Tax-Qualified Retirement Plans

5

The role of Social Security and employer-provided defined benefit pension plans in providing a secure retirement income is diminishing. The importance of self-directed plans such as 401(k)s and 403(b)s is increasing. Yet despite the significance of this shift, many people still do not understand the retirement plans and options they have. This understanding is essential if individuals are going to be able to effectively plan for their own retirement and make wise decisions about managing their income once they retire.

In recognition of the need to encourage individuals to save more for retirement, the U.S. Government has sanctioned a number of tax-favored retirement plans. These "tax-qualified" plans must meet the specific requirements of the Internal Revenue Code, as well as the requirements of various other laws that have been enacted over the years, such as the Employee Retirement Income Security Act of 1974 (ERISA) and the Pension Protection Act of 2006 (PPA).

Some of the most common types of tax-qualified retirement plans are described below.

Personal Retirement Savings Plans

Individual Retirement Arrangements (IRAs)

An individual retirement arrangement (also known as an individual retirement account or individual retirement annuity) is a tax-deferred retirement plan, typically set up through a bank, mutual fund company, or brokerage firm (in the case of an account), or a life insurance company (in the case of an annuity). An individual can contribute money earned each year to an IRA, subject to certain limits. In 2009, individuals younger than age 50 generally can contribute up to $5,000, while individuals age 50 and older generally can contribute up to $6,000. Earnings on the contributions (investments) grow tax deferred. Amounts withdrawn before age 59½ generally incur a 10% tax penalty, subject to certain exceptions.

The most common types of IRAs are Traditional IRAs and Roth IRAs, both of which are discussed in this chapter. Other types include SEPs (simplified retirement plans for self-employed individuals or small business owners) and SIMPLEs (flexible, easy-to-administer retirement plans for businesses with 100 or fewer employees).

Traditional IRA
Anyone with earned income can make contributions to a Traditional IRA. However, only those who do not participate in an employer-sponsored retirement plan, or who participate in such a plan but meet certain income limits, can make tax-deductible contributions. Distributions from a tax-deductible Traditional IRA are taxed as ordinary income in the year received. As described above, amounts withdrawn before age 59½ generally incur a 10% early-withdrawal tax penalty. Minimum distributions from a Traditional IRA generally must begin by April 1 following the year the owner turns 70½.

Roth IRA
A Roth IRA is similar to a Traditional IRA, but with several important distinctions. Similarities include the application of the same contribution limits (which apply on an aggregated basis to Traditional and Roth IRAs), the same earned income requirement, and the same penalty tax for distributions made before age 59½.

The key differences between Traditional and Roth IRAs are that (1) contributions to a Roth IRA are *never* tax deductible and (2) distributions from a Roth IRA are tax free if made on or after the taxpayer turns 59½ and at least five years after the year in which the taxpayer made his or her first contribution to any Roth IRA. (Distributions also are tax free if made after death, upon disability, or for the first-time purchase of a primary residence.) Unlike Traditional IRAs, Roth IRAs are not subject to minimum distribution requirements during the owner's lifetime. Currently, individuals with annual incomes above specified amounts either cannot establish Roth IRAs or are subject to lower contribution limits.

Defined Benefit Plans

With a defined benefit plan (pension plan), a retiree receives a specific monthly payment (the defined benefit) from his or her employer based on salary history, years of service, and age at retirement. These payments are guaranteed no matter how the underlying investments perform or how long the retiree lives. If returns are less than expected, or employees live longer than expected, the employer may have to increase contributions to the plan—thus bearing both the investment and longevity risks. Employees rarely contribute any of their own money to private-sector defined benefit plans. Many public-sector defined benefit plans, such as the California Public Employees Retirement System (CalPERS) require the employees to make a contribution to the plan. Pension payments generally begin at retirement and are taxable as ordinary income when received.

Defined Contribution Plans

"Defined benefit plans" are often contrasted with "defined contribution plans" under which the contribution made on behalf of the employee is defined, but the ultimate benefit to be paid is not. With a defined contribution plan, the exact sum to be received upon retirement is not known. Instead, the final benefit is determined by the amount of money contributed to the individual's account by the employer and/or employee, the rate of investment growth, and the length of time the assets remain in the account. Investment decisions typically are made by the employee who bears the entire investment risk in addition to the longevity risk. Some of the most common types of defined contribution plans are discussed below.

