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Financial and Estate Planning

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Chapter 9

Employee Benefits

¶901 Overview

Cash is the quintessential employee benefit, but cash alone is not sufficient to attract the best employees in today's competitive economy. Employees have come to expect a wide range of benefits as part of their total compensation package. Employers can provide many such benefits to employees on a tax-free or tax-deferred basis. The tax-favored treatment also works to the advantage of the employer. The employer can often provide benefits at a lower cost than additional cash compensation. The employee benefits by having more after-tax compensation than the employee would have solely from cash compensation.

Tax-free employee benefits generally escape payroll taxes. Another advantage is that the employer can provide such benefits to employees without raising the employee's adjusted gross income (AGI). This benefit is important because some tax benefits and credits are phased out after AGI reaches certain levels.[1] Some other deductions are permitted only to the extent that they exceed a certain percentage of AGI. Medical expenses are allowed as a deduction only to the extent that they exceed 7.5 percent for 2018 of AGI.[2]

This chapter covers, in some detail, what is perhaps the biggest employee benefit of all—the qualified retirement plan. Among other things, this chapter examines the various types of plans, distribution rules, factors in borrowing from plans, and financial planning for plan benefits. This chapter also addresses other popular benefits including health plans, cafeteria plans, and dependent care assistance.

Many of the benefits addressed in this chapter are equally suitable for both highly compensated employees and non-highly compensated employees. However, benefits of a character primarily for highly compensated employees, such as deferred compensation and stock options, are not considered in this chapter. They are discussed in ¶1605.

¶905 Primer on Qualified Retirement Plan Rules

An understanding of the basic qualified retirement plan rules is essential for every financial and estate planner. First, the planner should note that the law does not require that an employer furnish employees with any retirement benefits. However, if the employer offers a qualified retirement plan, the employer and the employees will receive significant income tax benefits. The employer receives a current income tax deduction for contributions to the plan.[3] The plan's earnings accumulate free of current income tax. Employees are generally taxed on their stake in the plan only when their share is distributed to them.

Although the law in this area consists of both tax and labor law provisions, the focus of this chapter is on the tax provisions, though the two sometimes overlap. The labor provisions cover notice requirements, plan administration, nondiscrimination, fiduciary responsibility, and other matters.

.01 Fundamental Aspects of Qualified Plans

Defined contribution versus defined benefit plans. Although a detailed discussion of different types of retirement and benefit plans appears in ¶910 and the paragraphs that follow, an introduction to the two basic types of qualified plans will be helpful in understanding fundamental concepts. Defined contribution and defined benefit plans are the two basic types of qualified plans. All other qualified plans essentially are hybrids of these forms.

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[1] Internal Revenue Code (IRC) Sections 68 and 151(d)(3).
[2] IRC Section 213(a).
[3] IRC Section 404.

A defined contribution or individual account plan involves a fixed employer contribution.[4] The employer's contributions, together with earnings thereon, yield a retirement benefit to the employees. In this type of plan, the contribution is fixed or defined. However, the actual retirement benefit is indeterminable at the outset because the earnings on the contributions ultimately determine the retirement benefit amount. A defined contribution plan formula would be expressed, for example, as 10 percent of employee compensation. The employer would contribute that amount annually to the plan and the plan would credit the contribution to a separate account maintained for a plan participant. Upon retirement, the participant is entitled to receive the amount in the account. A participant who separates from service with the employer before retirement would be entitled to receive the vested interest, if any, in the account.

The other basic plan variety is a defined benefit plan. A defined benefit plan is one in which the amount of the benefit, and not the amount of contribution, is determinable at the outset.[5] Benefit formulas under defined benefit plans are generally stated either as a percentage of final or average pay, or as a percentage of pay for each year of service. For example, an employee might retire with a benefit equal to 50 percent of final pay or average pay. Alternatively, an employee might receive 2 percent of pay for each year of participation up to a maximum of 20 years, yielding a maximum retirement benefit of 40 percent of pay. The contribution required to produce the benefit is determined actuarially and will vary depending on several factors. These factors include the amount of the benefit, the employee's age and projected length of service with the employer, and the plan's history of gains and losses (that is, the investment success of employer contributions).

Ceilings on benefits and contributions. Internal Revenue Code (IRC) Section 415 limits benefits and contributions under qualified plans. If an employer maintains more than one defined benefit plan, all the defined benefit plans will be treated as one defined benefit plan for purposes of determining the limitation on benefits.[6] If an employer maintains more than one defined contribution plan, all the defined contribution plans will be treated as one defined contribution plan for purposes of determining the limitation on contributions and other additions.[7] IRC Section 415 limits governing benefits and contributions are different from the limit on the amount that an employer may deduct. IRC Section 404 prescribes limits on the deductibility of employer contributions. Although the two limits are interrelated, different rules apply to both determinations.

The IRC Section 415 limit for defined contribution plans is expressed in terms of the maximum annual addition. The limit for 2018 is the lesser of 100 percent of compensation or $55,000.[8] The dollar limit is indexed to inflation in $1,000 increments.[9] Annual additions include employer contributions, employee contributions, and reallocated forfeitures.[10]

For 2018, the maximum annual benefit payable under a defined benefit plan is limited to the lesser of $220,000 or 100 percent of the participant's average compensation for the three highest consecutive

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[4] IRC Section 414(i).
[5] IRC Section 414(j).
[6] IRC Section 415(f)(1)(A).
[7] IRC Section 415(f)(1)(B).
[8] IRC Section 415(c)(1).
[9] IRC Section 415(d).
[10] IRC Section 415(c)(2).

years worked.[11] The dollar limit is indexed to inflation in $5,000 increments.[12] Adjustments to the dollar limit apply for early and late retirement.[13] Also, the dollar limit is based on 10 years of plan participation.[14]

Nondiscrimination rules. A plan may not discriminate in favor of highly compensated employees as to benefits or contributions.[15] Generally, all benefits, rights, and features of a qualified plan must be made available in a nondiscriminatory way. However, a plan is not discriminatory merely because benefits or contributions bear a direct relationship to compensation.[16] Certain disparities are permitted,[17] as discussed in the "Plan Integration" section that follows.

The nondiscrimination rules are extremely technical, and plans are always required to be in compliance with them. However, the IRS allows plans to be tested on one representative day of a plan year using simplified methods that do not always require total precision.[18] If the plan does not change significantly, testing only needs to occur once every three years.[19] In addition, certain plans can avoid regular nondiscrimination testing if they satisfy certain design-based safe harbors.

Coverage. The coverage rules require that the plan meet one of the following criteria:[20]

- At least 70 percent of the non-highly compensated employees are covered by the plan.
- The percentage of non-highly compensated employees covered by the plan is at least 70 percent of the percentage of highly compensated employees covered by the plan.
- The plan benefits such employees who qualify under a classification set by the employer and found by the IRS to not discriminate in favor of highly compensated employees. The average benefit under the plan for non-highly compensated employees is at least 70 percent of the benefit available for highly compensated participants.

IRC Section 401(a)(26) requires qualified plans to benefit at least 50 employees or 40 percent of all employees of the employer, whichever is less. This rule applies separately to each qualified plan of the employer and the employer may not aggregate plans to satisfy this requirement. In certain cases, a single plan may be treated as comprising separate plans.

Participation and eligibility. Generally, an employee may not be excluded from plan coverage if the employee is at least 21 years old and has completed a year of service.[21] However, a plan may require, as a condition of participation, that an employee complete up to two years of service with the employer if the plan also gives each participant a nonforfeitable right to 100 percent of the accrued benefit under the

[11] IRC Section 415(b)(1).
[12] IRC Section 415(d).
[13] IRC Sections 415(b)(2)(C) and 415(b)(2)(D).
[14] IRC Section 415(b)(5).
[15] IRC Section 401(a)(4).
[16] IRC Section 401(a)(5)(B).
[17] IRC Section 401(a)(5)(C).
[18] Revenue Procedure 93-42, 1993-2 Cumulative Bulletin (CB) 540.
[19] Ann. 93-130, Internal Revenue Bulletin (IRB) 1993-31 (September 28, 1993).
[20] IRC Section 410(b).
[21] IRC Section 410(a)(1)(A).

plan when the benefit is accrued.[22] Generally, an employer may exclude part-time workers, defined as those who have worked less than 1,000 hours during a year of service.[23]

Benefit accrual. Benefit accrual is a general concept that refers to the amount a participant earns under a qualified plan. In a defined contribution plan, a participant's accrued benefit is the amount set aside in a bookkeeping account. In a defined benefit plan, the accrued benefit is the present value of the retirement benefit being funded.

Revised rules for developing alternative mortality tables. Private sector defined benefit pension plans generally must use mortality tables prescribed by Treasury for purposes of calculating pension liabilities. Plans may apply to Treasury to use a separate mortality table.

For plan years beginning after December 31, 2015, the Bipartisan Budget Act of 2015 provides that the determination of whether the plan has credible information to use a separate mortality table is made in accordance with established actuarial credibility theory. In addition, the plan may use tables that are adjusted from Treasury tables if such adjustments are based on a plan's experience, and projected trends in such experience.[24]

Vesting. All qualified plans must confirm that participants have a nonforfeitable right to fixed percentages of their accrued benefits after a prescribed period. Employees must always be 100 percent vested in their own contributions.[25] Since 2006, all employer contributions to defined contribution plans must vest as rapidly as (1) 100 percent vesting after 3 years of service, or (2) 20 percent after two years and 20 percent each year thereafter to achieve 100 percent vesting after six years of service.[26] All years of service with an employer, after the employee has attained age 18, are taken into account.[27] Special rules apply to a plan maintained pursuant to a collective bargaining agreement.

Employers may always provide more rapid vesting than the minimum vesting requirements.

Two special rules apply in the vesting area. First, top-heavy plans are subject to different vesting requirements, as discussed in subsequent paragraphs.[28] Second, 100 percent vesting is triggered upon both normal retirement age[29] and plan termination, irrespective of the plan's regular vesting schedule.[30]

Funding. In a defined benefit plan, technical rules govern the manner in which benefits must be accrued and funded to ensure that requisite funds will be available when the promised benefit becomes payable.[31] These technical rules apply to a lesser extent to defined contribution (also known as money pur-

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[22] IRC Section 410(a)(1)(B).
[23] IRC Section 410(a)(3)(A).
[24] Bipartisan Budget Act of 2015, Section 503.
[25] IRC Section 411(a)(1).
[26] IRC Section 411(a)(2)(B) as amended by PL. 109-280.
[27] IRC Section 411(a)(4).
[28] IRC Section 416(b).
[29] IRC Section 411(a).
[30] IRC Section 411(d)(3).
[31] IRC Section 412.

chase) pension plans. Failure to satisfy the prescribed funding rules subjects the employer to a nondeductible excise tax.[32] The employer must make the required plan contributions quarterly to satisfy the minimum funding rules.[33]

Fiduciary responsibility. Both labor and tax law provisions contain a number of rules concerning fiduciary responsibility. The term *fiduciary* is broadly defined to include most persons who have an administrative or investment role in connection with a plan. Fiduciaries are subject to a knowledgeable prudent man standard, a duty to diversify investments, and detailed rules forbidding transactions between a plan and parties-in-interest, referred to as prohibited transactions. Actions must be taken in accordance with the best interests of the clients. IRC Section 4975 imposes excise taxes on disqualified persons engaging in prohibited transactions. In addition, elaborate reporting and disclosure rules govern fiduciaries both in their dealings with plan assets, governmental agencies, and plan participants.

Plan integration. Qualified plans are permitted to take into account certain benefits derived from employer contributions to Social Security when determining whether benefit or contribution levels discriminate in favor of the prohibited group.[34] The rationale for this rule is that a greater percentage of a non-highly compensated employee's retirement benefit will be covered by Social Security.

Automatic survivor benefits. Defined benefit plans and certain defined contribution plans must provide for automatic survivor benefits for married participants. A qualified joint and survivor annuity (QJSA) must be provided for a participant who retires. In addition, a qualified preretirement survivor annuity (QPSA) must be provided to the surviving spouse when a vested participant dies before the annuity start date.[35]

The participant may waive the joint and survivor annuity or the preretirement annuity for a spouse, but only if certain notice, election, and written spousal consent requirements are satisfied.[36] Consent contained in a prenuptial agreement does not satisfy the consent requirement. The waiver of either type of annuity by a nonparticipant spouse is not a taxable transfer for gift tax purposes.[37] Plans subject to the survivor annuity rules must offer a qualified survivor optional annuity (QSOA) to participants who waive the QJSA or QPSA.[38]

A plan generally is not required to treat a participant as married unless the participant and the participant's spouse have been married throughout the one-year period ending on the earlier of the participant's annuity starting date or the date of the participant's death.[39]

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[32] IRC Section 4971.
[33] IRC Section 412(m)(3).
[34] IRC Sections 401(a)(5)(C), 401(a)(5)(D), and 401(l).
[35] IRC Section 401(a)(11)(A)(ii).
[36] IRC Section 417.
[37] IRC Section 2503(f).
[38] IRC Section 417(a)(1)(A).
[39] IRC Section 417(d).

> **Planning Pointer.** The preretirement annuity for the surviving spouse of a participant who dies at a young age or with a very small amount of vested accrued benefits is likely to be small. If the plan provides a lump-sum preretirement benefit, the combined value of the lump sum and the annuity may not exceed the amount of death benefits permitted under the incidental death benefit rule.[40]
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> **Planning Pointer.** The preretirement annuity is no substitute for life insurance. A tax-free group term life insurance benefit[41] might be worth much more to the surviving spouse (and the family) than a small preretirement annuity that might not commence until the survivor reaches early retirement age (55) or later.

Top-heavy plans. More stringent rules apply for top-heavy plans, basically defined as plans in which *key employees* have more than 60 percent of the benefits.[42] The important additional requirements are that such plans must provide more rapid vesting[43] and minimum benefits for non-key employees.[44]

Since 2006, fewer plans will be deemed to be top heavy. Adjustments to the minimum benefit or contribution rules reduce the cost to employers. A safe harbor applies to 401(k) plans that meet certain requirements for the actual deferral percentage nondiscrimination test[45] and that meet the requirements for matching contributions.[46] Such 401(k) plans are specifically excluded from the definition of a top-heavy plan.[47] A special rule for 401(k) plans not deemed to be top heavy but that belong to an aggregation group that is a top-heavy plan allows the 401(k) plan's contributions to be taken into account in determining whether any other plan in the group meets the IRC Section 416(c)(2) minimum distribution requirements.[48]

The rule for computing the present value of a participant's accrued benefit or a participant's account balance applies for purposes of determining whether the plan is top heavy. Under this provision, the accrued benefit or account balance is increased for distributions made to the participant during the one-year period ending on the determination date.[49] However, a five-year lookback rule applies for distributions made for a reason other than separation from service, death, or disability. For such distributions, the accrued benefit is increased for distributions made during the five-year period ending on the determination date.[50]

A *key employee* is an employee who at any time during the year was one of the following:[51]

- An officer with annual compensation exceeding $175,000 (for 2018 and indexed for inflation in $5,000 increments)

[40] Revenue Ruling 85-15, 1985-1 CB 132.
[41] IRC Section 79.
[42] IRC Section 416(g)(1)(A).
[43] IRC Sections 416(a) and 416(b).
[44] IRC Sections 416(a) and 416(c).
[45] IRC Section 401(k)(12).
[46] IRC Section 401(m)(11).
[47] IRC Section 416(g)(4)(H)
[48] IRC Section 416(g)(4)(H).
[49] IRC Section 416(g)(4).
[50] IRC Section 416(g)(3)(B).
[51] IRC Section 416(i)(1) and IR 2014-99 (October 25, 2014).

- A 5-percent owner of the employer
- A 1-percent owner with annual compensation exceeding $150,000 (for 2018)

No more than 50 employees may be treated as officers. If the employer has fewer than 50 employees, the number of officers may not exceed the greater of three employees or 10 percent of the employees. Note that the family attribution rules of IRC Section 318 apply in determining if a person is a 5 percent owner.

Employer-matching contributions are considered when determining whether the employer has satisfied the minimum benefit requirement for a defined contribution plan. Any reduction in benefits that occurs because the employer may take matching contributions into account will not cause a violation of the contingent benefit rule of IRC Section 401(k)(4)(A). This provision overrides a provision in Regulation Section 1.416-1, Q&A M-19, which states that if an employer uses matching contributions to satisfy the minimum benefit requirement, the employer may not use such matching contributions for purposes of the IRC Section 401(m) nondiscrimination rules. Thus, employers can take matching contributions into account for purposes of both the nondiscrimination rules and the top-heavy rules.

Another provision applies for determining whether a defined benefit plan meets the minimum benefit requirement. Under this provision, any year in which the plan is frozen is not considered a year of service for purposes of determining an employee's years of service. A plan is frozen for a year when no key employee or former key employee benefits under the plan.[52]

Definition of highly compensated. A highly compensated employee for 2018 is one who, during 2017, was in the top 20 percent of employees by compensation for that year and who

- was a 5-percent or more owner of the employer, or
- received more than $120,000 in annual compensation (indexed in $5,000 increments) from the employer.[53]

The threshold for being a highly compensated employee is indexed to inflation.[54]

Compensation cap. A $275,000 (for 2018 indexed in $5,000 increments) cap applies to the amount of compensation that may be taken into account for purposes of determining contributions or benefits under qualified plans and simplified employee pension (SEP) plans.[55] This limit is indexed to inflation in $5,000 increments.[56]

Credit for plan startup costs of small employers. Employers with no more than 100 employees who received at least $5,000 of compensation from the employer for the previous year may claim a tax credit for some of the costs of establishing new retirement plans.[57] The credit is 50 percent of the startup costs

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[52] IRC Section 416(c)(1)(C)(iii).
[53] IRC Section 414(q) and IR 2014-99 (October 25, 2014).
[54] IRC Sections 414(q)(1) and 415(d).
[55] IRC Sections 401(a)(17)(A) and 404(l).
[56] IRC Sections 401(a)(17)(B) and 404(l)
[57] IRC Sections 45E(c)(1) and 408(p)(2)(C)(i).

the small employer incurs to create or maintain a new employee retirement plan.[58] The maximum amount of the credit is $500 in any one year, and an eligible employer may claim the credit for qualified costs incurred in each of the 3 years beginning with the tax year in which the plan becomes effective.[59] The employer may elect to claim the credit in the year immediately before the first year in which the plan is effective.[60] In addition, an eligible employer may elect not to claim the credit for a tax year.[61] A new employee retirement plan includes a defined benefit plan, a defined contribution plan, a 401(k) plan, a savings incentive match plan for employees (SIMPLE), or a SEP plan.[62] The plan must cover at least one employee who is not a highly compensated employee.[63] Qualified startup costs include any ordinary and necessary expenses incurred to establish or administer an eligible plan or to educate employees about retirement planning.[64] The credit allowed reduces the otherwise deductible expenses to prevent a double tax benefit.[65] The credit is allowed as a part of the general business credit.[66]

Credit for elective deferrals and IRA contributions. An eligible individual may claim a nonrefundable tax credit for elective deferrals and IRA contributions.

An eligible individual means an individual who is at least 18 years old at the end of the tax year, is not a student as defined in IRC Section 152(f)(2), and who cannot be claimed as a dependent on another taxpayer's return.[67]

The credit is in addition to any allowable deduction or exclusion from gross income. Its purpose is to encourage taxpayers with low or moderate incomes to establish and maintain retirement savings plans. The credit will not reduce a taxpayer's basis in an annuity, endowment, or life insurance contract. The credit is equal to the applicable percentage (described as follows) multiplied by the amount of qualified retirement plan savings contributions for the year up to $2,000.[68]

A taxpayer must reduce the contribution amount by any distributions received from a qualified retirement plan, an eligible deferred compensation plan, and a Roth IRA (other than qualified rollover contributions) during the testing period.[69] Distributions received by a taxpayer's spouse are treated as received by the taxpayer for purposes of computing the credit if the couple files a joint return.[70] However, certain distributions such as loans from annuities, distributions of excess contributions, and rollover distributions from traditional IRAs are not considered distributions for purposes of computing the credit.[71] The testing period includes (1) the current tax year, (2) the two preceding tax years, and (3) the period after

58 IRC Section 45E(a).
59 IRC Section 45E(b).
60 IRC Section 45E(d)(3).
61 IRC Section 45E(e)(3).
62 IRC Section 45E(d)(2).
63 IRC Section 45E(d)(1)(B).
64 IRC Section 45E(d)(1)(A).
65 IRC Section 45E(e)(2).
66 IRC Section 38(b)(14).
67 IRC Section 25B(c).
68 IRC Section 25B(a).
69 IRC Section 25B(d)(2).
70 IRC Section 25B(d)(2)(D).
71 IRC Section 25B(d)(3)(C).

such tax year and before the due date for filing the income tax return for the year, including extensions.[72]

The maximum credit is 50 percent of the elective deferral or IRA contribution up to $2,000. However, the credit percentage is reduced or eliminated for taxpayers with modified AGI (computed without regard to the exclusions for foreign earned income, foreign housing, and income from possessions of the United States or Puerto Rico) greater than certain limits.[73]

In 2018, the credit rate is completely phased out when AGI exceeds $63,000 for joint return filers; $47,250 for head of household filers; and $31,500 for single and married filing separately filers. The applicable percentage is the percentage determined in accordance with the following table.[74]

AGI Limitation

Joint Return Over		**Head of Household**		**All Other Cases**		**Applicable Percentage**
$ 0	$38,000	$ 0	$28,500	$ 0	$19,000	50%
38,001	41,000	28,500	30,750	19,000	20,500	20%
41,001	63,000	30,751	47,250	20,501	31,500	10%
63,000		47,250		31,500		0%

.02 Distributions From Qualified Plans

Generally, distributions must commence no later than April 1 of the year following the year in which the employee attains age 70½. An employee who is still working past age 70½ may choose to delay receipt of a qualified plan distribution until April 1 of the calendar year following the calendar year of retirement.[75] This alternative is not available to plan participants who are at least 5-percent owners of the company, nor does it apply to required distributions from IRAs.[76]

Planning Opportunity: A person who has an IRA and is an employee (not a 5-percent or more owner) covered by an employee plan can transfer the IRA to the employee plan (if the plan accepts such transfers) and delay the required minimum distributions. Similarly, a person who is a 5-percent or more owner of one company (Company 1) and an employee of another company owning less than 5 percent of that company (Company 2) can transfer the plan interest from Company 1 to Company 2 and delay the required minimum distributions. If required minimum distributions are already required in the year this is done, those distributions must be taken in the year of transfer before the transfer is completed.[77]

[72] IRC Section 25B(d)(2)(B).
[73] IRC Section 25B(b).
[74] IR 2017–177 (October 19, 2017).
[75] IRC Section 401(a)(9)(C)(i).
[76] IRC Section 401(a)(9)(C)(ii).
[77] PLR 200453015

The required distribution requirements generally applicable to retirement plans were suspended for 2009 with respect to defined contribution arrangements.[78] The required minimum distribution rules returned in 2010 and remain in effect going forward.

