

**PRESENT LAW AND BACKGROUND RELATING  
TO RETIREMENT PLANS**

Scheduled for a Public Hearing  
Before the  
SENATE COMMITTEE ON FINANCE  
on July 28, 2021

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION AND SUMMARY

The Senate Committee on Finance has scheduled a public hearing on July 28, 2021, on “Building on Bipartisan Retirement Legislation: How Can Congress Help?” This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a discussion of present law and data.

### **Present Law**

#### Tax-favored Employer-Sponsored Retirement Plans

##### Overview

Whether to offer a tax-favored retirement plan is a choice by an employer, with various factors entering into the decision. The Code provides for multiple types of tax-favored employer-sponsored retirement plans, including qualified retirement plans and annuities (sections 401(a) and 403(a)), tax-deferred annuities (section 403(b)), governmental eligible deferred compensation plans (section 457(b)), SIMPLE (savings incentive match plan for employees) IRAs (section 408(p)), and simplified employee pensions (“SEPs”) (section 408(k)). These plans afford employers flexibility in the design and structure of the retirement plans they adopt, subject to the requirements applicable to each type of plan under the Code and, in some cases, under the Employee Retirement Income Security Act of 1974 (“ERISA”).

##### Qualified retirement plans and annuities

Qualified retirement plans (and other tax-favored employer-sponsored retirement plans) are accorded special tax treatment under present law. Generally, contributions, earnings on contributions, and benefits are not included in gross income until amounts are distributed, even though the arrangement is funded and even if benefits are vested. Additionally, many distributions can be rolled over to another plan for further deferral of income inclusion. In the case of a taxable employer, the employer is entitled to a current deduction (within certain limits) for contributions even though the contributions are not currently included in an employee’s income. Contributions and earnings are held in a tax-exempt trust, which enables the assets to grow on a tax-free basis.

Qualified retirement plans are of two general types: defined benefit plans, under which benefits are determined under a plan formula and paid from general plan assets, rather than individual accounts; and defined contribution plans, under which benefits are based on a separate account for each participant, to which are allocated contributions, earnings, and losses. Defined benefit plans generally are subject to minimum funding requirements and benefits are guaranteed, within limits, by the Pension Benefit Guaranty Corporation (“PBGC”). Some qualified retirement plans are referred to as hybrid plans because they have features of both a defined benefit plan and

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<sup>1</sup> This document may be cited as follows: *Joint Committee on Taxation, Present Law and Background Relating to Retirement Plans* (JCX-32-21), July 26, 2021. This document can also be found on the Joint Committee on Taxation website at [www.jct.gov](http://www.jct.gov).

a defined contribution plan; for example, cash balance plans are defined benefit plans, but plan benefits are defined by reference to a hypothetical account balance.

Qualified retirement plans are subject to various requirements to receive tax-favored treatment. Some of these requirements define participant rights and provide participant protections, such as minimum participation, vesting, exclusive benefit, and minimum funding requirements. These requirements generally have parallels under ERISA. Some qualified plan requirements limit tax benefits, such as the limit on compensation taken into account under a plan and limits on contributions and benefits. Minimum coverage and nondiscrimination requirements and top-heavy requirements are intended to ensure that qualified retirement plans achieve the goal of retirement security for both lower-paid and higher-paid employees. The Code requirements also apply to individual retirement arrangements (“IRAs”) and certain other tax-favored savings arrangements.

The Code generally prohibits certain transactions between qualified retirement plans and a disqualified person, including a fiduciary. Under ERISA, similar prohibited transaction rules apply to employer-sponsored retirement plans and welfare benefit plans. Violation of the Code requirements may result in the imposition of an excise tax.

Qualified retirement plans are also subject to regulation under ERISA, which generally is under the jurisdiction of the Department of Labor (“DOL”). Some of the provisions of the Code and ERISA that apply to qualified retirement plans are identical or very similar. ERISA also contains general fiduciary duty standards that apply to all fiduciary actions.

Enforcement of the qualified retirement plan requirements depends on the source of the requirements. Failure to meet a qualification requirement may mean the loss of tax-favored status; however, in practice, the Internal Revenue Service (“IRS”) rarely disqualifies a plan. Certain Code requirements are enforced through an excise tax rather than through disqualification of the plan. ERISA requirements are generally enforced through administrative actions or lawsuits by DOL, lawsuits brought by plan participants or beneficiaries or plan fiduciaries, or, in some cases, the imposition of a civil penalty.

