestricted and nonforfeitable.
  - In other words, if there is constructive receipt or no substantial risk of forfeiture the employee will currently have taxable income.

Deferred Comp and Nonqualified Plans
IRC Section 83

- Property transferred to an employee in connection with the performance of services is taxable to the extent the fair market value of the property is greater than the amount paid by the employee.
  - Ordinary income subject to payroll taxes
- Employer gives employee stock with a FMV of $10, and employee pays $3, $7 is taxable as ordinary income for the employee.

Deferred Comp and Nonqualified Plans
Funding Arrangements

- Funded/Unfunded
  - Funded
    - Secular Trusts
    - Rabbi Trusts
  - Arrangements
    - Deferred Compensation
    - Salary Reduction
    - SERP
    - Phantom Stock Plan
    - 401(k) WRAP

Deferred Comp and Nonqualified Plans
Funding Types – Secular Trusts

- Irrevocable Trust
- Holds set-aside funds of a NQDC Plan
  - For the benefit of executive
  - Trust funds are not available to employer or the employer's creditors
- Usually, no substantial risk of forfeiture for employee
  - However, trust may require a vesting period
    - In such a case, the executive would have substantial risk of forfeiture until meeting the vesting period requirements
- Without substantial risk of forfeiture, value of trust is taxable to executive at the time it is funded

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Deferred Comp and Nonqualified Plans
Funding Types – Rabbi Trusts

- Irrevocable Trust
- Holds set-aside funds of a NQDC Plan
  - For the benefit of executive
  - Funds are not available to employer BUT may be available to the employer's general creditors under bankruptcy.
- Substantial Risk of Forfeiture exists.
- Assets within the rabbi trust are not currently taxable to the executive.

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Deferred Comp and Nonqualified Plans
Funding Types – Phantom Stock Plans

- Phantom Stock Plans
  - NQDC Plan
  - Employer gives fictional shares of stock to key executives.
  - At a later time, the stock is valued and the executive will receive the increase in value as compensation.
  - No actual stock is issued.
  - Executive has taxable income and employer has deduction at time payment is made to the executive.

Deferred Comp and Nonqualified Plans
Employer Stock Options

- Stock Options – The right to buy stock at a specified price for a specified period of time.
  - Agreement must be in writing, and holder has no obligation to exercise
- Option price = FMV at date of grant
- Vesting – Right to exercise options only after certain period of time, performance, or occurrence.
- Types of Options
  - Incentive Stock Options (ISOs)
  - Nonqualified Stock Options (NQSOs)
  - Stock Appreciation Rights (SARs)

Deferred Comp and Nonqualified Plans
Employer Stock Options - ISOs

- Incentive Stock Options (ISOs)
  - Statutory Stock Option
  - Ties an employee benefit to the stock price of the company and may provide special taxation.
  - May only be granted to employees.
  - The aggregate fair market value of ISO grants must not exceed $100,000 per year per executive.
  - For ISO special tax treatment, individual must hold stock two years from date of grant, one year from date of exercise.

Deferred Comp and Nonqualified Plans
Employer Stock Options – ISOs (1 of 2)

- Taxation of ISOs
  - Grant Date
    - No taxable income unless exercise price is less than fair market value at date of grant.
  - Upon Exercise
    - No regular tax.
    - AMT adjustment equal to appreciation over the exercise price.

Deferred Comp and Nonqualified Plans
Employer Stock Options – ISOs (2 of 2)

- Taxation of ISOs
  - Upon sale of stock
    - Long-term capital gain treatment for stock appreciation over exercise price.
    - Negative AMT adjustment.
  - Employer does not have a tax deduction related to the ISO.

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Deferred Comp and Nonqualified Plans
Employer Stock Options - ISOs

- Disqualifying Disposition
  - Selling stock acquired from an ISO before two years from grant date or one year from exercise date.
  - Loss of favorable tax treatment.
  - Appreciation over exercise price at exercise date = ordinary income (reported on W-2).
  - Appreciation after exercise date = capital gain (short/long based on holding period beginning at exercise date).
  - Employer has a tax deduction equal to the executive's W-2 income.

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Deferred Comp and Nonqualified Plans
Employer Stock Options - ISOs

- Cashless Exercise
  - An executive exercises an option without cash.
  - Very common.
  - Third-party lends executive cash to exercise the option.
  - Executive repays the lender almost immediately with the proceeds and has W-2 income for the excess value over the exercise price.
  - A cashless exercise is a disqualifying disposition.

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Deferred Comp and Nonqualified Plans
Employer Stock Options - NQSOs

- NonQualified Stock Option (NQSO)
  - Option that does not meet requirements of an ISO.
  - Ties an employee benefit to the performance of the company stock.
  - Exercise does not receive favorable tax treatment.
  - No statutory holding period requirements.
    - Employer's may place holding period requirements on the stock.

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Deferred Comp and Nonqualified Plans
Employer Stock Options - NQSOs

- Taxation of NQSOs
  - Grant Date
    - No taxable income unless exercise price is less than fair market value at date of grant.
  - Upon Exercise
    - Executive will have W-2 income for the appreciation over the exercise price.
    - Employer has income tax deduction for same amount.
  - Upon sale of stock
    - Executive will have capital gain/loss with a holding period beginning at the exercise date.