401(k)

A 401(k) is an employer-sponsored retirement plan that allows employees to specify the amount of income to be deducted from their paychecks and placed in the plan. Contributions are made on a pre-tax basis and all contributions and earnings remain untaxed until withdrawn. In 2009, individuals younger than age 50 can contribute up to $16,500 to their 401(k)s, while individuals age 50 and older can contribute up to $22,000. In many plans, a portion of the employee's contribution is matched by the employer based on a set formula (e.g., 50% of the employee's contribution up to a maximum of 6% of employee compensation). Employers also can make other types of contributions. Employee and employer contributions combined can total up to $49,000 in 2009. In-service distributions from a 401(k) plan generally are subject to restrictions. In addition, if a distribution is made, it generally will be subject to a 10% tax penalty unless the participant is at least age 59½ or another specified exception applies (e.g., disability, death). Minimum distributions must begin by April 1 following the calendar year in which the employee turns 70½ or, if later (and depending on the plan's provisions), the calendar year in which the employee retires.

Roth 401(k)

Starting in 2006, 401(k) plans were permitted to begin offering designated "Roth" accounts. A designated Roth account under a 401(k) plan is similar to a Roth IRA in that contributions are made with after-tax dollars (i.e., contributions are included in the participant's gross income when made) and distributions are tax free if certain conditions are met. However, designated Roth accounts under a 401(k) plan differ in certain ways from a Roth IRA. For example, lifetime minimum distribution requirements apply beginning at age 70½ or retirement, and in-service distributions are restricted, whereas such rules do not apply to Roth IRAs. In addition, the same limits that apply to non-Roth employee contributions to a 401(k) plan apply to employee contributions to a designated Roth account under the plan (generally $16,500 in 2009).

403(b)

A 403(b) plan is similar to a 401(k) plan, but is offered to the employees of educational, religious, and charitable organizations. Contribution limits for 403(b)s are generally the same as for 401(k)s. Also, like 401(k)s, in-service withdrawals generally are restricted, and a 10% tax penalty applies to permissible withdrawals made before age 59½ (subject to certain exceptions). Earnings grow tax deferred until they are withdrawn, at which point they are taxed as ordinary income. Minimum distributions must begin by April 1 following the calendar year in which the employee turns 70½ or, if later (and depending on the plan's terms), the calendar year in which the employee retires. A 403(b) plan can only invest in annuities or mutual funds, and most are invested in annuities.

Roth 403(b)

Starting in 2006, 403(b) plans were permitted to begin offering designated "Roth" accounts. Designated Roth accounts under a 403(b) plan are similar to such accounts under a 401(k) plan. Thus, as described above, contributions are made with after-tax dollars and distributions are tax free if certain conditions are met. Like their 401(k) counterparts, designated Roth accounts under a 403(b) plan also are subject to in-service withdrawal restrictions and minimum distribution requirements beginning at age 70½ or retirement.

457

A 457 plan is a tax-exempt deferred-compensation plan, similar to the 401(k), which is available only to employees of state and federal governments and tax-exempt organizations. Unlike 401(k) plans, 457 plans do not allow employer contributions; contributions to a 457 plan are made exclusively through employee elective deferrals of their salary. Participants can defer the same amount of their employment compensation as in a 401(k) plan ($16,500 in 2009), and contributions and earnings are tax deferred until withdrawn, at which time they are taxed as ordinary income. Currently, 457 plans are not permitted to offer designated Roth accounts.

Shift in Retirement Plan Assets

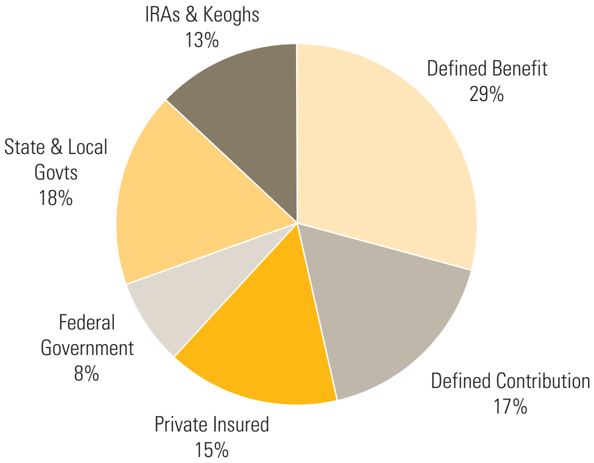
The percentage of assets held in various types of retirement plans has changed significantly over the last few decades, reflecting a shift from employer-sponsored defined benefit plans to employee-funded defined contribution plans, such as 401(k) plans. From 1983 to 2004, the percentage of workers who participated only in defined benefit plans decreased from 62% to 20%, while the percentage participating only in defined contribution plans rose from 12% to 63%.[1]

At the end of 2007 (the latest year for which total data is available), assets held in IRAs and Keoghs (tax-deferred retirement savings plans for self-employed individuals or small business owners) accounted for the largest segment of the retirement plan market with $4.7 trillion, or 28% of total assets. This compares to 13% in 1987. Assets in defined contribution plans were $3.5 trillion or 20% of total assets in 2007, compared to 17% in 1987. In contrast, assets held in employer-sponsored defined benefit plans decreased from 29% to only 16% of total retirement plan assets from 1987 to 2007.