Qualified annuity plans are similar to qualified retirement plans in treatment, but plan assets are invested in annuity contracts rather than held in a trust or custodial account.

#### Special types of plans for governmental and tax-exempt employers

Tax-exempt charitable organizations (section 501(c)(3)) and educational institutions of State or local governments may offer their employees a section 403(b) plan. State and local government employers may offer their employees a section 457(b) plan. Section 403(b) plans and governmental section 457(b) plans are similar to section 401(k) plans (discussed below).

#### Taxation of distributions

Distributions from tax-favored employer-sponsored plans are generally includible in income, except to the extent a portion of the distribution is treated as a recovery of the employee’s basis (if any). Subject to certain limitations, distributions from a plan may generally be rolled over to another tax-free retirement plan with a deferral of income inclusion. A distribution may

be rolled over directly to another plan or may be paid to the participant who may roll it over to another plan if, in general, the rollover is completed within 60 days. A distribution that is eligible for rollover is subject to income tax withholding at a 20-percent rate unless rolled over directly to another plan.

### Defined Contribution Plans

#### In general

Defined contribution plans may provide for nonelective contributions and matching contributions by employers and pretax (that is, contributions are either excluded from income or deductible) or after-tax contributions by employees. Total contributions made to an employee's account for a year cannot exceed the lesser of \$58,000 (for 2021)<sup>2</sup> or the employee's compensation. The deduction for employer contributions to a defined contribution plan for a year is generally limited to 25 percent of the participant's compensation. A participant must at all times be fully vested in his or her own contributions to a defined contribution plan and must vest in employer contributions under three-year cliff vesting or two-to-six-year graduated vesting.

Defined contribution plans often provide for loans to participants and generally provide for distributions on severance from employment and, depending on the type of plan, may provide for in-service distributions. Defined contribution plans may provide for distributions to be made in a lump sum or installments; defined contribution plans may offer annuity distributions, but most are not required to offer annuities.

#### General types of defined contribution plans

Defined contribution plans may themselves be of different types, specifically, profit-sharing plans, stock bonus plans, or money purchase pension plans, and may include special features, such as a qualified cash or deferred arrangement (section 401(k)) or an employee stock ownership plan ("ESOP"). Rules requiring annuity benefits for surviving spouses and spousal consent to certain distributions apply to money purchase pension plans and, in some cases, other defined contribution plans offering annuities. However, most defined contribution plans are exempt from these requirements as long as they provide that a participant's account balance will be paid to the participant's surviving spouse (unless the spouse consents to a different beneficiary).

#### Section 401(k) plans

Under a section 401(k) plan, an employee may elect to have contributions (elective deferrals) made to the plan, rather than receive the same amount in cash. For 2021, elective deferrals of up to \$19,500 may be made, plus, for employees aged 50 or older, up to \$6,500 in catch-up contributions. Elective deferrals generally cannot be distributed from the plan before the

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<sup>2</sup> Plans may permit employees aged 50 or older to make catch-up contributions; in that case the limit (including catch-up contributions) is \$64,500 for 2021.

employee's severance from employment, death, disability or attainment of age 59½ or in the case of hardship or plan termination.

Elective deferrals are generally made on a pretax basis. However, a section 401(k) plan may include a qualified Roth contribution program under which elective deferrals are made on an after-tax basis (designated Roth contributions), and certain distributions ("qualified distributions") are excluded from income. Many section 401(k) plans provide for matching contributions and may also provide for employer nonelective contributions and after-tax employee contributions.

Section 401(k) plans may be designed so that elective deferrals are made only if the employee affirmatively elects them. However, a section 401(k) plan may provide for "automatic enrollment," under which elective deferrals are made at a specified rate unless the employee affirmatively elects not to make contributions or to make contributions at a different rate. Various rules have been developed to provide favorable treatment for plans that provide for automatic enrollment, subject to certain notice requirements.

Elective deferrals under a section 401(k) plan are subject to a special nondiscrimination test, called the actual deferral percentage test or "ADP" test, which compares the average deferral rates for highly compensated employees and non-highly compensated employees. A similar test, the actual contribution percentage test or "ACP" test, applies to employer matching contributions and after-tax employee contributions. Design-based safe harbors are also available for satisfying the special nondiscrimination requirements.