Deferred Comp and Nonqualified Plans
Employer Stock Options – NQSOs vs ISOs

	NQSO	ISO - Reg		ISO – AMT
Grant	No tax	No tax		No tax
Exercise	W-2 Income (FMV – Exercise Price)	No income		Positive AMT Adjustment (FMV – Exercise Price)
Basis	FMV @ Exercise	Strike Price		FMV @ Exercise
Sale	Capital Gain or Loss (LT/ST depending on holding since exercise	w/in 1 year of exercise OR 2 Yrs of grant	After 1 yr from exercise AND 2 years from grant	Negative AMT Adjustment = the AMT Income previously included
		W-2 Income* (FMV @ Exercise – Strike Price) CG (LT/ST depending on holding since exercise	LTCG	

* Reported on the W2 but not subject to Payroll

Deferred Comp and Nonqualified Plans Employer Stock Options - Gifting

- Gifting of ISOs and NQSOs
  - ISOs
    - Unexercised ISOs cannot be gifted.
    - Can only be transferred after exercise date.
  - NQSO
    - May be gifted if allowed by employer.
    - When donee exercises -
      - Employee will have W-2 income.
      - Employer will have tax deduction.
    - Donee's basis equals exercise price plus W-2 amount.

Practice Question 8

Harry gifted 500 NQSO with an exercise price of $10 per share to his son Jr. in year 1. In year 3, when the price of the stock was $40 per share, Jr. exercised the options. What are the tax consequences to Jr.?

A. Ordinary income of $15,000 and a basis of $15,000
B. Ordinary income of $30,000 and a basis of $40,000
C. No ordinary income and a basis of $5,000
D. No ordinary income and a basis of $20,000

Deferred Comp and Nonqualified Plans
Employer Stock Plans - SARs

- Stock Appreciation Rights (SARs)
  - Rights that grant the holder cash in an amount equal to the excess of the fair market value of the stock over the exercise price.
  - Ties an employee benefit to the value of the employer's stock.
  - Essentially a cashless exercise without any right to purchase the stock.
  - No taxation at grant
    - Unless employee elects IRC Section 83(b) – discussed below.
  - Employee - W-2 income for excess value over exercise price.
  - Employer – Tax deduction for W-2 amount.

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Deferred Comp and Nonqualified Plans
Employer Stock Plans – Restricted Stock

- Restricted Stock Plans
  - Plan which pays executives with shares of the employer stock.
  - The executive does not pay any amount towards the stock.
  - The stock has restrictions preventing the executive from selling or transferring.
    - Usually on a vesting schedule.
    - Creates a substantial risk of forfeiture.
  - Plan increases executive retention and ties the executive's benefit to the employer stock price.

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Deferred Comp and Nonqualified Plans
83(b) election

- IRC Section 83(b)
  - Employee election to include value of stock in taxable income at date of grant rather than at date of vesting or when restrictions are lifted.
  - Any gain in value over the grant date is capital gain rather than W-2 income.
  - If employee does not vest, or otherwise loses rights, no tax deductible loss.
  - Employee's holding period for stock received will be the date the amount was included in the employee's gross income.

Deferred Comp and Nonqualified Plans
83(b) election

- Making the 83(b) election:
  - Must be filed no later than 30 days after the stock is transferred.
  - Employee must file a written statement with the IRS.

Deferred Comp and Nonqualified Plans
Employer Stock Plans – ESPP Plans

- Employee Stock Purchase Plan (ESPP)
  - Allows employees to purchase employer securities at a discounted price and receive favorable tax treatment on the subsequent disposition of the stock (if qualifying disposition).
  - Ties employee benefit to the price of the employer stock.

Deferred Comp and Nonqualified Plans
Employer Stock Plans – ESPP Plans

- Employer can allow employees to purchase stock through an ESPP at a discounted price:
  - No less than 85% of a date determined stock price or an average price.
    - Example of date determined stock price:
      - Lesser of fair market value at the grant date, or exercise date.

Deferred Comp and Nonqualified Plans
Employer Stock Plans – ESPP Plans

- Statutory purchase limit of $25,000 per year.
  - Based on the fair market value of the stock at the date of grant.

Deferred Comp and Nonqualified Plans
Employer Stock Plans – ESPP Plans

- Taxation
  - If held 2 years from grant and 1 year from exercise then the discount is taxed at Ordinary Income rates.
  - If not held for the required holding period then the discount is W-2 Income (OI + payroll)
  - Remaining Gain is LT/ST capital gain with holding period starting at exercise.
- ESPP - Losses
  - Short or Long Term Capital Losses
    - Holding period begins at exercise date

Employee Benefits
VEBA

- Voluntary Employees' Beneficiary Association (VEBAs)
  - Tax exempt trust vehicle
  - Provides out of pocket reimbursement for healthcare costs
  - Available to both employees and retirees
  - May not provide retirement benefits or commuting benefits
  - Taxation of VEBA Benefits
    - Employer deducts contributions to a VEBA
      - Earnings on contributions are not taxed to the employer or employee
    - Employee does not recognize income on contributions to VEBA

End of Retirement Planning

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