IRC Section 457 plans need only satisfy the minimum distribution rules applicable to qualified plans.[79] Amounts deferred under an IRC Section 457 plan sponsored by a state or local government are includible in the employee's gross income only when paid, rather than when otherwise made available to the employee.[80] This rule applies only to governmental IRC Section 457 plans and not to plans sponsored by tax-exempt organizations.

If an employee chooses to delay receipt of distributions until commencement of a post-age 70½ retirement, the employee's accrued pension benefit must be actuarially adjusted to reflect the value of the benefits that the employee would have received if the employee had chosen to retire at age 70½ and then began receiving benefits.[81] This actuarial adjustment rule does not apply to defined contribution plans, governmental plans, or church plans.[82]

Distributions are to be made, in accordance with regulations, over a period that does not extend beyond the life expectancy of the employee and the employee's designated beneficiary.[83]

Minimum distributions must comply with requirements of IRC Section 401(a)(9) and the lengthy regulations issued thereunder.[84]

Although delaying distributions may be the preferred route for many, some employees may want to begin receiving distributions while still working. Pension benefits may commence at age 62, even though an employee continues to work. A pension plan will not fail to be a qualified retirement plan solely because the plan stipulates that a distribution may be made to an employee who has attained age 62 and who is not separated from employment at the time of the distribution.[85]

Under final IRS regulations, a pension plan may begin the payment of retirement benefits after the participant has reached the plan's normal retirement age, even if the participant has not separated from service. In general, a plan's normal retirement age must not be earlier than the earliest age that is reasonably representative of the typical age for the employer's industry. As a safe harbor, a normal retirement age of at least age 62 will meet the requirement. If a plan's normal retirement age is between ages 55 and 62, then the determination of whether the normal retirement age meets the general rule is based on all of the relevant facts and circumstances. A normal retirement age that is lower than age 55 is presumed to be earlier than the earliest allowable age, unless the IRS determines otherwise.[86]

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[78] IRC Section 401(a)(9)(H), as added by the Worker, Retiree, and Employer Recovery Act of 2008 (Public Law No. 110-458).
[79] IRC Section 457(d)(2).
[80] IRC Section 457(a)(1)(A).
[81] IRC Section 401(a)(9)(C)(iii).
[82] IRC Section 401(a)(9)(C)(iv) and Conference Report to the Small Business Job Protection Act of 1996 (Public Law No. 104-188).
[83] IRC Section 401(a)(9)(A).
[84] Regulation Sections 1.401(a)(9)-0 through 1.401(a)(9)-9.
[85] IRC Section 401(a)(36).
[86] Regulation Section 1.401(a)-1(b)(2).

Calculating the required minimum distribution. The Commissioner may waive the 50-percent excise tax imposed under IRC Section 4974 for a tax year if the payee assures the Commissioner that the failure to distribute the required minimum distribution was due to reasonable error and that reasonable steps are being taken to correct the error.[87] Under the regulations, plan participant taxpayers must calculate the required minimum distribution using the Uniform Lifetime table in all situations, regardless of the beneficiary, unless the employee's spouse is the only beneficiary and is more than 10 years younger than the employee. In cases when the spouse of the participant is the sole plan beneficiary named by the participant and is more than 10 years younger than the participant, the required minimum distributions are calculated by using the Joint and Last Survivor Table.[88] This table is used to give the younger spouse, who will presumably be the survivor, an opportunity to collect some of the older spouse's retirement plan benefits. The following is a reproduction of the Uniform Lifetime table:

Uniform Lifetime Table			
Age	**Distribution Period**	**Age**	**Distribution Period**
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115 and older	1.9

[87] Regulation Section 54.4974-2, Q&A 7.
[88] Regulation Section 1.409(a)(9)-9, Q&A 2.

To calculate the required minimum distribution, the taxpayer finds the distribution period in the table based on his or her age at the end of the year. The taxpayer then divides the account balance as of December 31 of the previous year by the distribution period to determine the required minimum distribution. The taxpayer returns to the table each year to determine the new distribution period to use to calculate the required minimum distribution. Because the table has a distribution period of 1.9 years even for someone who is more than 115 years old, the regulations never require a taxpayer to deplete the entire account balance. Thus, the account holder will not outlive his or her benefits and may always leave some portion of the retirement plan to a beneficiary as long as voluntary withdrawals do not deplete the retirement account.

Planning Pointer. The IRS provides an IRA Required Minimum Distribution Worksheet to calculate RMDs for the current year.

> **Example 9.1.** Simon had $500,000 in his defined contribution pension plan on December 31, 2017. On December 31, 2018, Simon will be 73 years old. The distribution period for a person age 73 in 2018 is 24.7 years. His required minimum distribution for 2018 is calculated as follows: $500,000 ÷ 24.7 = $20,242.91. If, on December 31, 2018, Simon has $560,000 in his defined contribution pension plan, his required minimum distribution for 2019 (when he will be 74 years old) would be calculated as follows: $560,000 ÷ 23.8 (the factor for age 74) = $23,529.41.

The account holder does not have to designate a beneficiary or select a distribution method to compute the minimum required distribution. Only one required distribution method applies to all participants unless the more than 10-year younger spousal exception applies. As illustrated in the following example, if the designated beneficiary is the account holder's spouse and the spouse is more than 10 years younger than the account holder, the account holder may use the longer of the period determined under the Uniform Lifetime table or the couple's actual joint life expectancy using the Joint and Last Survivor Table in Regulation Section 1.401(a)(9)-9, Q&A 3 to calculate the required minimum distribution.[89]

> **Example 9.2.** Ron has a defined contribution pension fund with a balance of $340,000 on December 31, 2017. His wife, Gladys, is 15 years younger. On December 31, 2018, Ron will be 75 years old and Gladys will be 60 years old. If Hurst used the Uniform Lifetime table, his required distribution period would be 22.9 years. His required minimum distribution for 2018 would be computed as follows: $340,000 ÷ 22.9 = $14,847.16. However, using the couple's actual joint life expectancy, the distribution period is 26.5 years from Joint and Last Survivor Table in Regulation Section 1.401(a)(9)-9, Q&A 3. The required minimum distribution is calculated as follows: $340,000 ÷ 26.5 = $12,830.19.

Beneficiary selection. The term *designated beneficiary* has special meaning with respect to retirement distributions. Although the law allows a trust designated as a beneficiary to be looked through to its actual individual beneficiaries, generally, only an individual may be a *designated beneficiary*.

The regulations provide a flexible approach to the designation of a beneficiary. They allow for the selection or change of a beneficiary after the plan participant's required beginning date without penalty in terms of the required minimum distribution amount. The rules allow for a designation of beneficiary to be recognized up until September 30 of the calendar year following the calendar year of the account

[89] Regulation Section 1.401(a)(9)-5, Q&A 4(b).

holder's death.[90] Accordingly, not only may the account holder change beneficiaries after the required beginning date, but a postmortem beneficiary change motivated by estate planning strategies may be accomplished through a disclaimer. In a case in which the account holder has selected multiple beneficiaries and one of them is not an individual (for example, a charity), the regulations allow for buying out a beneficiary who is not an individual by paying the beneficiary all benefits due before September 30 of the calendar year following the calendar year of the account holder's death. Thus, a charity could be disregarded in determining a designated beneficiary for purposes of the distribution rules.

The rule allowing a post-mortem beneficiary change requires that any change be made to a beneficiary designated by the decedent through available post-mortem planning, such as by means of a qualified disclaimer under IRC Section 2518. Fiduciaries cannot appoint new plan beneficiaries not authorized by the decedent.

If the account holder *has* designated a beneficiary other than his or her spouse or estate, the life expectancy method[91] will now apply rather than the five-year rule.[92] This will allow the chosen beneficiary or beneficiaries to take minimum required distributions over the beneficiaries' own remaining life expectancies. In fact, except in the case of a contrary plan provision or election of the five-year rule, the life expectancy rule will always apply if the account holder has a designated beneficiary. If there was no designated beneficiary as of September 30 of the calendar year following the calendar year of the employee's death and the employee died before his or her required beginning date (the April 1 following the year in which the employee turned age 70½), the five-year rule applies automatically.[93]

The application of this rule means that the participant's plan benefit must be withdrawn from the plan by the end of the fifth year following the participant's year of death. If the participant died after reaching his or her required beginning date, the required period of withdrawal, if there was no designated beneficiary, would be the remaining actuarial life expectancy of the deceased participant beginning in the year following the year of the participant's death. For each year after the participant's death, the distribution period is reduced by one year.[94] Note that a person's estate is *not* considered a designated beneficiary under these rules. Accordingly, naming one's estate as a designated plan beneficiary will likely result in a faster required withdrawal of plan assets than if an individual beneficiary or a trust for individual beneficiaries is named.

Planning Pointer. The rule allowing a change in beneficiary until September 30 of the calendar year following the calendar year of the account holder's death is very beneficial. The rules allow a disclaimer to be coupled with use of a younger contingent beneficiary's life expectancy in the required minimum distribution calculation. Thus, the regulations allow significant tax deferral. However, a financial planner should not interpret the regulations to mean that an account holder no longer needs to select a designated beneficiary. The flexibility provided by the potential to change beneficiaries by a disclaimer is welcome, but the account holder should still designate a beneficiary, and also successor beneficiaries in case the disclaimer opportunity proves advantageous.

[90] Regulation Section 1.401(a)(9)-4, Q&A 4.
[91] IRC Section 401(a)(9)(B)(iii).
[92] IRC Section 401(a)(9)(B)(ii).
[93] Regulation Section 1.401(a)(9)-3, Q&A 4.
[94] Regulation Section 1.401(a)(9)-5, Q&A 5.

Trust look-through rules. The regulations provide that only individuals may be designated beneficiaries for purposes of determining the required minimum distribution.[95] However, the regulations also provide that if a trust is named as a beneficiary of a retirement plan, the beneficiaries of the trust, and not the trust itself, will be treated as beneficiaries of the participant under the plan for purposes of determining the distribution period under IRC Section 401(a)(9).[96] Unless separate shares within the trust are created for each beneficiary, the trust beneficiary with the oldest age will be the measuring life for minimum required distributions. The trust must be valid under state law, irrevocable, and the trust beneficiaries must be individuals ascertainable at the time of the decedent's death. The trustee of the trust named as beneficiary must provide the administrator of the plan with a final list of beneficiaries of the trust, including information on contingent beneficiaries and remaindermen, as of September 30 of the calendar year following the calendar year of the participant's death. The trustee must provide other administrative information to the plan administrator by October 31 of the calendar year following the calendar year of the participant's death.[97]

Qualified domestic relations order. As provided under IRC Section 401(a)(13), retirement assets may be assigned pursuant to a qualified domestic relations order (QDRO). A QDRO is an order, judgment, or decree that relates to child support, alimony, or property rights of a spouse or former spouse, child, or dependent of the participant made pursuant to a state domestic relations law.[98] The regulations provide that a former spouse to whom all or a portion of the participant's qualified retirement plan benefit is payable pursuant to a QDRO will be treated as a spouse (including a surviving spouse) of the participant for purposes of IRC Section 401(a)(9), regardless of whether the QDRO specifically provides that the former spouse is treated as the spouse for purposes of IRC Sections 401(a)(11) and 417.[99] This rule applies regardless of the number of former spouses a participant has who are alternate payees with respect to the participant's qualified retirement benefits.

In addition, if a QDRO divides the individual account of a participant in a defined contribution plan into separate accounts for the participant and for the alternate payee, the required minimum distribution to the alternate payee during the participant's lifetime must still be determined using the same rules that apply to distributions to the participant. Thus, required minimum distributions to the alternate payee must commence by the participant's required beginning date. The required minimum distribution for the alternate payee during the lifetime of the participant may be determined using the Uniform Lifetime table. Alternatively, if the alternate payee is the participant's former spouse and is more than 10 years younger than the participant, the required minimum distribution is determined using the joint life expectancy of the participant and the alternate payee.

QDRO-based rules also apply to distributions, transfers, and payments from IRC Section 457 deferred compensation plans.[100] For purposes of determining whether a distribution from an IRC Section 457 plan is made pursuant to a QDRO, the special rule of IRC Section 414(p)(11) for governmental and church plans will apply. A distribution or payment from an IRC Section 457 plan will be treated as made from a QDRO if the plan makes the payment pursuant to a domestic relations order and the order creates or recognizes the existence of an alternate payee's rights to, or assigns to an alternate payee the right to,

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[95] Regulation Section 1.401(a)(9)-4, Q&A 3.
[96] Regulation Section 1.401(a)(9)-4, Q&A 5.
[97] Regulation Section 1.401(a)(9)-4, Q&A 6.
[98] IRC Section 414(p).
[99] Regulation Section 1.401(a)(9)-8, Q&A 6.
[100] IRC Sections 414(p)(10), 414(p)(11), and 414(p)(12).

receive all or a portion of the benefits payable to the participant in the plan.[101] Rules similar to IRC Section 402(e)(1)(A) will apply to a distribution or payment pursuant to a QDRO.

If a QDRO orders a distribution of funds from a participant's plan to a spouse or former spouse, those funds will not represent taxable income to the plan participant. The spouse or former spouse will be responsible for the income tax due on the payment. The 10 percent early withdrawal penalty will not apply.

If the alternate payee is a child or dependent (rather than a spouse), then the distribution will be taxed to the plan participant. In such a case, the 10 percent early withdrawal penalty will still not apply.

If there is no QDRO between the spouses, and retirement plan assets are distributed to a spouse (or anyone else), then the distribution will be taxed to the plan participant. Furthermore, the 10 percent early withdrawal penalty may apply, as may income tax withholding requirements.

If the alternate payee is the spouse or former spouse, the taxable part of any distribution received by such person will qualify as an eligible rollover distribution. Thus, it can be rolled over into an IRA. If the alternate payee is a child or other dependent, the money may not be rolled over into an IRA.

Timing of distributions. If a participant in pay status dies before his or her entire interest has been distributed, the balance must be distributed to the participant's beneficiary at least as rapidly as it would have been distributed under the method in effect at the participant's death, subject to several exceptions described next.[102]

If distributions have not commenced before the participant's death, the balance must be distributed in five years,[103] subject to the following exceptions. First, if the participant has designated a beneficiary other than a spouse, distributions may be made over a period that does not extend beyond the beneficiary's life expectancy. Such distributions must begin no later than the end of the year after the year of the participant's death (or such later date as the IRS may permit).[104] Second, if the designated beneficiary is the participant's spouse, distribution need not commence until the date on which the participant would have attained age 70½ or, if the spouse is younger than the participant and rolls over the participant's benefit to the spouse's own IRA, distributions from the spouse's IRA need not commence until the date the surviving spouse attains age 70½.[105]

The distribution rules present opportunities for clients who have no present need for distributions to take them over longer periods. By deferring the receipt of payments, the clients derive the benefit of deferred payment of taxes and continued tax-free buildup of the funds during the deferral period. In addition, if the client or his or her beneficiary is in a lower tax bracket when the plan distributes the money, the recipient will realize further benefits.

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[101] IRC Section 414(p)(11).
[102] IRC Sections 72(s)(1)(A) and 401(a)(9)(B).
[103] IRC Sections 72(s)(1)(B) and 401(a)(9)(B)(ii).
[104] IRC Sections 72(s)(2) and 401(a)(9)(B)(iii).
[105] IRC Sections 72(s)(3) and 401(a)(9)(B)(iv).

Retirement plan distributions are not considered as net investment income under the 3.8 percent net investment income tax rules. However, the receipt of taxable retirement benefits will increase the taxpayer's modified AGI, potentially causing other income to be subjected to the net investment income tax.

In figuring the amount that must be distributed each year under the regulations, a participant's life expectancy must be recalculated annually using the Uniform Lifetime table. The joint life expectancy of a participant and his or her spouse who is more than 10 years younger than the participant must also be recalculated annually using the Joint and Last Survivor tables in Regulation Section 1.409(a)(9)-9, Q&A 3.[106]

An individual who fails to take a required distribution must pay a 50-percent nondeductible excise tax on the excess of the minimum required distribution over the amount actually distributed.[107] This is sometimes called the *excess accumulations tax*. The IRS can waive this penalty on a case-by-case basis if the payee can establish that the shortfall in the required distribution was due to reasonable error and reasonable steps are being taken to remedy the shortfall.

In order to waive the penalty, it is not necessary to request a private letter ruling and pay the required user fee. Reasonable cause to avoid the penalty includes proof of serious illness, mental incapacity, financial institution error, natural disaster, or seizure of funds by a court pending the outcome of litigation over who was entitled to the account.

Form 5329 should be filed for each year that reflects a shortfall in the required payment. Form 5329 can be attached to Form 1040 if that form has not yet been filed. Otherwise, for years when the income tax return has already been filed, file Form 5329 for each shortfall year as a separate stand-alone return. The client should take the missed required distribution as soon as possible.

It is suggested that the client take a separate withdrawal check for each year that a required distribution was missed, that the check not be combined with any other distribution, and that the client not have any taxes withheld from the "shortfall" check.

Additional tax on premature withdrawals. Early withdrawals from qualified plans (as well as from IRC Section 403[b] annuities and IRAs) are subject to a 10-percent additional excise tax.[108] Early withdrawals generally are distributions made before age 59½, or in the absence of the plan participant's death or disability.[109] This additional tax is often called a penalty, but it is technically an additional tax. Unlike penalties, which a taxpayer may avoid for reasonable cause, a taxpayer must meet a specific statutory exception to avoid this additional tax. The following are recognized exceptions to the additional tax:[110]

- A distribution that is part of a scheduled series of substantially equal periodic payments based on the life of the participant (or the joint lives of the participant and the participant's designated

[106] IRC Section 401(a)(9)(D).
[107] IRC Section 4974(a).
[108] IRC Section 72(t)(1).
[109] IRC Section 72(t)(2)(A).
[110] IRC Section 72(t)(2).

beneficiary) or the life expectancy of the participant (or the joint life expectancies of the participant and the participant's designated beneficiary). Such periodic payments must last at least five years or until the participant attains age 59½, whichever occurs later.

- A distribution from a qualified plan to an employee after separation from the employer's service and after attainment by the employee of age 55.
- A distribution that does not exceed the amount allowable as a medical expense deduction (that is, expenses in excess of 7.5 percent in 2018 of AGI determined without regard to whether the taxpayer itemizes deductions).
- Payments made from a qualified plan to or on behalf of an alternate payee pursuant to a QDRO.
- Certain distributions of excess contributions to and excess deferrals under a qualified cash or deferred arrangement.
- Dividend distributions under IRC Section 404(k).

In the case of distributions from IRAs, the post-age 55 and QDRO exceptions do not apply.

The 10-percent additional tax on early distributions will not apply to distributions from an IRA that are used to pay for the following:

- Health insurance premiums of an unemployed individual after separation from employment[111]
- Qualified higher education expenses[112]
- First-time homebuyer expenses (a lifetime cap of up to $10,000 or $20,000 for a married couple) and expenses for persons called to active duty in the military[113]
- A one-time transfer from an IRA to fund a health saving account contribution
- The exception for a series of substantially equal periodic payments described previously applies to IRAs
- Withdrawals by a reservist called to active duty
- IRS levy

The qualified higher education expense exception covers amounts withdrawn and used to pay qualified higher education expenses (tuition, fees, books, and supplies) of the taxpayer, spouse, children, and

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[111] IRC Section 72(t)(2)(D).
[112] IRC Section 72(t)(2)(E).
[113] IRC Section 72(t)(2)(F) and (G).

grandchildren. The amount of qualified educational expenses is reduced by payments received for a student's education that are excludable from gross income (such as a qualified educational scholarship, educational allowance, or payment).[114]

Planning Pointer. The amount that can be withdrawn from the IRA without imposition of the 10-percent additional tax is generally reduced by excludable educational payments.[115] However, this rule does not apply to excludable payments arising from a gift, bequest, devise, or inheritance.[116] Thus, planned or unplanned gratuitous payments for the student's education will not cause an otherwise qualifying educational early withdrawal to be subjected to the 10-percent additional tax. The IRA withdrawal for educational expenses must be made at the same time the payment for the education expense is required.

An additional exception to the 10 percent excise tax for early withdrawals was added by 2015 legislation. This exception is for distributions from an IRC Section 414(d) defined benefit governmental plan made to a "qualified public safety employee" who has separated from service after attaining age 50.[117]

Under the Trade Preference Extension Act of 2015 (TPA Act), effective for distributions made after December 31, 2015, the term *qualified public safety employees* for IRC Section 72(t) purposes is broadened to allow younger workers to collect sooner and includes specified federal law enforcement officers, customs and border protection officers, federal firefighters, and air traffic controllers,[118] and the types of plans from which distributions eligible for the exception can be made is broadened to include defined contribution plans and other types of governmental plans.[119] Additionally, the fact that a federal public safety worker takes such newly permissible distributions will not constitute a modification of otherwise qualifying substantially equal periodic payments under IRC Section 72(t)(4)(A)(ii).[120]

Hardship distributions. There is no general hardship exception to the 10 percent early withdrawal penalty. In order to qualify for relief, a taxpayer must fit within one of the enumerated statutory exceptions or use the series of substantially equal periodic payments exception. The courts have not been sympathetic to claims of relief from the penalty in situations in which funds have been withdrawn to pay for subsistence living or to avoid jail for failure to pay child support.[121] Several cases have imposed the penalty tax when the taxpayer withdrew the funds from a qualified plan in which only IRA withdrawals are permitted as penalty-free. Had the taxpayer rolled over the plan distribution to an IRA and then withdrew the funds from the IRA to pay such expenses, the IRA withdrawal would have satisfied the exception, and the penalty tax would not have been imposed.[122]

The hardship withdrawal rules from plans such as 401(k) plans, 457 plans, and certain nonqualified deferred compensation plans are more generous. The rules now extend permitted withdrawals for hardships and unforeseen emergencies not only to the participant and his or her dependents, but also to *any* beneficiary named under the plan, regardless of the beneficiary's relationship to the participant. This

[114] IRC Section 72(t)(7).
[115] IRC Section 72(t)(7)(B).
[116] IRC Sections 72(t)(7)(B) and 25A(g)(2)(C).
[117] IRC Section 72(t)(10).
[118] IRC Section 72(t)(10)(B).
[119] IRC Section 72(t)(10)(A), as amended by TPA Act Sec. 2(b).
[120] IRC Section 72(t)(4)(A)(ii), as amended by TPA Sec. 2(c).
[121] *Robertson v. Commissioner*, TC Memo 2000-100; *Czeipel v. Commissioner*, TC Memo 1999-289.
[122] *McGovern v. Commissioner*, TC Summ. Op. 2003-137 (higher education expenses); *Joseph v. Commissioner*, TC Summ. Op. 2003-153 (first-time homebuyer expenses).

new provision certainly underscores the importance of paying attention to one's beneficiary designation forms and keeping them updated.