### ESOPs

An ESOP is a stock bonus plan that is designated as an ESOP and is designed to invest primarily in employer stock. An ESOP can be a standalone plan or it can be a portion of another type of defined contribution plan.

ESOPs are subject to additional requirements that do not apply to other plans that hold employer stock, including a requirement that certain participants must be permitted to diversify a portion of their accounts. However, certain benefits are available to ESOPs that are not available to other types of qualified retirement plans, including an exception to the prohibited transaction rules for certain loans and, in the case of a C corporation, higher deduction limits. ESOPs maintained by S corporations are subject to special rules, including restrictions on the provision of employer stock and stock options (or other "synthetic equity") to certain "disqualified persons."

### Plan loans and hardship distributions

A defined contribution plan may provide for loans to participants, subject to certain conditions on the amount of the loan and repayment terms. A loan that does not meet these conditions is a deemed distribution. If a loan meets the required conditions, but the participant's account balance is later reduced (offset) to repay the loan, a distribution occurs in the amount of the plan loan offset.

Despite general restrictions on in-service distributions of elective deferrals, defined contribution plans and section 403(b) plans may offer hardship distributions. Section 457 plans

may provide for distributions in the case of an unforeseeable emergency, a similar, but narrower, concept than hardship.

### Lifetime income under defined contribution plans

Although pension plans are required to offer annuity forms of distribution, most defined contribution plans are not required to offer annuities. Instead, a participant's benefit consists of an account balance, which can be depleted during the participant's lifetime. The Department of the Treasury and the IRS in collaboration with DOL have issued guidance to facilitate, and expand, the availability of lifetime income options under defined contribution plans and IRAs. Recent legislative efforts have also addressed a number of statutory barriers to promoting and offering lifetime income investment options in defined contribution plans including, for example, providing for the portability of lifetime income investments in certain circumstances, as further described below.

### Individual Retirement Arrangements

There are two basic types of IRAs: traditional IRAs, to which deductible or nondeductible contributions can be made, and Roth IRAs, contributions to which are not deductible. The total contributions made to all IRAs for a year cannot exceed \$6,000 (for 2021), plus an additional \$1,000 (not indexed) in catch-up contributions for individuals age 50 or older. Certain individuals are not permitted to make deductible contributions to a traditional IRA or to make contributions to a Roth IRA, depending on their income.

Distributions from traditional IRAs are generally includible in income, except to the extent a portion of the distribution is treated as a recovery of the individual's basis (if any). Qualified distributions from a Roth IRA are excluded from income; other distributions from a Roth IRA are includible in income to the extent of earnings. IRA distributions generally can be rolled over to another IRA or qualified retirement plan; however, a distribution from a Roth IRA generally can be rolled over only to another Roth IRA or a designated Roth account.

SIMPLE IRAs and SEPs are special types of employer-sponsored retirement plans under which the employer makes contributions to IRAs established for each of its employees in accordance with the Code requirements for each type of plan. Deemed IRAs are permitted to be provided in conjunction with a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan. An employer may also establish a payroll deduction IRA program, under which employees can elect to have amounts withheld from their pay and contributed to an IRA opened by the employee.

### Early Distributions and Required Minimum Distributions

Distributions before age 59½ that are includible in income are also subject to an additional 10-percent early distribution tax unless an exception applies.

Under the minimum distribution requirements, distributions from a qualified retirement plan are required to begin within a certain period after a participant attains age 72 or, in certain circumstances, after a participant retires, if later, and distributions must be taken over the life or life expectancy of the participant (or the participant and a beneficiary). Minimum distribution

requirements also apply after a participant's death. An excise tax may apply if required minimum distributions are not made.

### **Data Relating to Retirement Savings**

Data show that, in 2020, 67 percent of private-sector workers had access to a qualified retirement plan and 76 percent of those with access participated. Over the last 50 years, the number of participants in private single-employer defined contribution plans has steadily increased while participation in private single-employer defined benefit plans and multiemployer defined contribution and defined benefit plans has remained steady. Among private defined benefit plan participants, a steadily decreasing portion consists of active participants and a steadily increasing portion consists of inactives. Within the private sector, rates of access to and participation in qualified retirement plans vary between full-time and part-time workers and between union and non-union workers. Rates of access to and participation in qualified retirement plans also vary between workers in the private sector and in State and local government.