[1] "An Update on Private Pensions," by Alicia H. Munnell and Pamela Perun, *An Issue in Brief*, August 2006, Number 50, Center for Retirement Research at Boston College.

Figure 5-1 ***Total U.S. Retirement Plan Assets—1987***

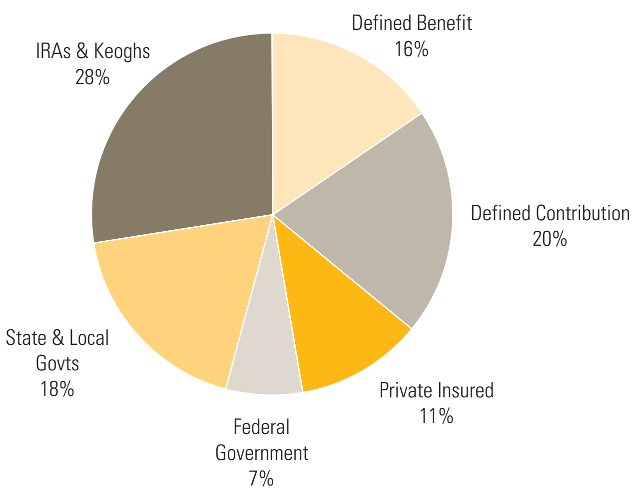
(100% = $3.0 trillion)



Source: Employee Benefit Research Institute

Figure 5-2 ***Total U.S. Retirement Plan Assets—2007***

(100% = $17.3 trillion)



Source: Employee Benefit Research Institute

The Use of Variable Annuities in Qualified Plans

As more and more Americans face retirement without the safety net of a traditional defined benefit pension plan that provides retirement income for life, new sources of guaranteed income will need to be identified. Annuities are uniquely suited to fill this need. While some people question the wisdom of putting an annuity in a qualified retirement plan, their use in this market is both longstanding and widespread.

In 1952, the Teachers' Insurance and Annuity Association - College Retirement Equity Fund (TIAA-CREF) developed the first variable annuity for use in college and university retirement plans. Since then, annuities have become an increasingly popular funding vehicle for these and other tax-qualified arrangements such as IRAs and 401(k)s. Specifically created and designed for the qualified market, variable annuities are subject to a variety of rules when used as funding or distribution vehicles for qualified plans. For example, the required minimum distribution requirements applicable to qualified plans include specific rules for the use of variable annuities in satisfying those requirements.

At the end of 2008, variable annuity assets invested in qualified retirement plans totaled $737.4 billion, or 65.4% of total variable annuity assets, a 4% increase from 2007. Yet despite this growth, critics continue to question the value of using variable annuities to fund qualified plans. Why, they ask, should investors put one tax-deferred vehicle (a variable annuity) inside another tax-deferred vehicle (a qualified plan), particularly when fees for variable annuities are higher than for those of other investments such as mutual funds?

Using a variable annuity to fund a qualified retirement plan will *not* provide any additional tax-deferred treatment of earnings beyond that already provided by the qualified retirement plan itself. However, variable annuities offer other benefits in addition to tax deferral that can make them suitable for use in qualified plans, such as lifetime income payments, principal protection, death benefits, and fee guarantees.

It is important to remember that the primary goal of a retirement plan is not to obtain tax deferral, but rather to provide retirement income that will last for the life of the retiree. Variable annuities are designed to accomplish this goal by providing for the accumulation of assets during the owner's income-producing years, and guaranteeing payments in retirement that last a lifetime—a benefit most defined contribution plans do not otherwise offer their participants.

The 2006 Pension Protection Act

In 2006, Congress enacted the most comprehensive revision of the nation's pension laws in three decades. One of the most important benefits of the Pension Protection Act is that it not only encourages people to contribute more to their employer-sponsored retirement plans, but provides them with additional support in the management of their investments. The new law makes it easier for employers to automatically enroll their employees in 401(k) plans and provides a safe harbor against discrimination allegations when doing so. It allows plan sponsors to offer fund-specific investment advice to their plan participants, and it includes automated features such as automatic deferral into default investment options and automatic annual increases in salary deferral rates. In addition, it directs the Department of Labor to revise applicable fiduciary standards to better facilitate the selection of annuity contracts as optional forms of distributions from qualified plans.

The Pension Protection Act also makes permanent many savings opportunities that were scheduled to sunset in 2010, including the Roth 401(k), higher contribution limits, and catch-up contributions for employees age 50 and over. It mandates that employers fully fund their defined benefit pension plans over seven years, closes loopholes that allowed underfunded plans to skip payments, and requires employers that underfund plans to pay higher premiums to the Pension Benefit Guaranty Corporation.

These provisions, and many others in the Pension Protection Act, will help Americans maximize the benefits they receive from their retirement plans—plans that will play an increasingly important role in providing financial security in the years ahead.