The IRS issued new guidelines (February 23, 2017) addressing hardship withdrawals from 401(k) plans. Unlike a loan from the plan, participants do not have to repay the funds accessed via a hardship withdrawal. Absent proof of hardship, however, the withdrawal may be subject to income tax and the 10 percent excise tax. The plan participant must prove there is a serious and immediate need for the money and that the distribution is necessary to satisfy that need.

Items that qualify for hardships include expenses related to medical care, purchase of a principal residence, tuition, prevention of eviction from a principal residence, burial or funeral expenses, and repair of damages to a principal residence. The IRS requires verification that a distribution is for one of the foregoing reasons. IRS auditors are instructed to look for "source documents" such as estimates, statements, and receipts addressing the hardship or a summary in paper or electronic format or telephone records verifying the information contained in the source documents. It is important for the participant to retain these documents and make them available to the plan sponsor or administrator upon request.

The Tax Court has determined that a retired police officer who received two distributions from his retirement accounts while suffering from major depressive disorder and failed to roll them over into another qualified retirement account within the requisite 60-day period was entitled to a hardship waiver under IRC Section 402(c)(3)(B). (*Trimmer v. Commissioner*, 148 T.C. # 14 (2017).)

Tax treatment of distributions. Amounts distributed from qualified plans are subject to being taxed as annuities or as lump-sum distributions, or may qualify for tax-free rollover treatment.[123] Each is separately discussed in the following sections. Early withdrawals are subject to a 10-percent additional tax, as previously discussed. Failure to take a large enough required distribution may result in a 50-percent penalty, as previously discussed.

Annuity rules. As a general rule, qualified plan distributions are taxed under the annuity rules of IRC Section 72. Under these rules, a portion of each payment is treated as a tax-free return of employee contributions, if applicable, and a portion of each payment is taxable. The annuity rules are discussed in detail in chapter 8, "Annuities."

Lump-sum distributions. Ten-year averaging and pre-1974 capital gain treatment for lump-sum distributions continue to apply only to individuals who attained age 50 before January 1, 1986.

An individual who attained age 50 before January 1, 1986, and who receives a lump-sum distribution from a qualified plan, is permitted to use 10-year averaging to report the distribution and to elect capital gain treatment with respect to the pre-1974 portion of a lump-sum distribution, with the capital gain being taxed at a flat rate of 20 percent. This special rule may be used by any individual, trust, or estate in regard to a lump-sum distribution with respect to an employee who had attained age 50 by January 1, 1986. Form 4972 is used to report these distributions.

A lump-sum distribution is a distribution made within one taxable year of the receipt of the balance to the credit of the participant in the plan or any plan of the same type on account of the employee's death,

[123] IRC Section 408(d)(3).

after the employee attains age 59½, on account of the employee's separation from service (except in the case of a self-employed individual), or on account of disability in the case of a self-employed individual.[124]

Net unrealized appreciation (NUA) attributable to that part of a lump-sum distribution that consists of employer securities (other than appreciation attributable to deductible employee contributions) is excluded in figuring the tax on the lump sum. The unrealized appreciation attributable to the employer securities is taxable only on a disposition of the securities in a taxable transaction. Ordinary income tax is paid on the cost basis of the stock when a distribution is taken, but the appreciation is taxed at capital gains rates (long-or short, depending on the holding period) when the stock is sold. The NUA does not receive a basis step-up upon death, it is treated as income in respect of a decedent.

Tax-free rollovers. No current income tax is owed on eligible rollover distributions from plans that are rolled over to an eligible retirement plan. An eligible retirement plan that can accept tax-free rollovers is (1) a traditional IRA, (2) a qualified plan, (3) an annuity plan, (4) a Section 403(b) annuity, or (5) a governmental Section 457 plan.[125]

An eligible rollover distribution is any distribution to an employee of part or all of his or her account balance in a qualified trust, except for the following:

- Distributions that are part of a series of substantially equal periodic payments
- Required distributions, such as a minimum distribution required because the taxpayer has reached age 70½[126]

Rollover-eligible distributions can avoid current tax when the employee uses a direct rollover to another eligible retirement plan or, in limited circumstances, takes the distribution personally and rolls it over into another eligible retirement plan within 60 days.[127] However, if a direct rollover is not used, the distribution is subject to 20-percent withholding, making it difficult for the recipient to roll over the entire amount and thereby fully avoid tax on it.[128] Any part of an eligible rollover distribution that is not timely rolled over is subject to current taxation.[129] The financial planner should always recommend direct trustee-to-trustee rollovers, which will avoid withholding issues as well as the client's failure to complete the rollover transaction within the required 60-day period. Transfers to an "inherited IRA" by any non-spouse beneficiary can be accomplished successfully only if there is a trustee-to-trustee transfer.

A surviving spouse who is the named beneficiary of an employee's retirement plan may roll a distribution over to a qualified plan, annuity, or IRA in which the surviving spouse participates, either in a trustee-to-trustee rollover or via a rollover into an IRA within 60 days of receipt of the funds.[130] Distributions to a beneficiary other than a surviving spouse can be rolled over into an inherited IRA for the beneficiary.[131] The IRA receiving the rollover is treated as an inherited IRA. Benefits must be distributed in

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[124] IRC Section 402(d)(4)(A).
[125] IRC Section 402(c)(8)(B).
[126] IRC Section 408(d)(3)(E).
[127] IRC Section 408(d)(3).
[128] IRC Section 3405(c)(1).
[129] IRC Section 408(d)(1).
[130] IRC Section 408(d)(3)(C).
[131] IRC Section 402(c)(11).

accordance with the required minimum distribution rules that apply to inherited IRAs of nonspouse beneficiaries, which require annual minimum required distributions to the nonspouse beneficiary based on the age of the beneficiary commencing in the year following the year of the plan participant's death.

IRS provides relief from the 60-day rollover rule. Late Rollovers May Now Be Accepted.

The IRS issued Revenue Procedure 2016-47 to provide relief for most late 60-day rollovers to IRAs. A self-certification procedure is now available. Clients may use the procedure to roll over distributions from both company plans and all IRAs. The client treats the transaction as a rollover. Nothing need be reported or attached to the client's tax return. A self-certification letter must be provided to the plan administrator or IRA custodian. The administrator or custodian is not required to accept the late rollover to an IRA. No fee is required from the client, thereby avoiding the cost of a private letter ruling, which had previously been the only avenue for relief. Misapplied funds must be deposited into an IRA account. The IRS is not required to accept the self-certification if the criteria for allowance have not been met.

The Revenue Procedure lists 11 acceptable reasons for a late rollover, including financial institution or postal error, misplacing and never cashing the distribution check, depositing the check into an account mistakenly believed to be a retirement account, not obtaining needed information from the distributing company despite attempts to do so, personal misfortune (illness, death of a family member, damage to principal residence, incarceration, problem in a foreign country, IRS levy).

The revenue procedure does not apply to situations in which multiple rollovers in one year are not allowed or anything other than a trustee-to-trustee rollover is prohibited (such as in the case of an inherited IRA).

The best advice: Avoid the problem by using direct trustee-to-trustee transfers in all cases.

Eligible rollover distributions are subject to mandatory 20-percent federal income tax withholding,[132] unless the recipient elects to have the distribution paid directly to another eligible retirement plan in a trustee-to-trustee transfer.[133] Withholding is not required if only employer securities are distributed or if $200 or less in cash is disbursed instead of fractional employer securities.[134] Distributions that are not eligible rollover distributions are excused from mandatory 20-percent withholding.

A direct rollover can be accomplished by any reasonable means, including a wire transfer or a check from the old plan to the trustee (or custodian) of the transferee eligible retirement plan designated by the taxpayer. The check can be mailed to the transferee eligible retirement plan; it can even be given to the participant for delivery to the eligible retirement plan if it is made out properly to the new plan's trustee or custodian. Distributing plans must offer a direct rollover option to participants eligible to receive eligible rollover distributions; however, plans are not required to accept rollover contributions.

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[132] IRC Section 3405(c)(1).
[133] IRC Section 3405(c)(2).
[134] IRC Section 3405(e)(8).

A plan participant may decide that only part of an eligible rollover distribution be transferred via a direct rollover to another plan. In that case, only the part that is not directly rolled over is subject to 20-percent withholding.

Plans are permitted to limit distributees to a single direct rollover for each eligible rollover distribution.[135] Therefore, a retiree who wants a large distribution to be transferred to more than one IRA institution may not be able to accomplish this directly. However, the retiree can achieve this goal by a direct transfer of the entire distribution to one traditional IRA. Trustee-to-trustee transfers can then be made tax-free from that IRA to the others.

A qualified plan may provide for mandatory distributions to employees with small accrued benefits who terminate employment if the present value of the employee's benefit is $5,000 or less. Mandatory distributions must be transferred to an IRA of a designated trustee or issuer if (*a*) the distribution is more than $1,000 but not more than $5,000 and (*b*) the employee receiving the distribution does not elect a direct rollover to another plan or IRA and does not elect to receive the distribution.[136] The plan must notify the employee of the option to have the distribution transferred without cost or penalty to a different IRA.

¶910 Employee Stock Ownership Plan Opportunities

Employers will want to consider the advantages an employee stock ownership plan (ESOP)[137] provides. The ESOP from the employer's standpoint is considered in some detail in ¶1920.

Although employers receive significant benefits under ESOPs, the main focus here is on the benefits that employees can expect to derive from an ESOP. Like most employee benefit plans, an ESOP (under Employee Retirement Income Security Act (ERISA) rules) is designed to benefit participating employees—generally, those who stay with the employer the longest and contribute the most to the corporation's financial success. All cash and employer stock contributed to the ESOP are allocated each year to the accounts of the participating employees under a specific formula.[138] These amounts are held in trust and administered by a trustee who is responsible for protecting the interests of the participants and their beneficiaries.

An employee's ownership generally depends on the vesting schedule adopted by the company within the limits prescribed by IRC Section 411(a), which are the same as those available to other qualified plans (¶905).

In general, unless a participant elects otherwise with any required spousal consent, payment of benefits must commence no later than one year after the later of the close of the plan year (1) in which the participant retires, becomes disabled or dies, or (2) that is the fifth year following the plan year in which the participant otherwise separates from service.[139] Unless the participant elects otherwise, distribution is to be made in substantially equal installments (not less frequently than annually) over a period not longer

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[135] IRC Section 408(d)(3)(B).
[136] IRC Section 401(a)(31)(B).
[137] IRC Section 4975(e)(7).
[138] IRC Section 409(b).
[139] IRC Section 409(o)(1)(A).

than five years.[140] Additional time to distribute is provided if the account balance is over $1,105,000 for 2018.[141] This amount is indexed annually to inflation in $5,000 increments.[142]

Distribution of an employee's vested benefits must normally be made in cash or in shares of employer stock as determined by the administrator of the plan, subject to the distributee's right to demand stock, unless the charter or bylaws restrict ownership of stock to employees.[143]

The following questions and answers are designed to help in further apprising employees of ESOP rights.

Q. May an ESOP provide for the purchase of incidental life insurance whose proceeds are payable to beneficiaries of employees participating in the ESOP?

A. Yes, provided the aggregate life insurance premiums for each participant do not exceed 25 percent of the amount allocated to his or her ESOP account at any particular time. This 25-percent limit applies, regardless of the type of life insurance purchased (for example, ordinary life or term insurance).[144]

Q. May the employer be required to purchase the securities distributed to a participant?

A. Yes, if the securities are not readily tradable on an established market. The price is to be determined by a fair valuation formula.[145] The requirement of a put option is satisfied if the option exists for at least 60 days following distribution of the stock and if it is not exercised within such 60-day period for an additional period of at least 60 days in the following plan year.[146] An employer that is required to repurchase employer securities distributed as part of a total distribution under the put option requirements must pay the employee in substantially equal payments over a period not exceeding five years. In the case of a put option exercised as part of an installment distribution, the employer is required to repay the option price within 30 days of exercise. These last two rules apply to distributions attributable to stock acquired after 1986.

Q. Must an employee be permitted to direct account diversification?

A. Effective with respect to stock acquired after 1986, ESOPs must allow qualified participants (those who have attained age 55 and have completed 10 years of participation in the plan) to direct diversification of up to 25 percent of their account balances over a six-year period (50 percent in the sixth year). The election period generally begins with the plan year during which the participant attains age 55 unless the participant has not yet completed 10 years of service, in which case the period begins in the year in which such service is completed.[147] In addition, more

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[140] IRC Section 409(o)(1)(C).
[141] IRC Section 409(o)(1)(C)(ii).
[142] IRC Section 409(o)(2).
[143] IRC Section 409(h).
[144] Revenue Ruling 70-611, 1970-CB 89.
[145] IRC Section 409.
[146] IRC Section 409(h)(4).
[147] IRC Section 401(e)(28).

generous diversification rights for defined contribution plans that permit the divestiture of all employer securities may apply to certain ESOPs.[148]

Q. May an employee who receives employer stock from an ESOP trust be required to offer to sell the stock to the employer before offering to sell it to a third party?

A. Yes.

Q. What are some of the problems or disadvantages of an ESOP?

A.

1. In a closely held corporation, the major disadvantage of using an ESOP is that a large number of minority shareholders may be created unless stock ownership is restricted to employees or the ESOP.

2. A closely held corporation might have problems with the expense of annual appraisals to determine fair valuation. However, the corporation can overcome these problems by a specific valuation provision or formula.

3. The corporation might have problems of compliance with SEC rules on offerings, disclosure, and stock restrictions.

4. ESOPs are intended to motivate employees and to give them a share of the ownership in their employer-corporation. In a declining market, employees might not be motivated by the potential for appreciation in the value of the stock.

¶915 Individual Retirement Account Opportunities

This section examines the rules and applicable planning strategies related to traditional IRAs—deductible and nondeductible as well as SEP plans, SIMPLE plans, and Roth IRAs.

.01 In General

For tax year 2018, subject to certain phase outs subsequently discussed, every employee or self-employed individual may contribute the lesser of 100 percent of his or her earnings or $5,500 to his or her own IRA.[149] The $5,500 limit is adjusted for inflation in $500 increments. In addition, a taxpayer who is age 50 or older may contribute an additional "catch-up" amount of $1,000 through 2018. The earnings on the contributions increase tax-free until withdrawn. Tax liability will be due when the taxpayer starts making withdrawals (required when age 70½ is reached).

However, IRC Section 219(g) limits the deductibility of IRA contributions in the case of an active participant in a qualified retirement plan, SEP, IRC Section 403(b) annuity, or government plan whose AGI exceeds certain levels. For 2018, if an individual who files a single or head of household return is covered by a qualified retirement plan, his or her IRA deduction begins to phase out when AGI reaches $63,000 and is completely eliminated once income reaches $73,000. For 2018, the phase out begins at

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[148] IRC Section 401(a)(35), as added by Public Law No. 109-280.
[149] RC Section 219(b)(1).

$101,000 for a married individual who is covered by a qualified plan and is complete when income reaches $121,000. The phase out range is higher for a married individual who is not covered by a qualified plan, but whose spouse is covered. For 2018, the individual's deduction phases out if income is between $189,000 and $199,000. For married individuals filing separately, the phase out range is $0–$10,000. These dollar amounts are indexed annually for inflation.

Individuals denied deductions may make nondeductible IRA contributions and achieve deferral of tax on the IRA earnings.[150]

Planning Pointer. The phase out amounts will reduce or eliminate IRA deductions for a good number of individuals and families. If the taxpayer faces this situation, the advisability of nondeductible investments in a traditional IRA should be seriously considered in light of the availability of the Roth IRAs. Roth IRAs do not provide a deduction for contributions, but they do give the benefit of both tax-free buildup (like a traditional IRA) and receiving the IRA funds tax-free on retirement (¶915.04).

Spousal IRAs. Note: Spousal IRAs have been now renamed "Kay Bailey Hutchison Spousal IRAs" in honor of the retired Texas senator. A spouse who does not have earned income or who has only a small amount of earned income can still make the maximum contribution for the year, provided the other spouse's earnings are sufficient to support the contribution. Thus, a spouse with no earned income may contribute as much as $5,500 to an IRA for 2018.[151]However, if the spouse who has earned income is an active participant in an employer-sponsored retirement plan and the couple's AGI is greater than the amount at which the phase out begins, the maximum amount of the spousal IRA contribution that will be deductible will be proportionately reduced in the same way that a nonspousal IRA is reduced.[152]

The $5,500 limit will be adjusted for inflation annually, but may increase only in $500 increments. In addition, a spouse who is age 50 or older may contribute an additional catch-up contribution of $1,000 through 2018.

Additionally, an individual will not be considered to be an active participant in an employer-sponsored plan merely because the individual's spouse was a participant. Thus, most spouses who are not actually participants in an employer plan will be able to make the maximum deductible contribution to an IRA. The maximum deduction for such nonparticipant spouses, however, is phased out for couples with AGIs between $189,000 and $199,000 for 2018.[153]

Deemed IRAs. If a qualified plan allows employees to make voluntary contributions to a separate account or annuity established under the plan, and under the terms of the plan the account or annuity meets the requirements for a traditional IRA or a Roth IRA, the account or annuity will be treated as an IRA and not as a qualified plan for all purposes under the IRC.[154] In addition, a qualified plan will not lose its qualified status solely because it establishes and maintains a deemed IRA program. This provision effectively allows employers to set up traditional IRAs or Roth IRAs for their employees without affecting

[150] IRC Section 408(o)(2)(B).
[151] IRC Section 219(c).
[152] IRC Section 219(g).
[153] IRC Section 219(g)(7).
[154] IRC Section 408(q)(1).

any other qualified plan. The deemed IRA and contributions to it are subject to ERISA's exclusive benefit and fiduciary rules to the extent otherwise applicable to the plan. However, they are not subject to the ERISA reporting and disclosure, participation, vesting, funding, and enforcement requirements applicable to the eligible retirement plan.

Distributions. Distributions from traditional IRAs must commence by April 1 of the year following the year in which the IRA owner attains age 70½.[155] For 2009, the required distribution requirement applicable to IRAs was suspended.[156] The required distribution rules were reinstated prospectively for 2010 and subsequent years.

Failure to take a required distribution results in a 50 percent excise tax.[157] Treasury regulations[158] that govern required minimum distributions from qualified plans also apply to IRAs with some modifications.[159] Taxpayers with IRAs may use the uniform distribution rules without revising their governing documents. The Uniform Lifetime table and more details on the distribution rules are discussed in ¶905.02.

Trustees, custodians, or issuers of IRAs must provide account holders with information regarding the minimum amount required to be distributed from the IRA each year.[160] An IRA trustee must provide a statement to the IRA owner by January 31 following the end of the calendar year if the IRA owner is living and subject to a minimum required distribution.[161] The trustee must inform the IRA owner of the required minimum distribution in accordance with two alternatives.

Under the first alternative, the IRA trustee must provide the IRA owner with a statement of the amount and date of the required minimum distribution with respect to the IRA for the calendar year. The trustee may calculate the amount of the required minimum distribution, assuming that the only beneficiary of the IRA is not the spouse of the IRA owner who is more than 10 years younger than the IRA owner. The trustee may also assume that no amounts received by the IRA after December 31 of the previous year are required to be taken into account to adjust the value of the IRA as of December 31 of the previous year for purposes of calculating the required minimum distribution with respect to rollovers and trustee-to-trustee transfers.

Under the second alternative, the trustee must provide a statement to the IRA owner that a minimum distribution is required for the IRA for the calendar year and the date by which the distribution must occur and offer to provide the IRA owner, upon request, a calculation of the amount of the required minimum distribution. If the IRA owner makes a request for the calculation, the trustee must make the calculation and provide it to the IRA owner.

Under both alternatives, the trustee must inform the IRA owner that the trustee will report to the IRS and the IRA owner must receive a required minimum distribution for the calendar year. The trustee may provide the statement to the IRA owner, along with the statement of the fair market value of the IRA as of December 31 of the previous year by January 31 following the end of the calendar year. The trustee

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[155] C Section 401(a)(9)(C).
[156] IRC Section 401(a)(9)(H), as added by the Worker, Retiree, and Employer Recovery Act of 2008 (Public Law No. 110-458).
[157] IRC Section 4974(a).
[158] Regulation Sections 1.401(a)(9)-0 through 1.401(a)(9)-9.
[159] Regulation Section 1.408-8.
[160] Regulation Section 1.408-8, Q&A 10.
[161] Notice 2002-27, Internal Revenue Bulletin (IRB) 2002-18, 814 (April 16, 2003).

must report to the IRS on Form 5498, "IRA Contribution Information," that a minimum distribution is required. The trustee does not have to report the amount of the required minimum distribution to the IRS. The trustee does not have to file any reports for deceased owners of traditional IRAs or for any Roth IRAs.