## I. PRESENT LAW

### A. Tax-Favored Employer-Sponsored Retirement Plans

#### 1. Overview of employer-sponsored tax-favored retirement plans

Employers may choose to offer a tax-favored retirement plan to employees. For employers that do so, the Code provides rules as to the amount of benefits, the timing of benefit distributions, and the deductibility of contributions. The Code also imposes protections for employees to ensure that they receive the benefits promised under the plan, for example, by requiring defined benefit plans to be adequately funded and protecting the integrity of individual accounts under defined contribution plans by making sure account assets are not misused or diverted; parallel rules generally apply under ERISA. However, subject to these rules, an employer has a great deal of flexibility in deciding the structure of its retirement plan and the level of benefits, as permitted under the various types of plans available.

One element in a plan's structure is whether the employer offers retirement benefits as a unilateral benefit that the employee accepts implicitly by accepting employment with, or remaining employed by, the employer. Alternatively, within limits, the employer may allow a year-by-year choice by the employee whether to accept current compensation or make contributions to the plan. Employers may structure a retirement plan in part as a retention tool so that only employees who work for a certain number of years become vested in the benefits accrued under the plan (within limits as discussed below).

The most common type of tax-favored plan is a qualified retirement plan,<sup>3</sup> which may be a defined benefit plan or a defined contribution plan. A defined contribution plan may include a qualified cash or deferred arrangement (commonly called a "section 401(k) plan"),<sup>4</sup> which offers an employer great flexibility in designing a retirement program for its employees. Another option is a qualified annuity plan,<sup>5</sup> which is similar to and subject to requirements similar to those applicable to qualified retirement plans.

Additional options are available to certain tax-exempt or governmental employers, including tax-deferred annuities<sup>6</sup> and eligible deferred compensation plans,<sup>7</sup> which are sometimes offered in lieu of a section 401(k) plan. Certain small employers have the option of maintaining a

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<sup>3</sup> Sec. 401(a).

<sup>4</sup> Sec. 401(k).

<sup>5</sup> Sec. 403(a).

<sup>6</sup> Sec. 403(b).

<sup>7</sup> Sec. 457(b).

SIMPLE IRA plan<sup>8</sup> or a simplified employee pension (“SEP”),<sup>9</sup> both of which are funded through direct contributions by the employer to an IRA established for each employee.

Tax credits are available to small employers that start new retirement plans or establish an automatic contribution arrangement in a retirement plan and to lower-income individuals who contribute to a retirement plan (or an IRA).

## **2. Qualified retirement plans and annuities**

### **In general**

A plan of deferred compensation that meets the qualification requirements under the Code (a “qualified retirement plan”) is accorded special tax treatment. Employees do not include employer contributions, earnings on contributions, or benefits in gross income until amounts are distributed, even though the arrangement is funded and even if benefits are vested. Certain distributions (such as lump sums) can be rolled over to another tax-favored plan with further deferral of income inclusion. In the case of a taxable employer, the employer is entitled to a current deduction (within limits) for contributions even though the contributions are not currently included in an employee’s income.<sup>10</sup> Contributions to a qualified retirement plan (other than elective deferrals and after-tax contributions) are exempt from FICA tax, as are plan distributions. Pretax contributions are exempt from income tax withholding, and special withholding rules apply to distributions. Contributions to a qualified retirement plan, and earnings thereon, are held in a tax-exempt trust, which enables the assets to grow on a tax-free basis.

### **Defined benefit and defined contribution plans**

Qualified retirement plans are broadly classified into two categories, defined contribution plans and defined benefit plans, based on the nature of the benefits provided.<sup>11</sup> Although both types of plans are subject to the qualification requirements, the requirements differ somewhat for the two types of plans.

Under a defined contribution plan, a separate account is maintained for each participant, to which contributions are allocated and investment earnings (and losses) are credited, and a

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<sup>8</sup> Sec. 408(p).

<sup>9</sup> Sec. 408(k).

<sup>10</sup> Sec. 404. Under section 4972, an excise tax may apply if contributions in excess of the deduction limits are made.

