Taxation of Retirement Contributions

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Types of retirement plans

- Government Pensions
  - Civil Service Retirement System (pre-1987), Federal Employee Retirement System
  - Military
  - State and municipal employees, teachers, etc.
- Social Security
- Railroad Retirement
- 457 Deferred compensation
- Other plans

Other types of plans

- 401(k) qualified cash or deferred arrangement in trust
- 403(b) tax-sheltered annuity for 501(c)(3) nonprofits and public schools
- Individual Retirement Account (IRA)
    - Traditional (pre-tax)
    - Roth (after-tax)
- Simplified Employee Pension (SEP) – IRA
- Savings Incentive Match Plan for Employees (SIMPLE) – IRA or 401(k)
- Qualified plans
    - Also called H.R. 10 plans or Keogh plans when covering self-employed individuals, can include 401(k) plans

Contributions in General

- Employees can make contributions pre-tax then pay tax on the distribution, or make contributions post-tax and take tax-free distributions. Annual limits apply that increase closer to age of retirement (catch-up payments). Employees do not deduct pre-tax contributions, but the contribution reduces their taxable income. Employees’ post-tax contributions are not deductible.
- Employers can deduct contributions to employees’ accounts.
- Self-employed can be treated like an employer and deduct contributions to their own accounts.

Individual Retirement Accounts

Traditional IRA – pre-tax contributions

- Contribution limit: $6,000 or additional $7,000 for age 50 and over
- Deduction limit: depends on filing status (spouse's retirement account may affect deduction), covered work plan, social security benefits.

Roth IRA – post-tax contributions

- Contribution limit: $6,000 or additional $7,000 for age 50 and over
- No deduction allowed

Simplified Employee Pension (SEP)

- Simplified method for contributing to a retirement plan, for self-employed or small businesses.
- Requires agreement and setting up an individual retirement account or annuity.
- Maximum deduction
  - Employers: lesser of contributions or 25% of compensation paid (up to $280K per participant) to participants (up to $56K/participant)
  - Self-employed: net earnings from self-employment, which takes into account deduction for deductible part of self-employment tax and deduction for own contributions.
  - Carryover if contributions exceed deduction limit.
  - Excise tax: 10% on excess contributions (special rule exempts self-employed who meet certain conditions)

Savings Incentive Match Plan for Employees (SIMPLE)

- 100 or fewer employees who received at least $5,000 in compensation
- Can be an IRA or a 401(k). 401(k) plans must meet qualified plan requirements.
- Requires agreement using model IRS form and setting up individual retirement account with financial institution or a trust if 401(k).

SIMPLE IRA and 401(k)

- Contributions to SIMPLE IRA
  - Employees can choose to make salary reduction contributions up to $13,000 rather than receiving amounts as pay.
  - Employers make matching contributions (up to 3% of each employee’s salary) or non-elective contributions (up to 2% of each employee’s salary who earns at least $5,000).
  - SIMPLE IRA plan contributions aren't subject to withholding but salary reduction contributions are subject to social security, Medicare, and federal unemployment (FUTA) taxes. Employer matching and nonelective contributions are not subject to these taxes.
- Deduction limits
  - Employers can deduct contributions to SIMPLE IRAs
  - SIMPLE 401(k) contributions are subject to deduction limits for qualified plans

Qualified plans

- Also called H.R. 10 plans or Keogh plans when covering self-employed individuals, can include 401(k) plans
- Must meet certain requirements
  - No asset diversion; min. coverage, vesting, and contributions; no discrimination in favor of highly compensated employees, top heavy rules, etc.
- Eligible individuals: self-employed, sole proprietors, partnerships, corporations, but not common-law employee or partner
- Defined benefit or defined contribution, typically contributions only by employer, but employee can make nondeductible contributions.
- Contribution limits
  - Defined benefit: annual benefit of participant can't exceed lesser of 100% of participant's average compensation for highest 3 consecutive calendar years or $225,000.
  - Defined contribution: annual contributions and other additions (excluding earnings) can't exceed the lesser of 100% of participant's compensation or $56,000.
  - Self-employed: contributions only if income from personal services, not investments. If there is a net loss, no contributions for individual, but can contribute for common-law employees based on their compensation.

Qualified plans (Keogh or H.R. 10) (cont.)

- Deduction limits
  - Employers:
    - Defined contribution: less than 25% of compensation paid (or accrued) to employees up to 280,000.
    - Defined benefit plan: based on actuarial assumptions and computations.
  - Self-employed:
    - Contributions for self limited to net earnings from self-employment taking into account deduction for deductible part of self-employment tax and deduction for contributions.