The IRS clarified this guidance by providing that IRA trustees may use the first alternative for some IRA owners and the second alternative for other IRA owners. In addition, the IRA trustee may transmit the required statement electronically. The electronic transmission must comply with a reasonable and good faith interpretation of the applicable law. The trustee may provide the information electronically only if the trustee satisfies the procedures applicable to the electronic transmission of Forms W-2, including the consent requirement described in the regulations under IRC Section 6051.[162]

Requiring custodians to inform the IRS that the IRA owner has a required minimum distribution obligation allows the IRS to easily determine whether account holders have taken the required minimum distribution. Account holders who do not take the required minimum distribution are subject to a 50-percent excise tax on the difference between the required minimum distribution and the actual distribution.[163] The law treats taxpayers with multiple IRAs as having one account.[164] The required minimum distribution must be calculated separately for each IRA. However, taxpayers may take distributions from their choice of one or more of their IRAs as long as they take total distributions greater than or equal to the total required minimum distribution.[165] This rule allows holders of multiple IRAs to use lower-yielding IRAs to satisfy the minimum distribution requirements. However, distributions from Roth IRAs or IRC Section 403(b) accounts may not be used to satisfy the required minimum distribution from IRAs.

> **Example 9.3.** Peter is 76 years old. He has two IRAs. On December 31, 2017, the balance in the first IRA is \$180,000 and the balance in the second IRA is \$120,000. His required minimum distribution for 2018 is (\$180,000 + \$120,000) = \$300,000 ÷ 22 = \$13,636.36. (22 is the factor from the Uniform Lifetime table for persons age 76.) Peter may take all of the required minimum distribution from either account or receive a partial distribution from each account as long as the total distribution is at least \$13,636.36.

The regulations provide that the election by a surviving spouse eligible to treat an IRA as the spouse's own IRA may be accomplished by redesignating the IRA with the name of the surviving spouse as owner rather than as beneficiary.[166] This election allows the surviving spouse to wait until reaching age 70½ to take required minimum distributions and to name a new designated beneficiary. If making this election, the spouse should then immediately name a new designated beneficiary.

If the surviving spouse contributed to the IRA or did not take the required minimum distribution for a year under IRC Section 401(a)(9)(B) as a beneficiary of the IRA, the regulations treat the surviving spouse as having made a deemed election to treat the IRA as the surviving spouse's own IRA. The deemed election is permitted only if the spouse is the sole beneficiary of the account and has an unlimited right of withdrawal from it. This requirement is not satisfied if a trust is named as beneficiary of the

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[162] Notice 2003-3, IRB 2003-2 (December 20, 2002).
[163] IRC Section 4974(a).
[164] IRC Section 408(d)(2).
[165] Regulation Section 1.408-8, Q&A 9.
[166] Regulation Section 1.408-8, Q&A 5(b).

IRA, even if the spouse is the sole beneficiary of the trust, unless the spouse obtains a private letter ruling treating the spouse as having all rights in the trust and permitting the spouse to be recognized as owner of the IRA.[167]

Distributions are to be made over a period that does not extend beyond the life expectancy of the IRA owner and the designated beneficiary.[168] If an owner in pay status dies before his or her entire interest has been distributed, the balance must be distributed to the beneficiary at least as rapidly as it would be under the method in effect at the IRA owner's death, subject to important exceptions for rollover IRAs by a spouse and inherited IRAs by other named beneficiaries.[169]

If required distributions have not commenced before the owner's death, the balance must be distributed in five years, subject to the following exceptions.[170] First, if the owner has designated a beneficiary, distributions can be made over a period that does not extend beyond the life expectancy of the designated beneficiary. Such distributions must begin no later than the end of the year following the year of the owner's death.[171] Second, if the designated beneficiary is the owner's spouse, distribution need not commence until the later of the date on which the spouse attains age 70½ or the deceased owner would have attained age 70½.[172]

Also, in the case of holders of multiple IRAs with different beneficiaries, funds can be left in IRAs with younger beneficiaries, thereby maximizing the total possible tax deferral, unless the needs of older beneficiaries dictate otherwise.

If an individual has made no nondeductible contributions to any IRA, the entire amount of any distribution is taxable as ordinary income. If an individual has made a nondeductible contribution to any IRA, special rules apply. Under the special rules, any withdrawal will be taxable on a pro rata basis, taking into account the ratio of the nondeductible contributions to the entire amount in the account.

> **Example 9.4.** If nondeductible contributions over five years add up to $10,000 and earnings thereon equal $5,000, there is $15,000 in the account. Two-thirds of the account represents nondeductible contributions. Accordingly, on a withdrawal of $1,200, the tax-free recovery of basis would be two-thirds of the withdrawal (that is, $800, and $400 would be taxable).

Another pro rata rule applies if the individual also has a deductible IRA, as shown by the following example.

> **Example 9.5.** The nondeductible IRA is as previously described in example 9.4. The taxpayer also has $35,000 in a deductible IRA, for a total of $50,000 in both IRAs. On a withdrawal of $1,000 from the nondeductible IRA, only one-fifth, or $200, would be deemed to come from the nondeductible IRA. To compute the taxable versus nontaxable amounts, first divide the total nontaxable amount by the total in both accounts (in this case, $10,000 ÷ $50,000 = 0.2 = 20%).

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[167] Regulation Section 1.408-8, Q&A 5(a) and (b).
[168] IRC Section 401(a)(9)(A).
[169] IRC Section 401(a)(9)(B).
[170] IRC Section 401(a)(9)(B)(ii).
[171] IRC Section 401(a)(9)(B)(iii).
[172] IRC Section 401(a)(9)(B)(iv).

Then multiply the resulting percentage by the amount of the withdrawal ($1,000 ×.20 = $200). The result is that $800 is taxable as ordinary income and $200 is a tax-free recovery of basis.

The larger the deductible IRA in relation to the nondeductible IRA, the larger the amount of the withdrawal subject to tax. In general, withdrawals taken before attaining age 59½ or resulting from other than death or disability are subject to an additional 10-percent excise tax.[173] The exceptions to this rule are discussed in ¶905.02, under the heading "Additional tax on premature withdrawals."

State law considerations. The income tax treatment of IRA contributions and distributions by individual states varies widely and can present problems for the financial planner and the client.

Most states that have an income tax give their residents a deduction equivalent to the federal deduction for IRA contributions. However, some states limit the deduction to amounts less than the federal maximum deduction, and other states (for example, New Jersey) bar a deduction altogether.

As to distributions, although most states follow the federal approach, in many states the income tax treatment of IRA distributions is more complex. The financial planner should check applicable state law, especially in states where the deduction is denied and the client receives a 1099 from the plan administrator when distributions are made. At least some part of that distribution has already been taxed by the state disallowing the deduction, and a complex calculation may be necessary (along with adequate records from the client reporting the previously taxed contributions) to separate the federal taxable amount from the amount already taxed by the state.

Selecting IRA investments. The two most common types of IRA investments or approaches to IRA investments are (1) individual retirement accounts with a bank or other qualified person as trustee and (2) individual retirement annuities (nontransferable annuities issued by a life insurance company).

That formal listing does not do justice to the investment opportunities open to the IRA investor. There is intense competition within the financial services industry for IRA dollars. The competition among financial institutions to provide products aimed at the IRA market has spawned a bewildering array of investment choices. The best advice is to choose investments with the best combination of expected return and risk.

The following paragraphs include a brief summary of some types of investments offered by various entities marketing IRAs.

Thrift institutions. The investment options that may be offered by savings and loan associations and mutual savings banks for IRA accounts are limited to fixed and variable rate certificates of deposit of varying maturities and money market accounts. The investments are protected by FDIC insurance, up to $250,000 per institution. The fees, if any, charged for opening and maintaining an IRA are relatively small.

Brokerage houses. Brokerage houses, including some that offer self-directed IRAs, offer the widest range of investment options, with some offering everything from money market funds, stocks, bonds, and mutual funds to limited partnership interests in real estate.

[173] IRC Section 72(t).

As long as the self-directed IRA holder keeps the same brokerage house as custodian, the IRA assets can be moved among different investments to get the best return. The ability to reallocate assets offers an important advantage over investments in bank certificates of deposit, which the investor cannot dispose of prior to maturity without suffering interest penalties.

Most IRA custodians accept and allow only approved stocks, bonds, mutual funds and CDs. A self-directed IRA custodian allows those types of investments in addition to real estate, notes, private placements, tax lien certificates, and much more. Self-directed IRAs appear to be gaining increased popularity for their greater investment flexibility; they must still follow rules addressing prohibited IRA investments, including collectibles (such as artwork, stamps, rugs, antiques, and gems), certain coins, and life insurance.

Self-directed IRAs may not engage in transactions with "disqualified persons." *Disqualified persons* are individuals with whom or entities that an IRA is prohibited (absent a special exception) from engaging in any direct or indirect sale or exchange or leasing of any property; lending of money or other extension of credit; furnishing goods, services, or facilities; or transferring to or permitting the use of IRA income or assets.

Disqualified persons include fiduciaries (which, in the case of a self-directed IRA, includes the IRA owner) as well as the following family members of the IRA owner: spouse; parents; grandparents and great-grandparents; children (and their spouses); grandchildren and great-grandchildren (and their spouses); service providers of the IRA (for example, IRA custodian, CPA, financial planner); an entity (such as a corporation, partnership, limited liability company, trust, or estate) of which 50 percent or more of that entity is owned directly or indirectly or held by a fiduciary or service provider and, also, a partner who holds 10 percent of a joint venture of such entity.

Self-directed IRAs may not provide an indirect benefit to the participant. It is considered an "indirect benefit" if the IRA is engaged in transactions that, in some way, can benefit the participant currently. Some examples of prohibited transactions include personally using property held in the IRA, such as an office, personal residence, vacation home, or retirement home, or receiving personal benefits from the IRA, such as lending yourself money from the IRA or paying the participant, or a company that the participant owns, to do work on property purchased by the IRA. Caution must be exercised to avoid having a self-directed IRA receive unrelated business taxable income from conducting a trade or business activity or engaging in debt financing. Such activity could lead to taxation of the IRA income, additional tax return filing requirements (Form 990-T), income tax on the IRA receipts at the trust tax rate, and possibly disqualification of the IRA entirely.

Generally, an investor will pay a price for the flexibility offered by brokerage houses, especially if a self-directed IRA is used. There may be a fee for opening the account, as well as custodial fees, possibly based on a percentage of the amount in the account, with a fixed-dollar minimum.

Zero coupon bonds. Zero coupon bonds based on underlying U.S. Treasury issues, which are often marketed by brokerage houses under such names as certificates of accrual on Treasury securities (CATs) or certificates on government receipts (COUGARS), can serve to lock in good interest rates and maximize returns on IRAs. The zero coupon bond provides the investor with a means to avoid the problem of reinvesting periodic income payments at lower yields if interest rates fall. Of course, with interest rates on bonds and certificates of deposit at or near record lows, the client may urge the financial planner to suggest investments that may generate higher returns. Here, the financial planner must determine the risk tolerance of the client and the need for long-term financial security in making appropriate recommendations.

U.S. Treasury Separate Trading of Registered Income and Principal Securities (STRIPS) are federally sponsored zero coupon bonds. The STRIP program allows the IRA owner to purchase zero coupon bonds guaranteed by the United States Government.

The zero coupon bond's failure to produce any current income prior to maturity makes such bonds more volatile than ordinary bonds. Also, brokers may charge steep fees for zero coupon bonds based on underlying Treasury securities.

Mutual funds. Mutual funds are often used for IRAs. Mutual funds offer a range of investment options almost as broad as those offered by brokerage houses. Families of mutual funds range from conservative to very aggressive growth funds, index funds, exchange traded funds, and money market funds. The IRA investor may move from one fund to another without penalty, so long as it is within the same family and maintains the same manager or trustee. FDIC insurance is lacking, but funds are available that invest in government securities. These funds might require fees and charges. The financial planner may want to consider a blended portfolio of equities, bonds, and cash that is tailored to the client's risk tolerance and mindful of longevity issues.

Commercial banks. Commercial banks may offer certificates and FDIC insurance of up to $250,000 on principal and interest, as can thrift institutions. They may market and manage common funds for IRA customers, giving them broad investment options and flexibility. They might also offer other conveniences, such as transfers from checking accounts and direct payroll deductions.

Insurance companies. In a bid for IRAs, some insurance companies have set up stock equity funds, fixed-dollar or bond funds, and money market funds in addition to their more conventional annuity plans. State regulation of insurance companies can be counted upon to provide some element of safety, but FDIC insurance, which is provided to banks, is lacking. The financial planner should check the fees and other charges.

Investment choices in times of low interest rates. IRA contributions should not be put off in anticipation of higher interest rates, but investment choices should be made accordingly. The earlier in a given year the taxpayer makes a contribution, the sooner earnings on the contribution begin to accrue on a tax-deferred basis for traditional IRAs or on a tax-free basis for Roth IRAs. Earlier contributions lead to a greater compounding of interest. Over the life of the IRA, the additional compounding can mean thousands of extra dollars.

Individuals who are conservative in their investment philosophy and who anticipate a rise in interest rates might consider non-fixed income investments for the short term, such as money market funds or money market-type bank accounts. When interest rates climb, the individuals can move the money to a higher yielding fixed-income vehicle, such as a CD.

Collectibles. IRC Section 408(m) penalizes an IRA participant who directs his or her investments into collectibles (art works, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, and any other tangible personal property so characterized by the IRS). It also assumes that if any IRA assets are used to acquire a collectible, the amount is treated as a distribution taxable to the participant. However, IRA investments are permitted in state-issued coins and the following U.S. gold and silver coins: one-ounce, half-ounce, quarter-ounce, and 10th-of-an-ounce gold bullion coins and a one-ounce silver bullion coin. Also, IRA investments are allowed in certain platinum coins and in gold, silver, platinum, and palladium bullion. However, the bullion must be in the physical possession of the IRA trustee.

Rollovers and *Bobrow v. Commissioner*—new rules must be followed. Qualified plan distributions may be rolled over tax-free into an IRA only within 60 days of distribution (¶905.02).[174] However, the IRS may waive the 60-day rollover period if the failure to roll the funds over within 60 days is due to good cause, such as a casualty, a disaster, or an error by a bank or other custodian.[175] A taxpayer-directed IRA-to-IRA rollover under the so-called 60-day rollover rule, where the taxpayer withdraws funds from one IRA and returns them to another IRA within 60 days of the withdrawal, may be made without tax penalty only once a year.[176] (See the preceding discussion regarding Revenue Procedure 2016-47 and the relaxation of the 60-day rollover rule by the IRS in Section ¶905).

The Tax Court held in *Bobrow v. Commissioner*, T.C. Memo 2014-21 (contrary to the IRS's published example in Publication 590, page 25) that regardless of how many IRAs a taxpayer maintains, there may be only one nontaxable rollover contribution within each one-year period. The IRS has indicated that they will follow the holding in this case but will not apply it to transactions that occurred before January 1, 2015.[177] However, an unlimited number of direct transfers from one IRA trustee to another, even if it is the same trustee, may be made without tax penalty. In either case, depending on the particular IRA, the individual might incur interest penalties for premature withdrawals and might not be able to recover prepaid fees. The rules will also apply to Roth IRAs; but a conversion to a Roth IRA is not considered a rollover for purposes of these rules.

The *Bobrow* case is a game-changer in the IRA rollover field. The IRS changed its rules as a result of the case in a manner unfavorable to taxpayers. Practitioners should be aware of these rules so they can protect their clients against the imposition of possible tax issues and penalties. For many years, the IRS rollover guidance found in Publication 590 provided that if a person had multiple IRAs, it was permissible to do multiple IRA rollovers. The rules found in Publication 590 stated:

> Generally, if you make a tax-free rollover of any part of a distribution from a traditional IRA, you cannot, within a one-year period, make a tax-free rollover of any later distribution from that same IRA. You also cannot make a tax-free rollover of any amount distributed, within the same one-year period, from the IRA into which you made the tax-free rollover. The one-year period begins on the date you receive the IRA distribution, not on the date you roll it over into an IRA.

Publication 590 even provided an example pre-*Bobrow*:

> You have two traditional IRAs, IRA-1 and IRA-2. You make a tax-free rollover of a distribution from IRA-1 into a new traditional IRA (IRA-3). You cannot, within one year of the distribution from IRA-1, make a tax-free rollover of any distribution from either IRA-1 or IRA-3 into another traditional IRA. However, the rollover from IRA-1 into IRA-3 does not prevent you from making a tax-free rollover from IRA-2 into any other traditional IRA. This is because you have not, within the last year, rolled over tax-free, any distribution from IRA-2 or made a tax-free rollover into IRA-2.

Following the guidance from the IRS in Publication 590, a taxpayer with multiple IRAs could accomplish multiple IRA rollovers during a one-year period because the one-year limitation rule was applied on an IRA-by-IRA basis. Each IRA maintained by an IRA owner would have its own one-year period

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[174] IRC Section 408(d)(3)(A).
[175] IRC Sections 402(c)(3) and 408(d)(3).
[176] IRC Section 408(d)(3)(B).
[177] Notice 2014-15.

within which a rollover could occur. The rules of Publication 590 were widely known by financial planners and their clients. They were used as an income tax planning technique to provide a short-term, tax-free loan with no cost or penalty to a taxpayer if the taxpayer had multiple IRAs. Planning, in fact, encouraged clients to maintain multiple IRAs for this very purpose.

In the *Bobrow* case, the taxpayer—a tax lawyer—used multiple IRA rollovers from multiple IRAs to take advantage of the opportunity of tax-free loans, which Publication 590 appeared to permit. However, the Tax Court determined that notwithstanding the IRS guidance, the "clear" reading of the statute required that the one-year limitation rule under IRC Section 408(d)(3)(B) applied on an aggregate basis and not on an IRA-by-IRA basis. The IRS determined it would follow the Bobrow holding and issued new rules effective January 1, 2015.

The IRS explained its new IRA rollover rules in Publication 590-A:

> Beginning in 2015, you can make only one rollover from an IRA to another (or the same) IRA in any one-year period regardless of the number of IRAs you own. The limit will apply by aggregating all of an individual's IRAs, including SEP and SIMPLE IRAs as well as traditional and Roth IRAs, effectively treating them as one IRA for purposes of the limit. However, trustee-trustee transfers between IRAs are not limited and rollovers from traditional IRAs to Roth IRAs (conversions) are not limited.

The IRS provided a new example in the revised Publication 590-A[178]referring to a taxpayer named John who has three traditional IRAs: IRA-1, IRA-2, and IRA-3. "On January 1, 2015, John took a distribution from IRA-1 and rolled it over into IRA-2 on the same day. For 2015, John cannot roll over any other 2015 IRA distribution, including a rollover distribution involving IRA-3. This would not apply to a conversion."

In addition to revising its Publication 590, the IRS issued two announcements involving the application of the one-rollover-per-year limitation in IRA rollovers: Announcements 2014-15 and 2014-32. The IRS determined that the new rules for administrative purposes should become effective as of January 1, 2015, and should not be applied on a retroactive basis. IRS Announcement 2014-32 was fairly comprehensive and made the following points:

- Amounts received from an IRA will not be included in the gross income of a distributee to the extent that the amount is paid into an IRA for the benefit of the distributee under the 60-day rollover rule. Publication 590-B indicates that certain distributions are not eligible for rollover, such as amounts that must be distributed (required minimum distributions) during a particular year.

- The IRC at Section 408(d)(3)(B) is the key section involved under the one-rollover-per-year limit on IRA rollovers.

- An individual receiving an IRA distribution on or after January 1, 2015 cannot roll over any portion of the distribution into an IRA if the individual has received a distribution from any IRA in the preceding one-year period that was rolled over into an IRA.

[178] The guidance from the IRS has now been split into Publications 590-A and 590-B.

- The IRS, in Publication 590 and its proposed regulations, had previously provided that the IRA rollover rules were based on an IRA-by-IRA basis. However, in *Bobrow v. Commissioner*, the Tax Court held that the one-rollover-per-year limit applied to taxpayers on an aggregate basis and not on an IRA-by-IRA basis.

- A rollover from a traditional IRA to a Roth IRA (a conversion) is exempt from the one-rollover-per-year rule. It is not considered in applying the one-rollover-per-year rule to other rollovers.

- A rollover from a Roth IRA to any Roth IRA (including the same Roth IRA) would preclude any other Roth IRA rollovers to any Roth IRA under the one-year rule. It would also preclude any rollovers from one traditional IRA to a traditional IRA (including the same traditional IRA) under the one-year rule.

- A rollover from a traditional IRA to any traditional IRA (including the same traditional IRA) would preclude any other traditional IRA rollovers under the one-year rule. It would also preclude any rollover from any Roth IRA to a Roth IRA (including the same Roth IRA) under the one-year rule.

- For purposes of Announcement 2014-32, the term *traditional IRA* includes a simplified employee pension (SEP) under IRC Section 408(k) and a SIMPLE IRA under IRC Section 408(p).

- The one-rollover-per-year limitation does not apply to a rollover to an IRA from a qualified plan. In addition, the one-rollover-per-year limitation does not apply to a rollover to a qualified plan from an IRA.

- The one-rollover-per-year limitation rule does not apply to trustee-to-trustee transfers.

Violations of the one-rollover-per-year-limit on IRA rollovers can be costly to the taxpayer. The violation of the rollover limitation rule may trigger a taxable event (possible income tax, accuracy penalties, and early distribution penalties), and it could also be treated as an excess contribution that was made to the receiving IRA. An excess contribution to an IRA is subject to a 6 percent penalty tax that is ongoing on the excess amount that remains in the IRA at the end of each tax year. A special correction rule, however, applies to the first year in which an excess contribution is made.

A cautionary note here involves spousal IRAs. Where a taxpayer dies and a surviving spouse inherits the decedent's IRA, the surviving spouse becomes the IRA owner.[179] It would appear that the revised rollover rules would arguably prohibit a spouse from taking a withdrawal from his or her own IRA and rolling it over into another IRA and then, within the same taxable year, taking a withdrawal from the deceased spouse's IRA and rolling it into the survivor's IRA. This would violate the "one rollover per year rule" and subject the spouse to income tax on the second rollover and possibly to the 6 percent excess contribution tax. This potential problem may be avoided by having the surviving spouse accomplish a direct trustee-to-trustee transfer of the decedent's IRA account to the surviving spouse's IRA account.

[179] Revenue Procedure 89-52.

.02 SEP Plans Using IRAs

A SEP plan offers employers a simplified way of providing employees with pensions. SEPs make use of IRAs.

Although a SEP takes the form of an IRA, employees can set up their own IRAs. Participation in the SEP will cause deductions for contributions to the IRA to be phased out for participants with AGIs greater than certain levels (¶915.01).[180]

Employer contributions to a SEP are excluded from the employee's federal gross income (and that of some, but not all, states) and are not subject to employment taxes. Elective deferrals and salary reduction contributions are also excluded from gross income, but they are subject to employment taxes.