<sup>11</sup> Under the Code as in effect since before ERISA, retirement plans fall into three general types - pension plans, profit-sharing plans, and stock bonus plans, defined respectively at Treas. Reg. sec. 1.401-1(b)(1)(i), (ii), and (iii). Defined benefit plans and money purchase pension plans (a type of defined contribution plan) are pension plans under the Code; other defined contribution plans are either profit-sharing plans or stock bonus plans. The application of some Code requirements depends on whether the plan is a pension plan, a profit-sharing plan, or a stock bonus plan. Under ERISA, the term “pension plan,” defined at ERISA section 3(2)(A), includes both defined benefit plans and defined contribution plans.

participant's benefits are based solely on the participant's account balance.<sup>12</sup> Defined contribution plans commonly allow participants to direct the investment of their accounts. Because the account balance, and thus the participant's benefits, depends on the rate of return on the account, the risk of investment loss (and reward of investment gain) under a defined contribution plan lies with the participant rather than the employer.

Under a defined benefit plan, benefits are determined under a plan formula.<sup>13</sup> Benefits under a defined benefit plan are funded by the general assets of the trust established under the plan, which are invested by plan fiduciaries in accordance with plan terms; individual accounts are not maintained for employees participating in the plan. Employer contributions to a defined benefit plan are subject to minimum funding requirements to ensure that plan assets are sufficient to pay the benefits under the plan.<sup>14</sup> The amount of required annual contributions depends on the type of plan and is determined under certain actuarial methods taking into account this valuation. This structure generally results in the risk of investment gain or loss under a defined benefit plan being borne by the employer through increases or decreases in required contributions to fund the promised plan benefits. An employer is subject to an excise tax for a failure to make required contributions, unless the employer obtains a funding waiver.<sup>15</sup> Benefits under defined benefit plans are generally guaranteed (within limits) by the PBGC.<sup>16</sup>

Certain types of qualified retirement plans are referred to as hybrid plans because they have features of both a defined benefit plan and a defined contribution plan. However, legally, the plan is either a defined contribution plan or a defined benefit plan.<sup>17</sup>

### **Qualified retirement plan requirements**

Present law imposes a number of requirements on qualified retirement plans that must be satisfied for favorable tax treatment to apply.<sup>18</sup> Some of these requirements define the rights of plan participants and beneficiaries, such as the minimum participation and vesting requirements.

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<sup>12</sup> Defined contribution plan is defined at section 414(i) and ERISA section 3(34). Under ERISA, a defined contribution plan is also referred to as an individual account plan.

<sup>13</sup> As defined in section 414(j) and ERISA section 3(35), a defined benefit plan is any plan that is not a defined contribution plan. For a more detailed discussion of defined benefit plans, see Joint Committee on Taxation, *Present Law and Background Relating to Defined Benefit Plans* (JCX-99-14), September 15, 2014. This document is available at [www.jct.gov](http://www.jct.gov).

<sup>14</sup> Secs. 412 and 430.

<sup>15</sup> Sec. 4971.

<sup>16</sup> To the extent benefits are not guaranteed by the PBGC, participants in an underfunded defined benefit plan bear the risk of losing benefits in the case of a distress termination of a single-employer defined benefit plan or insolvency of a multiemployer defined benefit plan.

<sup>17</sup> Under section 414(k) and ERISA section 3(35), a defined benefit plan that provides a benefit based partly on the balance of a separate account for a participant is treated as a defined contribution plan for certain purposes.

<sup>18</sup> In general, for purposes of these requirements, members of controlled groups under section 414(b) or (c) and affiliated service groups under section 414(m) or (o) are treated as a single employer.

In addition, assets of the plan must be held in a trust or custodial account for the exclusive benefit of plan participants, and prohibited transaction rules (that is, rules prohibiting self-dealing by employers and plan fiduciaries) apply to plan assets.<sup>19</sup> Defined benefit plans and money purchase pension plans (a type of defined contribution plan) are also subject to minimum funding requirements.

Under the minimum participation rules, a plan generally cannot delay an employee's participation in the plan beyond the later of completion of one year of service (*i.e.*, a 12-month period with at least 1,000 hours of service) or attainment of age 21.<sup>20</sup> In addition, a plan cannot exclude an employee from participation on the basis of attainment of a specified age. Employees can be excluded from plan participation on other bases, such as job classification, as long as the other basis is not an indirect age or service requirement.