Contributions must not discriminate in favor of highly compensated employees. Not more than $275,000 (for 2018) of compensation may be taken into account.[181] This amount is indexed to inflation in $5,000 increments.[182]

Basic advantages. SEPs offer the following advantages:

- Low startup costs
- Low administration costs
- No requirements for yearly contributions to the SEP
- Portability of benefits
- Reduced fiduciary responsibility on the part of the employer

Disadvantages. Possibly, the biggest disadvantage of the SEP for an employer is the required inclusion of part-time or seasonal employees—those short-term employees who arguably provide the least contribution to the company's success.[183]

Also, the employer should be made aware of the SEP provisions related to vesting, withdrawals, employee coverage, and the tax consequences on distribution, all of which are separately discussed in the following paragraphs.

IRS model SEP agreement. The IRS model Form 5305-SEP may be used by employers in establishing SEPs. However, employers who currently maintain any other qualified plan, or who have ever maintained a defined benefit plan, may not use Form 5305-SEP. The advantage of using the model form is that the employer is assured that the SEP meets applicable requirements without the need for an additional ruling, opinion, or determination letter from the IRS. Use of this form simplifies ERISA reporting

[180] RC Section 219(g).
[181] IRC Section 408(k)(3)(c).
[182] IRC Sections 401(a)(17) and 404(l).
[183] IRC Section 408(k)(2).

and disclosure requirements. Basically, all the employer has to do is provide copies of the completed form to participants and statements showing contributions made on their behalf.

Coverage. The employer must make contributions on behalf of each employee who has attained age 21, has performed services for the employer during at least three of the immediately preceding five years, and who has received at least $600 (for 2018 and indexed to inflation in $50 increments)[184] in pay during the year.[185]

Full vesting and withdrawals. All employer contributions to a participant's SEP are fully (100 percent) vested; the employee takes immediate ownership and may withdraw the contributions at any time with the understanding that such withdrawals are subject to income tax and a special penalty tax on a premature withdrawal.

Employer deductions. The contributions made by the employer under a SEP are deductible by the employer for the year in which they are made. The amount of the deduction is limited to 25 percent of compensation paid during the SEP's plan year. An employer may use its taxable year for purposes of determining contributions to a SEP. The excess of the employer contribution over the 25 percent limit is carried forward and deductible in future tax years in order of time and is also subject to the 25-percent limit in each succeeding tax year.[186]

Distributions. SEP distributions are subject to the regulations applicable in determining the required minimum distribution from qualified plans and IRAs. See more details and the Uniform Lifetime table in ¶905.02 and the IRA rules discussed in ¶915.01.

SEPs for persons past age 70. A sole proprietor, partner, or corporate employee who is past the age of 70½ may enjoy special benefits through SEPs because SEP contributions may be made even after reaching that age. However, when the SEP holder reaches the age of 70½, minimum distributions must commence at that time. The SEP holder may stretch out the payments by using the Uniform Lifetime table for minimum distributions (shown and discussed in ¶905.02). Under the Uniform Lifetime table, an individual's life expectancy from year to year is never reduced by a full year. Therefore, SEP distributions may be stretched out far beyond the individual's life expectancy, as computed when distributions first commenced.

Salary reduction simplified employee plans. In plan years beginning before January 1, 1997, an employer could establish a salary reduction (cash or deferred) arrangement as part of a SEP. Such arrangements may not be established in plan years beginning after December 31, 1996. However, salary reduction simplified employee plans (SARSEPs) set up before 1997 may continue to operate after 1997, subject to the same conditions and requirements that were previously in place. Further, new employees hired after December 31, 1996, may participate in a SARSEP of their employer established before January 1, 1997.

[184] IRC Section 408(k)(8).
[185] RC Section 408(k)(2).
[186] IRC Section 404(h)(1)(C).

The maximum annual elective deferral under a SARSEP is the lesser of $18,500 for 2018 or 100 percent of the participant's compensation. The $18,500 limit is indexed for inflation in $500 increments. This limit applies to total elective deferrals under all plans.

The election to have amounts contributed to a SARSEP or received in cash is available only if at least 50 percent of the employees of the employer who are eligible to participate elect to have amounts contributed to the SARSEP.[187] In addition, the election is available only to employers that did not have more than 25 employees who were eligible to participate (or who would have been required to be eligible if a SARSEP was maintained) at any time during the prior taxable year.[188]

The highly compensated employees may not defer more than 1.25 times the average deferral percentage for all other employees who participate.[189]

For purposes of meeting the participation requirements as to elective (salary reduction) arrangements, an individual who is eligible is deemed to receive an employer contribution.

The attractive feature of a SARSEP, from the employer's standpoint, is that the cost to the employer is limited to the cost of administering the plan. To the extent that owners are able to participate, their tax savings through elective deferrals can help offset the after-tax cost of administration. The latter involves a minimal amount of paperwork and bookkeeping.

Elective contributions are excludable from employees' gross income, but they are subject to Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes.

The employer is deemed to make the contributions that are produced by salary reductions. Accordingly, the employer receives a deduction.

.03 SIMPLE Retirement Accounts

The Savings Incentive Match Plans for Employees (SIMPLE) plans (¶925.02) are intended to encourage employers who currently do not maintain a qualified plan for their employees to set up a SIMPLE plan. These plans can either be set up as an IRA (discussed here) or as a 401(k) cash or deferred plan (discussed in ¶925).

Employers with 100 or fewer employees who received at least $5,000 in compensation from the employer in the preceding year may adopt a SIMPLE plan if they do not maintain another qualified plan. A SIMPLE plan allows employees to make elective contributions of up to $12,500 in 2018 or 100 percent of the participant's compensation.[190] The limit is indexed for inflation in $500 increments. Employers must make matching contributions.[191] Assets in the account are not taxed until they are distributed to an employee, and employers generally may deduct contributions to employees' accounts. In addition, a SIMPLE plan is not subject to the nondiscrimination rules (including top-heavy provisions) or other

[187] IRC Section 408(k)(6)(A)(ii).
[188] IRC Section 408(k)(6)(B).
[189] IRC Section 408(k)(6)(A)(iii).
[190] IRC Section 408(p)(2)(A).
[191] IRC Section 408(p)(2)(A)(iii).

complex requirements applicable to qualified plans. SIMPLE plans allow annual catch-up contributions of $3,000 in 2018 for participants age 50 and older.

SIMPLE plans must be open to all employees who meet the $5,000 compensation qualification[192] and all employer contributions to an employee's SIMPLE account are immediately vested.[193]

Employees covered by a SIMPLE plan may make elective contributions in greater amounts than they could contribute to traditional IRAs. Unlike contributions to a traditional IRA, the employee's SIMPLE elective contributions must be set up as a percentage of compensation, rather than a flat dollar amount.[194]

Employers must use one of two contribution formulas. First, under the matching contribution formula, the employer is generally required to match employee contributions, on a dollar-for-dollar basis, to a maximum of 3 percent of the employee's compensation for the year. (However, if the employer satisfies certain notice requirements to employees, in two out of five years, the employer may choose to match only a maximum of 1 percent of each employee's compensation.)[195] Alternatively, the employer may make a nonelective contribution of 2 percent of compensation for each eligible employee who earned at least $5,000 in compensation for the year.[196]

SIMPLE accounts may accept rollovers from an expanded list of retirement plans.

Effective for contributions made after December 18, 2015, rollover contributions to an employee's SIMPLE retirement account are permitted from

- a traditional IRA, under the rollover rules of IRC Section 408(d)(3),
- a qualified trust, under the rollover rules of IRC Section 402(c),
- a qualified annuity, under the rollover rules of IRC Section 403(a)(4),
- a 403(b) tax-sheltered annuity, under the rollover rules of IRC Section 403(b)(8), and
- a governmental Section 457 plan, under the rollover rules of IRC Section 457(e)(16).

However, no rollover contribution is permitted to be made to the SIMPLE retirement account until after the two-year period described in IRC Section 72(t)(6), which is the two-year period beginning on the date that the employee first participated in a qualified salary reduction arrangement maintained by the employer.[197]

[192] IRC Section 408(p)(4).
[193] IRC Section 408(p)(3).
[194] IRC Section 408(p)(2)(A)(ii).
[195] IRC Section 408(p)(2)(C).
[196] IRC Section 408(p)(2)(B).
[197] IRC Section 408(p)(1)(B).

Planning Pointer. Although the SIMPLE IRA plan may be an attractive alternative for a small employer that wants to avoid the administrative complexity associated with other types of qualified plans, those other qualified plans allow greater yearly elective contributions ($18,500 in 2018).[198]

Clearly, having a qualified retirement plan is a good thing for employees. However, employees need to be aware that they will incur a 25 percent additional excise tax if they withdraw funds from the SIMPLE plan during their first two years of participation.[199]

A participant in a SIMPLE plan may use the minimum required distribution rules that apply to other qualified plans. See ¶905.02 for the Uniform Lifetime Table and ¶915.01 for how these rules affect distributions from IRAs.

.04 Roth IRAs

Although the maximum permissible contribution to a Roth IRA is not deductible,[200] distributions from the account are received tax free if certain requirements are met.[201] The maximum amount that a taxpayer may contribute to a Roth IRA is $5,500 for 2018. The $5,500 limit may be adjusted annually for inflation in increments of $500. In addition, taxpayers who are at least 50 years old may contribute an additional $1,000 through 2018. With a traditional IRA, distributions related to deductible contributions are fully taxed as ordinary income, and distributions related to nondeductible contributions are taxed in the same manner as annuity payments (nontaxable return of contributions or ordinary income tax on earnings).

Distributions from a Roth IRA are tax-free to the extent that they represent nondeductible contributions to the account. To qualify for tax-free distribution treatment of earnings, the Roth IRA distributions must satisfy a five-year holding period and must also meet one of the following requirements:[202]

- The distribution is made on or after the date the individual attains age 59½
- The distribution is made to a decedent's beneficiary (or the decedent's estate) on or after the decedent's death
- The distribution is attributable to the individual being disabled
- The distribution is a qualified special purpose distribution defined as a qualified first-time homebuyer distribution[203]

Nonqualifying distributions are treated as coming first from nondeductible contributions. Therefore, distributions representing earnings become taxable, if at all, only after all contributions have been recovered.

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198 IRC Section 402(g)(1)(B).
199 IRC Section 72(t)(6).
200 IRC Section 408A(c).
201 IRC Section 408A(d).
202 IRC Section 408A(d)(2)(A).
203 IRC Sections 408A(d)(2)(A)(iv), 408(d)(5), and 72(t)(2)(F).

Unlike a traditional IRA, distributions from a Roth IRA do not have to commence by April 1 in the calendar year in which the individual reaches age 70½.[204] In fact, there are no minimum distribution requirements of any kind imposed on the person who contributed to a Roth IRA.

Contributions. A Roth IRA has an advantage over traditional IRAs because an individual may still contribute to a Roth IRA after reaching age 70½.[205]

An individual's ability to contribute to a Roth IRA is phased out in 2018 for single individuals and heads of households with modified AGI between $120,000 and $135,000; for joint filers with AGI between $189,000 and $199,000; and for a married individual filing a separate return between $0 and $10,000.[206]

Rollovers and conversions. Amounts in a traditional IRA may be rolled over into a Roth IRA and, after the income tax is paid, these amounts may be entitled to future tax-free distributions under the Roth IRA rules.[207]

The 10-percent excise tax will not apply to the IRA rollover distribution. However, the regular income tax that would have been due if the IRA account balance had been distributed upon retirement must still be paid.

Since 2010, anyone can convert a traditional IRA to a Roth IRA, regardless of the amount of AGI reported and irrespective of their filing status.

Pros and cons of Roth IRAs. Roth IRAs offer financial planners and their clients attractive tax benefits and a good measure of flexibility. However, Roth IRAs also have disadvantages. The following list notes the advantages and disadvantages of Roth IRAs, as contrasted with those of traditional IRAs.

Advantages of Roth IRAs

- If the relevant qualifications are met, qualified distributions from Roth IRAs are not taxable.[208]

- If the accumulation period is long, the benefit from the tax-exempt treatment of the Roth IRA distributions should outweigh the tax deductions allowed for contributions to a traditional IRA. This possibility will be enhanced when high-appreciation-potential investments (such as growth-oriented stocks and certain mutual funds) are housed in the Roth IRA.

- The primary tax benefit flowing from the Roth IRA (contributions that will later produce tax-free distributions) does not begin to be phased out until single individuals have modified AGI (for 2018) of at least $120,000 and married taxpayers filing jointly have modified AGI of at least $189,000. The primary benefit associated with traditional IRAs (deductible contributions that will later produce taxable distributions) begins to be phased out for taxpayers who are active participants in a qualified plan when income (for 2018) reaches $100,000 for joint filers ($0 for

[204] C Section 408A(c)(5).
[205] IRC Section 408A(c)(4).
[206] IRC Section 408A(c)(3).
[207] IRC Section 408A(c)(3)(B).
[208] IRC Section 408A(d)(1).

married persons filing separately) or $63,000 for singles, heads of households, and surviving spouses.[209]

- Unlike a traditional IRA, the law does not require that distributions from a Roth IRA begin in the year in which the individual attains age 70½.[210]

- Contributions to a Roth IRA may continue after the individual reaches age 70½,[211] unlike a traditional IRA. The Roth IRA contributor is never forced to take required minimum distributions.

- If a Roth IRA distribution has met the requirements to be tax-free when received, the distribution would not increase the adjusted gross income base for taxation of Social Security benefits or for the 3.8 percent tax on net investment income, unlike distributions from a traditional IRA.[212] Depending on the amount of income that the individual receives in addition to the Social Security benefits (¶3505), this advantage could be significant.

- Under the ordering rules that determine taxation of withdrawals from Roth IRAs that are not qualified distributions, amounts that do not exceed the individual's accumulated contributions in the account may be withdrawn tax-free.[213] These ordering rules differ from the rules applicable to ordinary IRAs that require early withdrawals to be taxed as income and are subject to the 10-percent additional tax. Consequently, Roth IRAs give the owner the flexibility to meet unexpected financial emergencies without an immediate tax disadvantage. However, withdrawing money from a tax-advantaged IRA is not something to be done lightly. Taking the money out early forfeits the tax-free buildup on the contributions. Additionally, once accumulated Roth IRA contributions are withdrawn, the taxpayer may not contribute them back to the account. However, the individual may continue to make the maximum yearly contributions to the account while still eligible to do so. Eligibility to make contributions to a Roth IRA requires that the taxpayer earn income in an amount that is at least equal to his or her Roth IRA contribution.

- A traditional IRA may be converted to a Roth IRA. The conversion is an income taxable event, but the subsequent growth of the account and its withdrawal can be free of further income tax. For Roth conversions done prior to 2018, could be "undone" by declaring a recharacterization of the Roth IRA to the traditional IRA by October 15 of the following year, and no taxable event will be deemed to have occurred. However, the 2017 Tax Cuts and Jobs Act eliminates the recharacterization opportunity for Roth conversions done in 2018 and beyond.

Disadvantages of Roth IRAs

- No current deduction is allowed for amounts contributed to a Roth IRA.[214] This aspect compares unfavorably with a traditional IRA deduction, which reduces the initial cost of the contribution.[215]

[209] IRC Section 219(g).
[210] IRC Section 408A(c)(5).
[211] IRC Section 408A(c)(4).
[212] IRC Section 86.
[213] IRC Section 408A(d)(4)(B).
[214] IRC Section 408A(c)(1).
[215] IRC Section 219(a).

- The advantage to be gained from the tax-free distributions from Roth IRAs might not outweigh the lost deductions for contributions, particularly if the number of years to accumulate the benefits is not great. In addition, the individual might be in a lower tax bracket at retirement than when the individual made the contributions. If the individual is a conservative investor, it may take a long time to earn back the required income taxes paid on the conversion from the traditional IRA to the Roth IRA.

- Although new contributions to Roth IRAs are likely to be advantageous, the same might not be true of rollovers from traditional IRAs to Roth IRAs. A taxpayer must pay tax on the rollover to the extent that the amount exceeds the taxpayer's basis, if any, in the traditional IRA.[216] The higher the tax bracket a taxpayer is in, the less likely the conversion will be beneficial, unless there is a long time span after the conversion with tax-free buildup and appreciation in the Roth IRA. That said, with the reduction in tax rates as the result of the 2017 Tax Cuts and Jobs Act, the conversion, while still taxable, may bear less tax than under prior law.

- Some individuals might not feel comfortable with trading the upfront tax advantage available with a traditional, deductible IRA for the future tax benefit promised by a Roth IRA. Congress may amend the tax law, and nothing can prevent a later Congress from reducing or eliminating the benefits of a Roth IRA.

Planning Pointer With the reduced income tax rates in effect for 2018 on high-income-earning taxpayers, Roth conversion advice must be considered. The future growth of the Roth IRA will be tax-free in times of possibly still high income tax rates. If a Roth conversion is done, and if the value of the IRA account declines following the conversion, the taxpayer will no longer have until October 15 of the following tax year (after 2018) to recharacterize the conversion of the traditional IRA to the Roth IRA back to the traditional IRA, with no resulting adverse tax consequences. The "hedge" opportunity of the Roth IRA conversion has been eliminated.

Bear in mind that as distinguished from the Roth IRA rules, amounts held in a Roth 401(k) account are subject to the required minimum distribution rules. Although a traditional 401(k) plan may now be converted to a Roth 401(k) plan, the participant must begin withdrawing minimum distributions from the Roth 401(k) plan at age 70½. Planning here suggests converting the Roth 401(k) plan to a Roth IRA (a tax-free conversion). If this is done, no minimum distributions will be required from the Roth IRA, under current law.

¶920 Profit-Sharing Plans

Profit-sharing plans offer very attractive tax advantages:

- The employer makes contributions to the plan for the future benefit of employees, but the employer receives a current deduction.

- Employer contributions are not taxable to the employee when made, which means all of the contribution is invested for the benefit of the employee.

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216 IRC Section 408A(d)(3)(A)(i).

- Income earned on invested contributions (by both employer and employee), earnings on earnings, and realized appreciation are not taxed while they are in the plan.

- When the employee receives distributions on retirement, the employee receives favorable tax treatment under the annuity rules (or, if eligible, the lump sum distribution rules), as discussed in ¶905.02. If the employee takes a distribution in employer stock that has appreciated in value over the stock's basis in the plan, no tax at all is paid on the appreciation (the net unrealized appreciation) until the employee sells the employer stock (unless the employee elects otherwise).

From the employer's standpoint, one of the key features of a profit-sharing plan is that it allows excellent cost control. Also, contributions are permitted to be made by the employer, even in the absence of profits.

.01 Making Plans Effective

Financial planners do not have to be pension and profit-sharing experts. However, they should be legitimately concerned with measures that can serve to make profit-sharing plans more effective instruments for attaining both company and employee objectives. Some of the ideas the financial planner should explore are described in the following paragraphs.

Individual investment choice. The law recognizes individual account plans in which the participant is permitted to exercise independent control over the assets in his or her individual account. In these cases, the individual is not regarded as a fiduciary and the other fiduciaries are not liable for any loss that results from control by the participant or beneficiary. With this approach, the employee is placed in essentially the same position as if the employee received cash and was left to invest it. However, the employee has the enormous benefit of the tax shelter offered by the plan.

Under Department of Labor regulations, a plan sponsor can be held liable for imprudent investment decisions by participants of individual retirement account plans unless the plan offers a broad range of investment alternatives.

Choice of funds. Typically, different investment funds are set up within the plan and the plan gives the participant a choice among various funds. The employee might have a choice of bonds, common stock, balanced or venture funds, mutual funds, or some combination of these funds.

Access to cash. A profit-sharing plan may make benefits available to participants after a relatively brief deferral period (as little as two years). However, a 10-percent additional tax is imposed on early withdrawals by the participant from the plan.[217]

Pension floor. A supplemental defined benefit pension plan can be used to provide a floor for retirement benefits. This defined benefit plan puts part of the risk of the profit-sharing plan's poor performance on the company. However, this will only work when the company is able and willing to assume the risk. The use of a SEP plan is another possibility to be considered.

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[217] IRC Section 72(t).

Minimum guarantees by company. In lieu of adopting a supplemental defined benefit plan, some companies guarantee a minimum annual contribution to the profit-sharing plan out of accumulated earnings in years in which the company has no profits.

Another possibility is for the company to guarantee investment performance of the plan up to a set amount.

.02 Incidental Insurance

Profit-sharing plans are looked upon primarily as a source of benefits for the participant while living. However, the trust created by the plan may buy insurance on the life of the participant, provided that the insurance is merely incidental. The insurance is considered incidental in the case of a profit-sharing plan if the aggregate life insurance premiums for each participant are less than one-half the total contributions standing to his or her credit at any specific time. The plan must require that, on retirement, the policy either be distributed to the participant or be converted by the trustee into cash to provide periodic payments.

The premiums paid by the company for incidental insurance are deductible by the company and only the pure insurance portion of the premiums, determined under a special rate table, is taxable to the participant.[218] The participant may be able to exclude the insurance proceeds from his or her gross estate if the policy meets the requirements of IRC Section 2042. This usually requires the participant to remove the life insurance policy from the plan and transfer it to an irrevocable life insurance trust more than three years prior to the participant's death.

¶925 Cash or Deferred (401(k)) Arrangements

IRC Sections 401(k) and 402(a)(8) permit employers to establish cash or deferred arrangements (often referred to as 401[k] plans) as part of a qualified plan. Under a 401(k) plan, the employee is given a choice of receiving cash or making a contribution (or having one made by the employer) to a qualified plan and deferring tax on the amount contributed to the plan.

.01 In General

The plan may be in the form of a salary reduction agreement. For example, under such an agreement, an employee could elect to reduce current compensation or forego a raise and have the amounts foregone contributed to the plan on his or her behalf. This particular feature makes the 401(k) very attractive to employers. Employers may adopt a 401(k) plan without added payroll costs other than the costs of setting up and administering the plan.

The 401(k) plan also has advantages for the employee. A 401(k) plan permits employees to provide for their own retirement with pretax dollars, rather than with after-tax dollars. The income generated by their contributions also avoids current taxation. The employees who choose contributions to the plan receive less current cash, but they pay correspondingly lower taxes. By choosing a contribution, employees who would have saved a like amount in the absence of a plan can receive more spendable cash. The employee may change the choice of cash or contribution annually, as the employee's needs and circumstances change.

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[218] Regulation Section 1.79-3(d)(2).

Note that a plan contribution can be the default option for a 401(k) plan. Employees who do not wish to contribute (or who wish to make a smaller or larger contribution) must make an affirmative election.

401(k) plans may allow participating employees to designate all or part of their elective deferrals to the plan to be treated as after-tax Roth contributions. IRC Section 402A. The designated Roth contributions are generally treated in the same manner as pretax elective deferrals for purposes of limitations and non-discrimination requirements, except that the plan must account for the Roth contributions separately. Although the employee is required to include the Roth contributions in gross income, the distributions from a Roth 401(k) are subject to rules similar to those applicable to Roth IRA distributions. Section 457 plans are now permitted to include a designated Roth contribution program.

A traditional 401(k) plan can be converted to a Roth 401(k) plan. However, use caution because a Roth 401(k) plan requires the participant to begin withdrawing minimum distributions upon attaining age 70½. If the Roth 401(k) plan is converted (tax free) to a Roth IRA, no minimum distributions to the participant are required from a Roth IRA.

Planning Pointer. The financial planner should consider recommending that a client who is participating in a Roth 401(k) plan convert that plan to a Roth IRA plan. There is no tax consequence on making that conversion because the contributions to the Roth 401(k) plan were already included in the client's gross income. If the conversion to the Roth IRA is accomplished, the client will be free of the rule of the Roth 401(k) requiring minimum distributions from the plan. Participants will not be required to take required minimum distributions from the Roth IRA.

Cap on deferrals. An aggregate cap applies to elective deferrals for all plans in which an employee participates. The cap is $18,500 for 2018. The limit is indexed for inflation in $500 increments. This cap does not bar matching contributions by the employer up to maximum contributions in the aggregate of $55,000 in 2018 by the employer and employee.[219] This limit is indexed for inflation in $1,000 increments.[220]

Qualification requirements. In general, an IRC Section 401(k) arrangement must be part of a plan that meets the general requirements for being a qualified plan. It must also meet special tests that prevent income deferrals made by highly compensated employees from exceeding a certain level determined with reference to deferrals by non-highly compensated employees.

Hardship withdrawals. Hardship withdrawals are permitted only if the participant or a designated beneficiary of the plan has an immediate and serious financial need and other resources are not reasonably available to meet the need. The plan or other legally enforceable agreement must prohibit the employee from making any contribution to the plan or any other plan maintained by the employer for at least six months after the employee receives a hardship withdrawal.[221]

The IRS issued guidelines on February 23, 2017, addressing hardship withdrawals from 401(k) plans. Unlike a loan from the plan, participants do not have to repay the funds accessed via a hardship with-

[219] IRC Section 415(c)(1) and IR 2017-177 (October 19, 2017).
[220] IRC Section 415(d).
[221] Regulation Section 1.401(K)-1(d)(3)(iv)(E)(2).

drawal. Absent proof of hardship, however, the withdrawal may be subject to income tax and the 10 percent excise tax. The plan participant must prove there is a serious and immediate need for the money and that the distribution is necessary to satisfy that need.

Items that qualify for hardships include expenses related to medical care, purchase of a principal residence, tuition, prevention of eviction from a principal residence, burial or funeral expenses, and repair of damages to a principal residence. The IRS requires verification that a distribution is for one of the foregoing reasons. IRS auditors are instructed to look for "source documents," such as estimates, statements, and receipts, addressing the hardship or a summary in paper or electronic format or telephone records verifying the information contained in the source documents. It is important for the participant to retain these documents and make them available to the plan sponsor or administrator upon request.

Wide availability. Tax-exempt organizations may establish 401(k) plans for their employees.[222] Rural cooperatives and Indian tribal governments may also establish 401(k) plans, but state and local governments (and their political subdivisions) still may not set up cash or deferred plans.[223]

A rule referred to as the *same desk rule* for distributions from 401(k) plans, 403(b) plans, and 457 plans has been repealed. Under the same desk rule, the law formerly treated a participant as not having separated from service if the employee retained the same job for a new employer following a liquidation, merger, or acquisition. Under current rules, an employee will not be prevented from receiving distributions from a plan if continuing in the same job for a different employer following a liquidation, merger, or acquisition.[224]

.02 SIMPLE 401(k) Plans

An employer that does not employ more than 100 employees or maintain another qualified plan may set up a SIMPLE plan as part of a 401(k) arrangement. SIMPLE plans in the form of an IRA are discussed in ¶915.03.

Under a SIMPLE 401(k) plan, the nondiscrimination rules (including the top-heavy rules) do not apply, provided that each of the following three requirements is met:[225]

1. Elective deferrals made by the employee in a year do not exceed $12,500 in 2018. This limit is indexed for inflation in $500 increments. These deferrals must be computed as a percentage of compensation, not as a fixed dollar amount.

2. The employer makes contributions matching the employee's elective deferrals up to a maximum of 3 percent of employee compensation. Alternatively, the employer may make a nonelective contribution of 2 percent of compensation for each eligible employee who earned at least $5,000 from the employer for the year.

3. No other contributions are made under the arrangement.

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[222] IRC Section 401(k)(4)(B)(i).
[223] IRC Sections 401(k)(4)(B)(ii) and 401(k)(4)(B)(iii).
[224] IRC Sections 401(k)(2)(B)(i), 403(b)(7)(A)(ii), 403(b)(11)(A), and 457(d)(1)(A)(ii).
[225] IRC Section 401(k)(11).

Employer contributions must be immediately vested in the employees' accounts.

> **Planning Pointer.** SIMPLE 401(k) plans may be an attractive alternative for small employers who want to set up a qualified plan because they lack the administrative complexity that is normally present. However, under a regular 401(k) plan, participants may contribute a greater amount each year than under a SIMPLE plan.
>
> Employers should also note that unlike SIMPLE IRA plans, SIMPLE 401(k) plans are not allowed to reduce matching contributions less than 3 percent by reason of the two-of-five year rule (¶915.03).

If the SIMPLE plan rules encourage the establishment of retirement plans by employers that otherwise would not have done so, the SIMPLE plan will certainly be advantageous to employees. However, employees should know that they will incur an additional excise tax of 25 percent[226] if they withdraw funds from the SIMPLE plan during their first two years of participation.

.03 Single (Individual) 401(k) Plans

These plans are available to sole proprietors or partners who have no common law employees. The plan can be funded by both employer and employee contributions on behalf of the individual participant. The maximum deductible employer contribution is 25 percent of compensation for 2018, capped at $55,000. An employee contribution can be made either as a pretax or Roth employee deferral contribution for up to $18,500 for 2018 ($24,500 for employees age 50 or older). The total contributions (the combined amount of employer plus employee contributions) may not exceed $55,000 for 2018 ($61,000 for employees age 50 or older).

¶930 Pension Plans

The three basic types of pension plans are as follows:

- A defined benefit plan, which promises fixed or determinable benefits
- A target plan, which aims at providing a certain benefit (the target benefit) but does not promise it
- A money purchase plan, in which there are fixed employer contributions and the participant gets whatever benefit his or her pension account will ultimately buy

All three may be viewed as a way of spreading an employee's compensation over his or her lifetime, including the period after retirement. A tax-qualified pension plan offers all the well-known tax advantages of any qualified plan:

- The employer receives a current tax deduction for contributions to the plan.
- The employee is not currently taxed.

[226] IRC Section 72(t)(6).

- The pension fund grows in a tax-sheltered deferred environment and certain benefit distributions may receive favorable tax treatment.

From the employer's point of view, pension plans have always involved a long-term commitment to support the plan financially in good times and bad times so long as the plan continues. A financially healthy employer with confidence in future strength is most likely to make the commitment. Terminating pension plans is difficult. The excise tax on reversions of plan funds to the employer is generally 50 percent.[227] This tax is reduced to 20 percent if a qualified replacement plan is set up and maintained.[228] These cost factors encourage the adoption of nonguaranteed arrangements, such as profit-sharing plans and cash or deferred plans, including salary reduction plans, stock bonus plans, ESOPs, thrift plans, and IRAs. However, none of these plans offers a perfect solution to satisfy the needs of both the company and the employee.

The defined benefit plan still has an important role in some situations; it can provide a benefit based upon 100 percent of average compensation for the employee's highest three earning years, whereas a profit-sharing plan is basically a plan based on average earnings over the employee's career. This benefit of a defined benefit plan might be especially attractive to shareholder executives in closely held corporations.

The future of defined benefit plans must rest on holding costs in check. The vital element in pension planning remains the same—keeping a balance between costs and benefits on a scale the company can financially support. In recent years, many companies have determined that the cost of their defined benefit plans was too high, and the plan benefits were either reduced or eliminated (or converted into a defined contribution plan or an employee deferral plan). Currently, the largest use of defined benefit plans is for employees of state and local government bodies, where cost restraint seems less of a concern.

The factors to be taken into account and the methods of holding down costs will vary from company to company. These factors and methods depend on the nature of the operation, the character of the work force, its age and composition, turnover, and union affiliations.

A company might decide to participate in a ready-made, master or prototype plan sponsored by a trade association, insurance company, mutual fund, or bank. If a substantial number of employees are involved, the company should most likely call in plan design experts to tailor a plan to the company's own situation and that of its employees. The experts will marshal the facts, make the projections and actuarial assumptions for various alternatives, and leave the final decision to the company. The company might want to check what the competition is doing or has done. The following is a list of factors that will affect the costs and benefits of a defined benefit plan:

- *Coverage and participation*. A plan may exclude certain employees (¶905). Use of independent contractors and leased employees can also hold down costs. Although rules can cause leased employees to be treated as actual employees for employee benefit plan purposes, it is generally not the case if a leased employee works for the employer for less than one year.[229]

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[227] IRC Section 4980(d)(1).
[228] IRC Section 4980(a).
[229] IRC Section 414(n).

- *Type of plan*. Money purchase and target plans, as distinguished from defined benefit plans, can limit costs.

- *Benefit formula*. A formula using a career average compensation yields lower cost to the employer than a final pay formula.

- *Incidental benefits*. A no frills approach obviously keeps costs down. Incidental benefits include disability insurance, death benefits, and health and accident benefits for retired employees.

- *Integration with Social Security*. An integrated plan begins with a few Social Security benefits as its base and then has the employer supplement these benefits so that a coordinated retirement plan results. This integration with Social Security also can help reduce costs.

- *Employee contributions*. Mandatory contributions can cut costs. Voluntary contributions permit an employee to increase his or her benefits.

- *Vesting formula*. Which minimum standard (¶905) will produce lower costs, taking into account age, composition of employees, and expected rates of turnover? This answer will vary from company to company, often depending on the type of business being done.

- *Retirement age*. The older the retirement age (up to age 65), the lower the cost of providing specific benefits. If the plan allows early retirement, reduced benefits on a sound actuarial basis might reduce cost.

- *Investment and actuarial assumptions*. All costs, liabilities, rates of interest, and other factors under the plan must be determined on the basis of actuarial assumptions and methods. Each of these assumptions must be reasonable, taking into account the experience of the plan and reasonable expectations. Alternatively, in the aggregate, the assumptions must result in a total contribution equivalent to the contribution that would be obtained if each assumption was reasonable. Further, the actuarial assumptions and methods must, in combination, offer the actuary's best estimate of anticipated experience under the plan.

- *Past service*. Providing benefits for service before the adoption of the plan obviously adds to cost. Nevertheless, providing benefits for past service might be necessary because of practical considerations, such as attracting desirable employees. IRC Section 415 bars the use of such service in determining the maximum benefit allowable.

- *Speed of funding*. Generally, the faster funding takes place, the lower the cost, because income of the fund accumulates tax-free inside the plan and would be taxable outside the fund. However, a cap applies to the deductible amount. In addition, a 10-percent excise tax applies to nondeductible contributions.[230]

[230] IRC Section 4972(a).

.01 Money Purchase Plan

A money purchase pension plan calls for a specified contribution by the employer, such as a percentage of compensation of each covered employee. The plan promises no specific benefit. The employee receives whatever benefits the aggregate contributions will buy at retirement, plus the income and gains realized. This approach, by itself, gives no recognition to past service. For this reason, employers sometimes supplement it with a unit-benefit approach that may give credit for past service.

.02 Target Plan

A target benefit plan can be described as a hybrid of a defined benefit plan and a money purchase plan. It resembles a defined benefit plan in that annual contributions are based on the amount necessary to buy specified benefits at normal retirement. However, it differs from a defined benefit plan in that it does not promise to deliver the benefits, but merely sets the specified benefit as a target. Therefore, as in a money purchase plan (and a profit-sharing plan), the ultimate benefit depends on investment experience.

A contribution to a target plan, once made, is allocated to the separate accounts of the participants, as are increases or decreases in trust assets. Decreases in the trust assets are at the risk of the participants, rather than the employer. In a defined benefit plan, the employer must make greater contributions if trust assets decrease in value. Likewise, gains in asset value are for the benefit of the participants and do not reduce the employer's contributions.

.03 Incidental Life Insurance

Pension plans are primarily for retirement benefits, but they may include incidental life insurance benefits.[231] Under regular pension plans, coverage under an ordinary plan (for example, a whole life policy) is considered incidental so long as the face amount of the policy does not exceed 100 times the projected monthly benefit. With money purchase pension plans, the same limitation applicable to profit-sharing plans is used. The aggregate premiums for an ordinary policy must be less than one half of the amount standing to the credit of the participant at any specific time.[232]

The company may deduct the premiums paid for incidental life insurance. The pure insurance portion of the premium, determinable under a special table,[233] (see ¶945.01) is taxable to the participant. The participant may exclude the insurance proceeds from his or her gross estate if the policy satisfies the requirements of IRC Section 2042.

¶935 Thrift and Savings Plans

Thrift plans may possess the predominant characteristics of a profit-sharing plan, a pension plan, or a stock bonus plan. All forms of thrift plans, however, have one common characteristic: the employee-participants contribute some percentage of their compensation to the plan and the employer matches their contributions dollar-for-dollar, or in some other way spelled out in the plan. The plan may or may not be tax qualified.

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[231] Regulation Section 1.401-1(b)(1)(i).
[232] Revenue Ruling 66-143, 1966-1 CB 79 (January 1, 1966); Revenue Ruling 61-164, 1961-2 CB 99.
[233] Regulation Section 1.79(3)(d)(2).

When the plan is tax qualified, the employer receives a current income tax deduction for its contributions to the plan, and the employee is not currently taxed on such contributions. The employee's own contribution is not tax deductible but comes out of after-tax dollars. Both employer and employee contributions are free to grow within the plan tax deferred, and withdrawals and distributions are subject to the same taxation rules applicable to pension, profit-sharing, and stock bonus plans.

In the typical plan, the employee is required to contribute a percentage of compensation if the employee is to participate in the plan. If too high of a percentage was required, the lower paid employees would be unable to participate in the plan, and only the highly compensated employee would benefit. Special, complex nondiscrimination rules contained in IRC Section 401(m) prevent this situation.

A savings plan differs from the type of thrift plans previously discussed in that it may simply be an adjunct plan to an otherwise qualified pension, profit-sharing, or stock bonus plan, with the employee permitted to make voluntary contributions out of after-tax dollars in order to receive the tax shelter of deferring income tax liability on the growth of the plan assets that the plan affords. IRC Section 401(m) limits the amount of voluntary contributions the highly compensated may make, depending on the contributions made by other employees. The more generous the contribution opportunity offered for the rank-and-file employees, the greater the benefits that become available to the highly compensated.

A thrift plan may permit an employee to suspend contributions temporarily without losing the right to participate in the plan. Most plans permit withdrawals while the employee is still on the job, usually with some conditions attached. Some thrift plans provide for periodic distributions at specified intervals (for example, five years). On retirement, death, or disability, the entire amount in the employee's account usually becomes payable, although the plan may provide for other types of distributions.

¶940 Borrowing From the Plan

The terms of a qualified plan may permit the plan to lend money to participants without adverse income or excise tax results, if certain requirements are met.

In general, the law treats loans from qualified plans as distributions.[234] However, a loan will not be treated as a distribution to the extent aggregate loans to the employee do not exceed the lesser of (1) $50,000 or (2) the greater of one half of the present value of the employee's vested accrued benefit under such plans, or $10,000. The $50,000 maximum sum is reduced by the participant's highest outstanding loan balance during the preceding 12-month period.[235]

Plan loans generally must be repaid within five years,[236] unless the funds are used to acquire a principal residence for the participant.[237]

In addition, plan loans must be amortized in level payments and loan repayments must be made on no less than a quarterly basis over the term of the loan.[238] The deduction of interest on all loans from qualified plans by the employee is subject to the general interest deduction limitations, which generally deny

[234] IRC Section 72(p)(1)(A).
[235] IRC Section 72(p)(2)(A).
[236] IRC Section 72(p)(2)(B)(i).
[237] IRC Section 72(p)(2)(B)(ii).
[238] IRC Section 72(p)(2)(C).

a tax deduction for personal interest paid.[239] However, interest on loans secured by elective deferrals and interest on loans to key employees are not deductible in any event.[240]

An unreasonable rate of interest may cause the plan to be disqualified.[241]

Repayments of loans, including those treated as distributions, are not considered employee contributions under the rules limiting employee contributions or limiting additions to defined contribution plans.

A pledge of the participant's interest under the plan or an agreement to pledge such interest as security for a loan by a third party, as well as a direct or indirect loan from the plan itself, is treated as a loan.[242]

The plan administrator is subject to loan reporting requirements. In addition, the employee must furnish the employer plan with information on loans.

Loans to S corporation shareholders, partners, and sole proprietors qualify for the statutory exemption to the excise tax under the prohibited transaction rules of IRC Section 4975. The prohibited transaction rules still apply to loans from IRAs.

If a participant fails to make a loan payment when it is due, the plan administrator may allow a cure period. The IRS limits the cure period to the last day of the calendar quarter after the calendar quarter in which the loan payment was due. If the participant does not cure the default, the entire loan balance, including any accrued interest, is treated as a deemed distribution to the participant, subject to income tax and possibly to the 10-percent excise tax as well.[243]

¶945 Group-Term and Group Permanent Life Insurance

.01 In General

Group-term life insurance has been a valuable tax-favored employee benefit for many years. An employer may provide up to $50,000 of group-term life insurance coverage, on a tax-free basis to employees, under a plan that meets the requirements of IRC Section 79 and the regulations thereunder. An employer may make amounts of life insurance in excess of $50,000 available on favorable terms. The plan may not discriminate in favor of key employees. If the plan discriminates in favor of key employees, the $50,000 exclusion will not apply to the key employees.[244]

The cost of employer-provided group-term life insurance is treated as wages for FICA purposes to the extent the cost is includible in gross income for income tax purposes.[245]

Retired and disabled employees. The amount of group-term life insurance coverage that an employer may provide tax-free to a disabled employee who has terminated employment is unlimited.[246] The same

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[239] IRC Section 163(h).
[240] IRC Section 72(p)(3).
[241] Revenue Ruling 89-14, 1981-1 CB 111.
[242] IRC Section 72(p)(1)(B).
[243] Regulation Section 1.72(p)-1, Q&A 10.
[244] IRC Section 79(d)(1)(A).
[245] IRC Section 3121(a)(2)(C).
[246] IRC Section 79(b)(1).

has been true of retirees. However, retirees are generally subject to the $50,000 ceiling, subject to a grandfather rule for those retirees covered under a plan in existence on January 1, 1984 (or any comparable successor plan), who attained age 55 on or before that date and who either (1) were employed by the company during 1983 or (2) retired on or before January 1, 1984 and who, when they retired, were covered by a group-term life insurance plan of the employer (or a predecessor plan).

Tax treatment to employer and employee. If the employer is not a direct or indirect beneficiary of the policy and all other IRC Section 79 requirements are met, the employer receives a deduction for the insurance premiums paid.[247]

Insurance Provided on or After July 1, 1999, Five-Year Age Bracket Cost per $1,000 of Protection for One-Month Period

Under 25	$.05
25 to 29	.06
30 to 34	.08
35 to 39	.09
40 to 44	.10
45 to 49	.15
50 to 54	.23
55 to 59	.43
60 to 64	.66
65 to 69	1.27
70 and over	2.06

These cost-per-$1,000 figures are arbitrary and are not related to the actual premiums paid for the coverage. To illustrate how to use the premium tables, consider a key employee who is age 45 and covered by $150,000 of group-term life insurance. The employee's gross income attributable to the insurance coverage over $50,000 is calculated as follows:

> Step 1: Cost of insurance per $1,000 for an individual age 45 for one year ($.15 × 12) = $1.80
>
> Step 2: Amount to be included in the employee's gross income for the insurance coverage over $50,000 (100 × $1.80) = $180

This sum is added to the employee's gross income.

Note that state law may decrease the $50,000 ceiling; the amount of tax-free coverage to the employee may not exceed a state ceiling.[249]

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[247] IRC Sections 162(a) and 264(a)(1).
[248] IRC Sections 79(a) and 79(c).
[249] Regulation Section 1.79-1(e).

.02 Effect of Changing Insurers or Policies

Often, an employer may cancel a group-term policy with one insurance company and purchase a new policy with a new carrier, possibly one offering better service or lower rates.

Two important questions arise as the result of such change:

1. If, following the change, the insured makes a new assignment of incidents of ownership in the new policy to the assignee of the old policy, does the new assignment start a new three-year period for purposes of IRC Section 2035? This IRC section includes all gifts of life insurance made within three years of death in the gross estate of the transferor.

2. Is an assignment of all rights in a current group-term policy and of rights under any arrangement for life insurance coverage provided by the employer effective as a present transfer of rights under a policy issued by a new carrier?

The IRS in Revenue Ruling 79-231[250] answered yes to the first question and no to the second. In 1980, the IRS revoked this ruling and gave a conditional no answer to the first question but seemed to adhere to the prior no answer to the second question.[251]

The facts in both Revenue Ruling 79-231 and Revenue Ruling 80-289 were identical. They were as follows:

> In 1971 an employee who was insured under a group-term life insurance policy, the premiums for which were paid by the employer, assigned to his spouse all rights under the policy and under any arrangement of the employer for life insurance coverage. In 1977, the employer terminated the arrangement with one insurance carrier and entered into an arrangement with a new carrier identical in all relevant respects to the prior arrangement. Shortly thereafter and within three years of death, the employee executed an assignment of all his rights under the new policy to his spouse.

Rev. Rul. 80-289 states:

> The Internal Revenue Service maintains the view that the anticipatory assignment was not technically effective as a present transfer of the decedent's rights in the policy issued by Z [the new carrier]. Nevertheless, the IRS believes that the assignment in 1977 to D's (deceased employee's) spouse, the object of the anticipatory assignment in 1971, should not cause the value of the proceeds to be includible in the gross estate of the decedent under IRC Section 2035 where the assignment was necessitated by the change of the employer's master insurance plan carrier and the new arrangement is identical in all relevant aspects to the previous arrangement with Y [the prior carrier].

Thus, the ruling appears to be based on fairly narrow grounds. Consequently, prudence suggests that assignments of group-term insurance in situations where the employer has changed carriers should follow the requirements of this ruling to the letter:

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[250] 1979-2 CB 323.
[251] Revenue Ruling 80-289, 1980-2 CB 270.

1. Following a change of carriers, the insured should make a new assignment, spelling out his or her interests in the new policy. The sooner this takes place, the better.

2. The assignee should be the same person or legal entity, such as a trust, in both assignments.

3. The new group-term arrangement should be identical in all relevant respects to the prior arrangement. The ruling leaves unanswered the question of whether added amounts of coverage would affect the result. If coverage is added, the insured might make separate assignments to the same assignee of the old and new coverage, lest the new coverage be deemed to taint the entire assignment.

4. All premiums should be paid by the employer.

5. Although the ruling appears to deny the effectiveness of the anticipatory assignment, it may be a good idea to arrange for, in the original assignment, an assignment of the assignor's interest in a new policy necessitated by a change of insurance carriers. Under the facts disclosed in the ruling, the anticipatory assignment was of "rights under any arrangement for life insurance coverage of the employees" of the corporation. In those terms, it was broad enough to cover both employer-provided permanent life insurance and group-term insurance. Although the ruling does not state that this factor is the basis for the assignment's ineffectiveness, greater specificity might possibly obtain a favorable result in situations where the insured, following a change of carriers, does not get around to making a new assignment. Such anticipatory assignments are apparently not harmful, except possibly when the insured, after making the anticipatory assignment, has a change of heart and wants to make the assignment to another person.

Revenue Ruling 79-231, which contains a fairly detailed discussion of anticipatory assignment under local law, indicates that it is to be treated as a contract to assign insurance policies subsequently obtained and may be enforceable if and when a new policy is acquired. In this view, the promise becomes enforceable when the employer acquires a master policy from the new carrier.

If the insured has not made an anticipatory assignment, when a new carrier is substituted, the insured should be free to make an assignment to a different assignee. However, in doing so, the insured runs the risk of having the proceeds includible in his or her gross estate if the insured dies within three years of the new assignment.[252] The risk of that happening might, in some circumstances, be preferable to having the proceeds go to the first assignee, particularly if the taxpayer will not be subject to federal estate tax liability.

.03 Use of a Trust for a Group-Term Policy

Use of an irrevocable trust to hold a group-term policy and its proceeds can be an effective way of keeping the proceeds out of the gross estate of the insured,[253] provided the insured is able to avoid the problems associated with IRC Section 2035 (transfers within three years of death) and its special application to group-term life insurance.

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[252] IRC Sections 2035(a) and 2042.
[253] IRC Section 2042.

If a trust is to be used, the premiums paid by the employer (and any paid by the insured) will be deemed to be gifts from the insured to the trust beneficiaries. These transfers will be deemed gifts of future interests for which the gift tax annual exclusion for gifts of present interests will not be available.[254] However, the annual exclusion may be made available if the trust contains a Crummey power that gives the beneficiary the right to withdraw trust contributions of up to the annual exclusion amount ($15,000 for 2018, indexed annually for inflation) each year on a noncumulative basis. The IRS has ruled that when an irrevocable life insurance trust contains a Crummey power, the premium payment made by the employer for a group life insurance policy constitutes a direct payment by the employee that qualifies for the present interest exclusion as a result of the unrestricted demand right held by the beneficiaries.[255]

If the trust is set up to provide the surviving spouse a life interest in the proceeds, with limited powers of invasion of principal at the survivor's death, the proceeds may pass to those given remainder interests without being included in the gross estate of the survivor.[256]

.04 Group Permanent Life Insurance

Permanent life insurance, standing by itself, is not within the tax shelter provided by IRC Section 79 for group-term life insurance. However, regulations permit a policy of group-term insurance to include permanent benefits, provided a great many conditions are satisfied. Complex formulas are provided for determining the amount taxable to the employee under such policies.[257]

¶950 Death Benefits

Financial planning considerations for qualified retirement plan and IRA benefits are considered in ¶955. This section focuses on death benefits payable outside of formal retirement plans. These death benefits might consist of payments that the employer has contracted to make or may be in the nature of extra compensation for services performed. The payments are generally taxable income to the recipient.[258]

The employee may name the beneficiary of the death benefit. The employee might also be in a position to control the type and form of payment to be made to the beneficiary. The employee will want to consider the means of control available. The employee should also consider the income tax on the beneficiaries to be selected, along with federal and state estate tax effects. Should the executor be named as the beneficiary of all or part of the death benefit, or should beneficiaries other than the executor be named? Will enough funds be available to the executor to satisfy any liquidity requirements the estate may have? Other questions include the steps, if any, needed to protect the interests of the beneficiary. Will a trust be needed to protect his or her interests? Will a trust limiting the primary beneficiary to a life interest be desirable only as a means of avoiding estate taxes on the death of the primary beneficiary? Contractual death benefits are not includible in the employee's estate as annuities within the reach of IRC Section 2039(a).

The more than 5-percent reversionary interest rule of IRC 2037 may be a concern if there is a possibility that the beneficiary might die before the employee dies under conditions that will result in the benefits going to the employee's estate. The value of the interest is measured by IRS tables in the first instance.

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[254] IRC Section 2503(b).
[255] Revenue Ruling 76-490, 1976-2 CB 300.
[256] IRC Section 2041(b).
[257] Regulation Section 1.79-1(b).
[258] IRC Sections 61(a) and 691(a).

The values given by the tables are presumptively correct. The value varies with the age of the beneficiary. In a low interest rate environment, it is difficult to create any reversionary interest that will avoid the estate inclusion 5-percent test.

The IRS has taken the position that when a nonqualified death benefit is combined with a plan offering disability benefits for the employee, the death benefits are includible in the employee's gross estate as an annuity, subject to the premises of IRC Section 2039(a). The IRS lost this argument in *W. Schelberg Est.*,[259] but won under the same facts in *J. Looney*.[260] However, for undisclosed reasons, the IRS, after its victory in *Looney*, moved to vacate the District Court's opinion, thereby providing the taxpayer in that case with a victory by default.

The resulting victory accorded the taxpayer offers an opportunity to escape the annuity pitfall, at least in factual situations identical to those in the two cited cases.

The IRS developed another technique for extracting revenue from a contractual death-benefit-only arrangement. The underlying theory is that, when an employee designates a beneficiary of the death benefit, the employee makes a gift that is perfected and complete when death occurs.[261]

The U.S. Tax Court, in *A. DiMarco Est.*,[262]expressly rejected the gift-on-death theory advanced by the IRS in Revenue Ruling 81-31.[263] In *DiMarco*, the decedent was employed by IBM and participated in its death-benefit-only plan. Under the plan, the death benefit could only be paid to a spouse, minor children, or dependent parents. The decedent-employee had no control over the beneficiary designation or the amount or timing of the payment of the death benefit, all of which were predetermined by the plan and subject to the employer's control. The court found that the decedent possessed no interest in any fund established to pay the death benefit. Indeed, the death benefit became payable out of the employer's general assets. Subsequently, the IRS conceded this issue. It revoked Revenue Ruling 81-31[264] and acquiesced in *DiMarco*.[265] However, the acquiescence applies only under the following conditions: (1) the employee is automatically covered by the benefit plan and has no control over its terms, (2) the employer retains the right to modify the plan, and (3) the employee's death is the event that first causes the value of the benefit to be ascertainable.

Planning Pointer. A carefully structured death-benefit-only plan, following the outlines of the IBM plan previously described, might present a major planning opportunity. The death payments will escape both estate and gift tax, although the recipient of the death benefit will be liable for income tax on the full amount of the payments. In any event, planning should avoid naming the decedent's estate as either a primary or even a default beneficiary of the death benefit. Having a list of beneficiaries other than the estate will avoid a possible reversionary interest claim.

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[259] 612 F.2d 25 (2d Cir. 1979).
[260] 569 F. Supp. 1569 (D.C. Ga. 1983).
[261] Revenue Ruling 81-31, 1981-1 CB 475.
[262] 87 T.C. 653 (1986) (Acq.).
[263] 1981-1 CB 475.
[264] Revenue Ruling 92-68, 1992-2 CB 257.
[265] 1990-2 CB 1.

¶955 General Financial Planning Factors for Qualified Plan and IRA Benefits

Financial planning for qualified plan and IRA benefits should take into account income and estate tax considerations, the gift tax consequences of choosing various forms of distributions, the treatment of life insurance provided under a qualified plan, and possible liquidity concerns. Commencement of payment to a spouse of a required joint and survivor annuity automatically qualifies for the estate and gift tax marital deductions,[266] as discussed in greater detail in subsequent sections. Apart from the required survivor annuity situation, irrevocably designating any beneficiary will constitute a gift. On the other hand, a nonparticipant spouse's consent to the naming of another beneficiary does not constitute a gift by the spouse.[267] These various factors are explored in the following sections.

.01 Gift Tax Factors

The gift tax consequences of a spouse's qualified plan annuity rights and of naming nonspousal beneficiaries are discussed in the following paragraphs.

Spouses. As a general rule, a qualified retirement plan (but not an IRA, which is a retirement plan but not a qualified retirement plan) must provide a Qualified Joint and Survivor Annuity (QJSA) in the case of a married participant who retires, unless the participant's spouse consents to some other form of distribution. Plans generally must also provide a Qualified Pre-Retirement Survivor Annuity (QPSA) in the case of a vested participant who dies before the annuity start date and who has a surviving spouse.[268] The spouse's consent is needed in such a case to waive the annuity.[269] Plans subject to the survivor annuity rules must offer a qualified optional survivor annuity (QSOA) to participants who waive the QJSA or QPSA.[270]

The participant will generally not be treated as making a gift to his or her spouse by virtue of the spouse's right to receive an annuity. No gift occurs provided that the spousal joint and survivor annuity automatically qualifies for the estate and gift tax marital deductions[271] and will do so as long as only the spouses have the right to receive any payments before the death of the last spouse to die. Although the provision applies automatically, the executor or donor may elect not to have it apply.

The lack of transfer tax applicability also applies to a joint and survivor annuity payable to a spouse under an IRA.

IRC Section 2503(f) makes it clear that a nonparticipant spouse does not make a gift by virtue of a waiver of his or her qualified plan annuity rights.

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[266] IRC Sections 2056 and 2523.
[267] IRC Section 2503(f).
[268] IRC Section 401(a)(11).
[269] IRC Section 417.
[270] IRC Section 417(a)(1)(A).
[271] IRC Sections 2056 and 2523.

Nonspousal beneficiary. Irrevocably designating a nonspousal beneficiary of a qualified plan annuity will constitute a gift for gift tax purposes. The gift will be of a future interest and will not qualify for the gift tax present interest annual exclusion.[272]

.02 Estate Tax

Qualified plan and IRA benefits are fully includible in a participant's gross estate[273] (except for certain very limited grandfathered benefits).[274] A survivor annuity paid to a participant's surviving spouse who is a United States citizen automatically qualifies for the estate tax marital deduction,[275] as long as only the spouses have the right to receive any payments before the death of the last spouse to die (for further details, see the previous discussion in section 955.01 in connection with the gift tax). The same would be true of an annuity payable under an IRA.

.03 Life Insurance Proceeds

If a qualified plan provides participants with cash value life insurance, the cash value of the policy immediately before death is not excludable from gross income under IRC Section 101(a). However, the remaining portion of the proceeds paid to the beneficiary is excludable under IRC Section 101(a).[276] Life insurance proceeds paid under a qualified plan would be includible in the gross estate under IRC Section 2042, dealing with life insurance policies rather than under IRC Section 2039.[277] Therefore, the participant may be able to exclude the insurance proceeds from the gross estate by removing any incidents of ownership that the participant had in the policy more than three years before death.[278] An actual distribution of the cash value of the policy to the participant might be the best way for the participant to begin the process of having the proceeds excluded from the gross estate. The insured must recognize gross income, if any, to the extent that the cash received exceeds the adjusted basis in the policy.[279]

¶960 Employee Awards

An item of tangible personal property (not cash or cash equivalents, gift cards or gift certificates, vacations, meals, lodging, or tickets) transferred to an employee for length of service or safety achievement is excludable from gross income, subject to dollar limitations subsequently discussed.[280] The item must be awarded as part of a meaningful presentation and under circumstances that do not create a significant likelihood of the payment of disguised compensation.[281]

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[272] IRC Section 2503(b).
[273] IRC Section 2031.
[274] IRC Section 2039.
[275] IRC Section 2056.
[276] Regulation Section 1.72-16(c)(2)(ii).
[277] Regulation Section 20.2039-1(d).
[278] IRC Sections 2035(a) and 2042.
[279] IRC Section 72(e).
[280] IRC Sections 74(c)(1), 162(a) and 274(j)(2).
[281] IRC Section 274(j)(3)(A).

Length-of-service awards qualify only if made after a minimum of five years of service.[282] Managers, administrators, clerical workers, and other professional employees are precluded from receiving qualifying safety awards because their positions do not involve safety concerns.[283]

The employer's deduction for all awards of tangible personal property provided to the same employee generally is limited to $400.[284] The limit is $1,600 in the case of a qualified plan award,[285] defined as an award provided under an established written plan or program that does not discriminate in favor of highly compensated employees.[286] The $1,600 limit also applies in the aggregate to both types of awards.

If the award is fully deductible by the employer, (a non-wage business expense) then the full fair market value of the award is excludable by the employee.[287] If the deduction limit prevents a portion of the cost from being deducted by the employer, then the employee receives only a partial exclusion. In such cases, the employee must include in his or her gross income the greater of (1) the portion of the cost that is not deductible, or (2) the amount by which the item's fair market value exceeds the deduction limitation.[288]

¶965 Health Plans

An employer may provide medical benefits to employees either without charge to the employees or on an employee contribution basis. The benefits may include payment or reimbursement of medical (including dental) expenses of the employee and his or her dependents. In addition, the employer may provide payment of or reimbursement for premiums for accident and health insurance, including major medical and dental insurance, for the employee and his or her dependents. That said, there are a number of issues arising under the Affordable Care Act that limit how an employer may reimburse an employee for health care benefits, including penalties imposed on an employer where reimbursement to employees for health care costs may constitute an impermissible group health plan. This issue was addressed in legislation enacted in late 2016 and is discussed in ¶1605.01 and in chapter 39.

The amounts the employer pays or reimburses for medical expenses may be completely tax-free to employees[289] (including those who are retired[290]and those who have been laid off)[291] and the payments are fully deductible by the employer, assuming that total compensation is not unreasonable.[292]

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282 IRC Section 274(j)(4)(B).
283 IRC Section 274(j)(4)(C).
284 IRC Sections 162(a) and 274(j)(2)(A).
285 IRC Section 274(j)(2)(B).
286 IRC Section 274(j)(3)(B).
287 IRC Section 74(c)(1).
288 IRC Section 74(c)(2).
289 IRC Sections 105 and 106.
290 Revenue Ruling 82-196, 1982-2 CB 53.
291 Revenue Ruling 85-121, 1985-2 CB 57.
292 IRC Section 162(a).

The benefit is especially valuable to employees because medical expenses paid by employees are deductible only to the extent that they exceed 7.5 percent of AGI[293] in 2018 and because itemized deductions of any kind operate to reduce tax liability only to the extent that they exceed the standard deduction.

Self-insured medical reimbursement plans are subject to special nondiscrimination rules.[294]

One type of health plan is worthy of particular note because it combines the ability to cover health costs on a tax-favored basis with the opportunity for tax-favored savings.

IRC Section 223 permits eligible individuals to establish health savings accounts (HSAs). An HSA is a tax-exempt trust or custodial account established exclusively for the purpose of paying out-of-pocket medical expenses of the account beneficiary who, for months in which contributions are made to an HSA, is covered under a high-deductible health plan (HDHP).[295] HSAs can receive tax-favored contributions by or on behalf of eligible individuals, and amounts accumulated in an HSA may be distributed on a tax-free basis to pay or reimburse qualified medical expenses.

In the case of an HSA established for an employee, the employee, the employer, or both may contribute to the HSA. Employer contributions to an employee's HSA are treated as employer-provided coverage for medical expenses under an accident or health plan and are excludable from the employee's gross income. The employer contributions are not subject to withholding from wages for income tax or subject to payroll taxes. An individual's own contributions to his or her HSA are deductible in determining AGI (that is, they are deductible above the line, whether or not the employee itemizes deductions). An employee's own contributions can be made through a cafeteria plan, in which case they are treated as employer contributions that are excludable from the employee's income. Employer-provided coverage under a HDHP is treated like other health plan coverage for tax purposes.

The HDHP supporting an HSA may be either an insured plan or an employer-sponsored self-insured medical reimbursement plan. For 2018, the minimum annual deductible is $1,350 for self-only coverage and $2,700 for family coverage. The annual out-of-pocket expense limit is $6,650 for self-only coverage and $13,300 for family coverage. These amounts are indexed annually for inflation. [296]

Employees or their employers (or a combination) can contribute one-twelfth of the maximum annual contribution for each month of eligibility.

For 2018, the maximum annual contribution is $3,450 for self-only coverage and $6,900 for family coverage.[297]

Planning Pointer. The elimination of the plan deductible limit can significantly increase the maximum deduction, especially for individuals covered by an HDHP with a relatively low annual deductible.

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[293] IRC Section 213(a).
[294] IRC Section 105(h).
[295] Notice 2004-2, 2004-2 IRB 269 (December 22, 2003).
[296] Revenue Procedure 2017-37, May 4, 2017.
[297] Revenue Procedure 2017-37, May 4, 2017.

Example 9.6. Sherman has self-only coverage under an HDHP and contributes to an HSA. His HDHP has the lowest permitted deductible—$1,350 for 2018. He can contribute up to the maximum contribution limit of $3,450, even though that's more than double the amount of his deductible.

Individuals age 55 or older can make catch-up contributions in addition to their regular contributions for the year. Catch-up contributions may also be made on behalf of a spouse who is covered under an individual's HDHP and who meets the age requirements (the catch-up contribution limit is $1,000 for 2018 and later years).

An individual is generally eligible for HSA contributions for a given month only if covered by an HDHP as of the first day of the month. However, an individual who establishes an HSA partway through the year can contribute the full annual amount. For purposes of calculating the maximum annual contribution, an individual who is an eligible individual for the last month of the tax year is treated as (*a*) having been an eligible individual during each of the months in that tax year and (*b*) having been enrolled in the same HDHP in which the eligible individual is enrolled for the last month of the tax year.[298]

Planning Pointer. Only those part-year enrollees who begin HSA participation during the year and are covered by an HDHP at year end are eligible to make the maximum annual contribution. Contributions by or for an individual who ceases to be eligible during the year continue to be limited to one-twelfth of the maximum contribution for each month of eligibility.

Another option for funding an annual HSA contribution is to use funds in a traditional or Roth IRA. An individual who is eligible for an HSA can make one lifetime qualified HSA funding distribution from an IRA or Roth IRA. Any amount that would otherwise be included in gross income on account of the distribution will be excluded if applicable requirements are met.[299] A qualified HSA funding distribution is not subject to the 10-percent tax on early withdrawals of IRA funds. However, no HSA deduction is allowed for the amount contributed to the HSA from a traditional IRA or from a Roth IRA. Moreover, the annual limit on other HSA contributions is reduced by the amount of a qualified HSA funding distribution. A qualified HSA funding distribution must be made by means of a direct trustee-to-trustee transfer. Once made, a qualified HSA funding distribution is irrevocable.

To ensure tax-free treatment for a qualified HSA funding distribution, an individual must remain eligible for HSA coverage during a 12-month testing period beginning with the month the qualified HSA funding distribution is made. If an individual is not eligible for HSA coverage (for example, if the individual is not covered by an HDHP) at any time during a testing period, the amount of the qualified HSA funding distribution must be included in gross income for the tax year that includes the first month in which the individual is not eligible. In addition, a 10-percent penalty tax applies to the included amount. Note, however, that if an individual ceases to be eligible because of death or disability, the addition to gross income and the penalty tax do not apply.

An HSA distribution that is used exclusively to pay qualified medical expenses (that is, medical expenses that are not covered by insurance or otherwise, including expenses for nonprescription drugs) of the account holder and his or her spouse or dependents is excludable from income. The exclusion applies even if the account holder is not eligible to make HSA contributions at the time of the distribution

[298] IRC Section 223(b)(8)(A).
[299] IRC Section 408(d)(9).

(for example, if the account holder is no longer covered by an HDHP or has reached age 65 and is enrolled in Medicare). Also, the exclusion applies to distributions for qualified expenses of a spouse or dependent who is not covered by the high-deductible plan.

The receipt of medical care for armed service-connected disability does not affect HSA eligibility. Eligible individuals may, subject to statutory limits, make deductible contributions to an HSA. Other persons (for example, family members) also may contribute on behalf of eligible individuals. Eligible individuals are those who are covered under an HDHP and are not covered under any other health plan which is not an HDHP, unless the other coverage is permitted insurance (for worker's compensation, torts, ownership and use of property such as auto insurance, insurance for a specified disease or illness, or providing a fixed payment for hospitalization) or coverage for accidents, disability, dental care, vision care, or long-term care. There is no deduction for an HSA contribution for any month an individual is eligible for and enrolled in Medicare.

For months beginning after December 31, 2015, an individual will not fail to be treated as an eligible individual solely because of receiving hospital care or medical services under any law administered by the VA for a service-connected disability.[300]

In general, payments for health insurance premiums are not qualified payments for purposes of HSA withdrawals, with several exceptions. Payments for four types of health insurance are qualified HSA medical expenses. These include the following:

1. Premiums for long-term care insurance
2. Health insurance premiums during periods of continuation coverage required by federal law (for example, COBRA coverage)
3. Health insurance premiums during periods that the individual or spouse is receiving unemployment compensation
4. For persons age 65 or older, any health insurance premiums, including Medicare Part B and Part D premiums, other than a Medicare supplemental policy

[300] IRC Section 223(c)(1)(C).

Planning Pointer. An individual can receive distributions from an HSA at any time and for any purpose. A distribution that is not used to pay qualified medical expenses is includable in the gross income of the account holder. In addition, such a distribution generally is subject to a 20 percent penalty tax. However, the penalty tax does not apply to a distribution that is made after the account holder's death or disability, or after the account holder reaches age 65. In other words, funds in an HSA that are not needed for medical expenses can serve as a tax-deferred savings account for retirement.

An employer with more than 19 employees must meet the COBRA continuation coverage requirements of IRC Section 4980B.

To improve the portability of health insurance coverage, the Health Insurance Act of 1996[301] placed restrictions on the ability of certain group health plans to exclude individuals from coverage based on preexisting conditions or health status. Group health plans, other than government and small employer plans (plans with fewer than two current employees at the beginning of the plan year) that fail to comply with these restrictions face stiff fines.

Broadridge Advisor offers a comprehensive Health Care Reform Resource Center to help financial planners answer questions such as the following: If I already have health insurance, can I keep my existing coverage? Do small businesses have to offer health insurance to employees or face a penalty? How does the law affect seniors and Medicare? What are health exchanges? AICPA PFP and PFS members have free access to Broadridge Advisor (a $499 value) included in their membership.

The AICPA Health Care Reform Resources Center offers additional Affordable Care Act tools and resources.

¶970 Below-Market Loans to Employees

Below-market interest loans made by the employer offer an attractive benefit to those employees to whom the loans are extended. An employer may offer loans to employees on a selective basis without meeting the nondiscrimination rules that apply to many other benefits. The loans may serve needs related to the borrower's employment or solely personal needs. For example, an employer may provide a loan to finance the purchase of company stock under a stock purchase plan or stock option. Employer loans might also provide funds for investment, college, a home purchase, or a family emergency.

.01 Demand Loans Versus Term Loans

The tax treatment of these loans is largely favorable for both the employer and the employee.[302] The law draws a distinction between demand loans and term loans.[303]

In the case of a demand loan, the employee-borrower is treated as having paid to the employer-lender imputed interest for any day the loan is outstanding. The employer-lender is treated as having received the amount so paid as interest and as having transferred an identical amount to the borrower as wages.[304]

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301 Public Law No. 104-191.
302 IRC Section 7872.
303 IRC Sections 7872(a) and 7872(b).
304 IRC Section 7872(a)(1).

The employee has gross income in the amount of the value of the use of the money lent[305] and a possible interest deduction for the imputed interest.[306] However, deductions for personal interest are generally disallowed.[307] The employer receives the imputed interest as gross income and has an equivalent deduction for imputed compensation paid, if any, subject to reasonable compensation limits.[308] The employer's real cost is the loss of the use of the money loaned.

In the case of a term loan, the employer is treated as transferring to the employee, on the date of the loan, compensation in an amount equal to the excess of the amount of the loan over the present value of principal and interest (if any) due under the loan. This excess is then treated as original issue discount, and the employer and the employee are respectively treated as receiving and paying interest over the life of the loan.[309] The employee is taxed upfront, but the employee's interest deductions, if any, are spread out over the term of the loan. The situation is just the opposite for the employer. Interest deductions are subject to various limitations and restrictions, including the fact that personal interest paid by the employee is not deductible.[310]

A compensation-related term loan is to be treated as a demand loan if the benefit derived by the employee from the interest arrangement is (1) nontransferable and (2) conditioned on the future performance of substantial services by the employee.[311]

.02 Factors to Consider

Loans of $10,000 or less. For any day on which the amount of the loan outstanding does not exceed $10,000, no amounts are deemed transferred by the employer to the employee-borrower and retransferred by the employee to the lender.[312]

Imputed interest rates. If the loan is for less than four years or is a demand loan, the imputed interest rate is the federal short-term rate. If the loan is for over four years, but not over nine years, the federal mid-term rate is to be used. If the loan is for over nine years, the federal long-term rate applies.[313] The rates are revised monthly.[314]

Advantage of loan secured by residence. If a no-interest loan from an employer is secured by the employee's residence and otherwise meets the IRC Section 163(h) rule for qualified residence debt, the employee may deduct the imputed interest as an itemized deduction. The deduction for the interest would provide the employee with a tax benefit to the extent that the employee's total itemized deductions exceed the standard deduction. The imputed interest deemed received is extra compensation income.

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305 IRC Section 61(a).
306 IRC Section 163.
307 IRC Section 163(h).
308 IRC Section 162(a).
309 IRC Section 7872(b).
310 IRC Section 163(h).
311 IRC Section 7872(f)(5).
312 IRC Section 7872(c)(3)(A).
313 IRC Section 1274(d)(1)(A).
314 IRC Section 1274(d)(1)(B).

¶975 Cafeteria Plans

Under an IRC Section 125 cafeteria plan, a participant may choose between two or more benefits, consisting of cash and qualified benefits. Cafeteria plans that reimburse health and dependent care costs are sometimes called flexible spending accounts. A plan must be in writing,[315] be maintained for the exclusive benefit of employees,[316] and must also meet various nondiscrimination requirements. First, the plan must not discriminate in favor of highly compensated employees for eligibility to participate.[317] Second, the plan must meet a concentration test under which qualified benefits provided to key employees may not exceed 25 percent of aggregate qualified benefits provided to all employees.[318] Third, each type of benefit available or provided under a cafeteria plan is subject to its own applicable nondiscrimination rules and to any applicable concentration test.[319]

Failure to meet the eligibility discrimination tests results in highly compensated employees being taxed on the value of available taxable benefits.[320] Similarly, failure to meet the 25-percent tests results in key employees being taxed on the value of available taxable benefits.[321] Failure to meet individual nondiscrimination requirements generally results in highly compensated employees being taxed on the discriminatory excess.

A cafeteria plan may offer the following nontaxable benefits: group-term life insurance up to $50,000 (¶945), coverage under an accident and health plan (¶965), coverage under a dependent care assistance program (¶980), adoption assistance (¶3450), and 401(k) plan participation (¶925). Any such benefits chosen and received will be nontaxable if the requirements of the applicable IRC sections are met.[322] A plan may also offer, as a qualified benefit, group-term life insurance in excess of $50,000.[323]

The most popular nontaxable benefits under cafeteria plans are health insurance, other medical costs, and dependent care assistance. Some cafeteria plans are known as premium-only plans (POP). A POP allows the employee to pay the employee's portion of group health insurance for the employee or for the employee's family with tax-sheltered dollars. Many cafeteria plans allow dependent care assistance in addition to the cost of group health insurance. Reimbursements from cafeteria plans are excluded from gross income and excluded from wages for employment tax purposes.

The IRS has ruled that a health flexible spending account cafeteria plan may reimburse employees for the cost of nonprescription drugs.[324] The reimbursement is nontaxable to the employee. By contrast, if an individual incurs nonprescription drug costs, except insulin, that are not reimbursed under an employee benefit plan, such costs are not deductible as an itemized deduction under IRC Section 213.[325] The cost of food supplements, such as vitamins, that an employee takes to maintain good health is not

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[315] Proposed Regulation Section 1.125-1(c).
[316] IRC Section 125(d)(1).
[317] IRC Section 125(b)(1).
[318] IRC Section 125(b)(2).
[319] IRC Section 125(f).
[320] IRC Sections 61(a) and 125(b)(1).
[321] IRC Sections 61(a) and 125(b)(2).
[322] IRC Section 125(f) and Proposed Regulation Section 1.125-1.
[323] Revenue Ruling 2003-102, IRB 2003-38 (September 22, 2003).
[324] Revenue Ruling 2003-102, IRB 2003-38 (September 22, 2003).
[325] Revenue Ruling 2003-58, IRB 2003-22 (May 15, 2003).

eligible to be reimbursed under a cafeteria plan.[326] Employers may need to revise their cafeteria plans to provide for the reimbursement of nonprescription drugs if they want to provide this benefit.

A plan may offer benefits that are nontaxable by reason of employee after-tax contributions. For example, a plan may offer participants an opportunity to purchase health coverage with their own after-tax contributions.[327]

A plan may not offer a benefit that defers the receipt of compensation,[328] subject to certain exceptions. One exception is that an employer may offer participants the opportunity to make elective contributions under an IRC Section 401(k) arrangement.[329]

A salary reduction feature is permitted, but the employee must choose the salary reduction in advance and forfeit any unused benefits. For instance, assume an employee takes a salary reduction of $2,000 in exchange for medical reimbursements in a like amount. However, the employee incurs medical expenses of only $1,500. The employee must forfeit the unused $500. In the past, this use-it-or-lose-it rule strictly applied on a year-by-year basis. However, IRS rules now permit a cafeteria plan to be amended to allow a grace period of up to 2½ months for tapping unused benefits from the prior plan year. If a grace period is adopted, qualified expenses incurred during the grace period may be paid or reimbursed from funds remaining in an employee's account at the end of the prior plan year.[330] A 2½ month grace period may, for example, be adopted for a health or dependent care flexible spending arrangement under a cafeteria plan.

The IRS now allows tax-free payment or reimbursements for medical costs under a cafeteria plan to be made by debit cards, credit cards, and other electronic media. However, the employer must have adequate controls in place to assure that such payments or reimbursements are for medical costs only.[331]

For 2017, the flexible spending arrangements (FSA) contribution limits are generally a minimum of $25 and a maximum of $2,650, with the dependent care limit of a minimum of $25 and a maximum of $5,000 for married persons filing joint returns and $2,500 for married persons filing separately.

¶980 Employer-Provided Dependent Care Assistance

IRC Section 129 provides that employees may exclude up to $5,000 of employer-provided dependent care assistance from their gross income.[332] The $5,000 limit is not indexed to inflation. For highly compensated employees to be allowed the exclusion, the employer must provide the benefits under a written nondiscriminatory plan.[333]

The dependent care may be directly provided by the employer or by a third party. Payments made to a person for whom the employee or his or her spouse may take a dependency exemption, and payments

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[326] IRC Sections 79(a) and 125(f).
[327] Proposed Regulation Section 1.125-1(h).
[328] IRC Section 125(d)(2)(A).
[329] IRC Section 125(d)(2)(B).
[330] Notice 2005-42, 2005-23, IRB 1 (May 18, 2005).
[331] Revenue Ruling 2003-43, IRB 2003-21 (May 6, 2003).
[332] IRC Sections 129(a) and 129(d).
[333] IRC Section 129(d).

made to children under age 19, are not eligible for the exclusion.[334] A child attains age 19 on the 19th anniversary of the date on which the child was born. For example, a child born on January 1, 1999, attained age 19 on January 1, 2018.[335]

The amount excluded from gross income reduces the amount of expenses that qualify for the credit available under IRC Section 21 for payments for household and dependent care services.[336]

Payments made by the employer are deductible under IRC Section 162(a) to the extent that they are ordinary and necessary business expenses.

IRC Section 129 plans can be tested for nondiscrimination under the IRC Section 129 rules. The penalty for failing the IRC Section 129 test is that all highly compensated employees must include the value of any benefits they receive from the plan in their gross income.[337]

There is a tax credit for employers that provide child care benefits to employees. The credit is part of the general business credit. The credit for the employer is equal to the sum of 25 percent of qualified child care expenditures and 10 percent of qualified child care resources and referral expenditures.[338] The employer credit is limited to a maximum amount of employer-provided child care credit of $150,000 per year.[339] The employer may not receive a deduction for any expenditures used as a base for the credit.[340] In addition, the employer must reduce the basis of the qualified property for expenditures claimed as a base for the credit.[341] The credit is subject to recapture if an employer terminates the child care benefits.[342] ATRA permanently extended this credit.

¶985 IRC Section 132 Fringe Benefits

IRC Section 132 excludes certain categories (discussed in the subsequent sections) of employer-provided benefits from an employee's gross income and from employment taxes.

.01 No-Additional-Cost Service

The entire value of any no-additional-cost service provided by an employer to an employee (including an employee's spouse or dependent children) or a retiree is excludable from the employee's or retiree's gross income. The exclusion is available to highly compensated employees only if the employer meets nondiscrimination requirements.[343] The employer may incur some additional cost or loss of revenue, provided it is not substantial.[344]Also, another business with which the employer has a reciprocal written

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[334] IRC Section 129(c).
[335] Revenue Ruling 2003-72, IRB 2003-33 (July 18, 2003).
[336] IRC Section 129(e)(7).
[337] IRC Sections 61(a) and 129(d)(1).
[338] IRC Section 45F(a).
[339] IRC Section 45F(b).
[340] IRC Section 45F(f)(2).
[341] IRC Section 45F(f)(1)(A).
[342] IRC Section 45F(d).
[343] IRC Section 132(j)(1).
[344] IRC Section 132(b).

agreement may provide the services.[345] For example, two airlines may provide seats for each other's employees.

Examples of such excluded services include airline, railroad, bus, or subway seats if customers are not displaced. Hotel rooms provided to employees working in the hotel business would also be excluded. Utilities may also qualify if excess capacity is available (for example, phone services provided to phone company employees).

.02 Employee Discounts

An employee may exclude a qualified employee discount from gross income.[346] The value of a discount on services provided to an employee is excluded from the employee's gross income to the extent that it does not exceed 20 percent of the selling price of the services to customers.[347] In the case of goods, the discount may not exceed the gross profit percentage of the price at which the employer offers the property for sale to customers.[348]

In either case, the property or service must be of the same type that is ordinarily sold to the public in the line of business in which the employee works. The discount must go to a current employee or retiree, the spouse or dependent child of either, or the surviving spouse or dependent child of a deceased employee.[349]

The discount is not excluded from the gross income of highly compensated employees unless the employer meets certain nondiscrimination requirements.[350] Also, discounts on the sale of real estate or personal property held for investment (for example, stock) do not qualify for exclusion. If an employee receives a discount on such property, the employee must include the discount in gross income.[351] For example, if a real estate broker allows a discount on the sale of real estate to a real estate salesperson, the salesperson must include the discount in gross income.

To some extent, employee discounts on merchandise can be a substitute for cash compensation. The law does not limit the aggregate value of the discounts that an employee may exclude from gross income. However, practical considerations might limit the ability of an employee to take full advantage of the available discounts.

.03 Working Condition Fringe Benefits

The fair market value of any property or services provided to an employee is excluded from the employee's income to the extent that the cost of the property or services would be deductible as ordinary

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[345] IRC Section 132(h)(3)(i).
[346] IRC Section 132(a).
[347] IRC Section 132(c)(1).
[348] IRC Section 132(c)(2).
[349] IRC Section 132(h).
[350] IRC Section 132(j)(1).
[351] IRC Sections 61(a) and 132(c)(4).

and necessary business expenses if the employee had paid for such property or services.[352] The nondiscrimination requirements do not apply to working condition fringe benefits.[353] Thus, a highly compensated employee may exclude working condition fringe benefits from his or her gross income even if the employer provides such benefits only for certain employees.

Examples of working condition fringe benefits include the following:

- Use of a company car or airplane for business purposes
- Subscription to publications useful for business purposes
- Use of a car by full-time salespersons
- Certain consumer product testing by employees
- A bodyguard or a car and a driver provided for security reasons
- On-the-job training
- Business travel
- Under certain circumstances, outplacement services[354]

.04 *De Minimis* Fringe Benefits

Property or services not otherwise tax-free are excluded from an employee's gross income if their value is so small that they make accounting for the benefits unreasonable or administratively impracticable. The frequency with which similar fringe benefits (otherwise excludable as *de minimis* fringes) are provided by the employer is to be taken into account, among other relevant factors, in determining whether the fair market value of the property or services is so small that accounting would be unreasonable or impracticable.[355]

Examples of *de minimis* fringe benefits include occasional use of copying machines, supper money, taxi fare because of overtime, and holiday gifts with a low fair market value.

Subsidized eating facilities operated by the employer on or near the employer's business premises are considered *de minimis* if revenue from the facilities equals or exceeds direct operating costs. The employer may restrict the use of the facilities to a reasonable classification of employees, as long as the employer does not discriminate in favor of highly compensated employees.[356]

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[352] IRC Sections 132(a) and 132(d).
[353] IRC Section 132(j)(1).
[354] Revenue Ruling 92-69, 1992-2 CB 51.
[355] IRC Sections 132(a) and 132(e)(1).
[356] IRC Section 132(e)(2).

.05 Qualified Transportation Fringe Benefits

Certain employer-provided transportation fringe benefits are tax-free to employees.[357] These benefits include transit passes or vouchers worth up to $260 a month (for 2018); commuting in a commuter highway vehicle worth up to $260 a month (for 2018); employer-provided parking worth up to $260 (for 2018) a month at or near the employer's premises, or a place from which the employee commutes by mass transit. For 2018 and beyond, as the result of the 2017 Tax Cuts and Jobs Act, these benefits are no longer deductible by the employer and the employee exclusion for bicycling is repealed, even if provided by the employer.[358] The aggregated tax-free amounts for transit passes and highway vehicle commuting may not exceed $260 a month (for 2018).[359] Commuters can receive both the transit and parking benefits (that is, up to $520 per month in total). Employers can allow employees to use pretax dollars to pay for transit passes, vanpool fares, and parking, but not for bicycle benefits. These amounts are indexed for inflation.[360] Employer-provided benefits greater than these amounts are taxable to the employee.[361]

What will likely happen is that many employers desiring to continue this program will increase the employee's taxable compensation to take into account the benefit of the transportation fringe, thereby allowing the employer a compensation deduction for what is paid.

These qualified transportation fringe benefits may not be provided on a tax-free basis to partners, 2-percent S corporation shareholders, sole proprietors, or independent contractors.[362] However, the IRS stated in Notice 94-3[363] that the *de minimis* and working condition fringe benefit rules apply to partners, S corporation shareholders, and independent contractors. Therefore, these taxpayers may still exclude from their gross income employer-provided transit passes, valued at no more than $21 a month, and employer-provided business-transportation-related parking (but not commuter parking) under the preexisting rules.

.06 On-Premises Athletic Facilities

The value of any on-premises athletic facilities (gym or other facilities) provided for employees, their spouses, or their dependent children is not includible in the employees' gross income.[364]

.07 Moving Expenses

As the result of the 2017 Tax Cuts and Jobs Act, employer reimbursements of qualified job-related moving expenses are no longer deductible by the employer or received tax free by employees.[365]

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[357] IRC Section 132(f)(2).
[358] IRC Sections 132(f)(1) and 132(f)(2); Revenue Procedure 2008-66, 2008-45 IRB 1107, as modified by Revenue Procedure 2009-21, 2009-16 IRB.
[359] IRC Section 132(f)(2)(A) and Revenue Procedure 2007-66, 2007-45 IRB 960 (October 18, 2007).
[360] IRC Sections 132(f)(6). IRS Publication 15-B, 2016.
[361] IRC Sections 61(a) and 132(f)(2).
[362] IRC Sections 132(f)(5)(E), 401(c), 1372(a), and Regulation Section 1.132-9.
[363] 1994-1 CB 327; T.D. 8933.
[364] IRC Section 132(j)(4).
[365] IRC Sections 132(a); 217

.08 Qualified Retirement Planning Services

An exclusion for qualified retirement planning services allows employees and their spouses to exclude from their gross income the value of qualified retirement planning services provided by employers that sponsor qualified retirement plans.[366] Qualified retirement planning services include retirement planning advice and information.[367] The exclusion applies to highly compensated employees only if the employer offers the retirement planning services to all employees of the group who normally receive information and education about the plan.[368] The exclusion does not extend to related services such as tax return preparation. This exclusion has been made permanent.

¶990 The "myRA"

The myRA has been suspended by the Treasury because it did not gain the following or popularity that had been intended. The intent of the myRA ("my retirement account") was to enable small-dollar savers to establish an after-tax Roth IRA contribution through payroll deduction with a Treasury-designated custodian without paying fees or start-up costs.

Exhibit 9-1: Annual Limits for Retirement Plans

Annual Limits

Type of Limit	2018	2017
Elective deferral limit for 401(k), 403(b), 457, and salary reduction simplified employee plans (SARSEP)	$18,500	$18,000
Catch-up amount for 401(k), 403(b), and 457(b) plans for age 50 and over	$6,000	$6,000
Elective deferral limit for savings incentive match plan for employees (SIMPLE)-IRA and SIMPLE-401(k) plans	$12,500	$12,500
Catch-up amount for SIMPLE-IRA and SIMPLE-401(k) plans for age 50 and over	$3,000	$3,000
Limit on annual additions to defined contribution plans, including 401(k), profit-sharing, and money purchase plans	$55,000 or 100% of pay	$54,000 or 100% of pay
Limit on annual benefits under defined benefit plans	$220,000 or 100% of pay	$215,000 or 100% of pay
Maximum compensation for qualified plans, simplified employee pension plans (SEPs), and 403(b) plans	$275,000	$270,000
Minimum compensation for SEP plans	$600	$600
Highly compensated employee definition benefit	$120,000	$120,000
Key employee compensation in top-heavy tests	$175,000	$175,000
ESOP payout limits (five-year threshold amount and one-year extender amount)	$1,105,000 ÷ $220,000	$1,080,000 ÷ $215,000
FICA taxable wage base	$128,400	$127,200

366 IRC Section 132(a)(7).
367 IRC Section 132(m)(1).
368 IRC Section 132(m)(2).

IRA and Roth IRA contribution	$5,500	$5,500
IRA and Roth IRA catch-up for age 50 and over	$1,000	$1,000
IRA deductibility, active participant, single tax filer	MAGI $63,000 – $73,000	MAGI $62,000 – $72,000
IRA deductibility, active participant, married joint tax filer	MAGI $101,000– $121,000	MAGI $99,000 – $119,000
IRA deductibility, active participant, married separately tax filer	MAGI $0 – $10,000	MAGI $0 – $10,000
IRA deductibility, spouse of active participant	MAGI $189,000 – $199,000	MAGI $186,000 – $196,000
Roth IRA contribution, single tax filer	MAGI $120,000 – $135,000	MAGI $118,000 – $133,000
Roth IRA contribution, married joint tax filer	MAGI $189,000 – $199,000	MAGI $186,000 – $196,000
Roth IRA contribution, married filing separately tax filer	MAGI $0 – $10,000	MAGI $0 – $10,000

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