Under the vesting rules, a participant's right to the benefits he or she has accrued under a plan ("accrued benefit") generally must become nonforfeitable after a specified period of service or, if earlier, at attainment of normal retirement age under the plan.<sup>21</sup> Benefits under either a defined benefit plan or a defined contribution plan that are attributable to employee contributions (including elective deferrals) must be fully vested at all times. The period of service after which benefits attributable to employer contributions must be vested depends on the type of plan (defined benefit or defined contribution). A plan may provide for vesting earlier than when required, but not later.

The vesting rules also generally prohibit amendments that reduce previously accrued benefits or eliminate optional forms of benefit with respect to previously accrued benefits. Reductions in an employee's rate of accrual under a defined benefit plan, or rate of allocation under a defined contribution plan, due to increasing age generally are also prohibited.

The vesting rules also prohibit distribution of an employee's accrued benefit without consent (an "involuntary" distribution) before the later of the time the participant has attained normal retirement age under the plan or attained age 62.<sup>22</sup>

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<sup>19</sup> Secs. 401(a)(2) and 4975. Under this exclusive benefit requirement, prior to satisfaction of all liabilities under the plan with respect to employees and their beneficiaries, assets are not allowed to be used for or diverted to purposes other than the exclusive benefit of employees or their beneficiaries.

<sup>20</sup> Sec. 410(a). Section 401(k) plans must allow part-time workers to make elective deferrals after the worker has completed three years of part-time service and attained age 21 by the end of the three consecutive year period. Sec. 401(k)(2)(D).

<sup>21</sup> Sec. 411. A plan may specify the plan's normal retirement age but may not specify a normal retirement age later than age 65 or, if later, the fifth anniversary of the time the participant commenced plan participation.

<sup>22</sup> Treas. Reg. sec. 1.411(a)-(11)(c)(4).

An exception generally allows an involuntary distribution if the present value of the employee's accrued benefit at the time of the distribution is not more than \$5,000 ("mandatory cash-out").<sup>23</sup>

Some qualified retirement plan requirements provide limits on the tax benefits for qualified retirement plans, such as the limit on compensation that may be taken into account for each participant for certain plan purposes (\$290,000 for 2021)<sup>24</sup> and limits on contributions, benefits and deductions.<sup>25</sup> The limits on contributions, benefits, and deductions apply separately to defined benefit and defined contribution plans.

### **Minimum coverage, nondiscrimination and top-heavy requirements**

#### **In general**

A qualified retirement plan is prohibited from discriminating in favor of highly compensated employees, referred to as the nondiscrimination requirements. These requirements are intended to ensure that a qualified retirement plan provides meaningful benefits to an employer's rank-and-file employees as well as highly compensated employees, so that qualified retirement plans achieve the goal of retirement security for both lower-paid and higher-paid employees. The nondiscrimination requirements consist of a minimum coverage requirement and general nondiscrimination requirements.<sup>26</sup> For purposes of these requirements, an employee generally is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of \$130,000 (for 2021).<sup>27</sup>

The minimum coverage and general nondiscrimination requirements apply annually on the basis of the plan year. In applying these requirements, employees of all members of a controlled group or affiliated service group are treated as employed by a single employer. Employees who have not satisfied minimum age and service conditions under the plan, certain nonresident aliens,

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<sup>23</sup> In determining present value for this purpose, benefits attributable to a rollover to the plan may be disregarded.

<sup>24</sup> This limit applies for purposes of determining the amount of a participant's allocations (in the case of a defined contribution plan) or benefit accruals (in the case of a defined benefit plan) under the plan, as well as for applying certain nondiscrimination rules. Treas. Reg. sec. 1.401(a)(17)-1(a)(1).

<sup>25</sup> Secs. 401(a)(16) and (17), 404 and 415.

<sup>26</sup> Sections 401(a)(3) and 410(b) deal with the minimum coverage requirement; section 401(a)(4) deals with the general nondiscrimination requirements, with related rules in section 401(a)(5). Detailed regulations implement the statutory requirements. In addition to the minimum coverage and general nondiscrimination requirements, under section 401(a)(26), the group of employees who accrue benefits under a defined benefit plan for a year must consist of at least 50 employees, or, if less, 40 percent of the workforce, subject to a minimum of two employees accruing benefits. Governmental plans are not subject to these requirements.

<sup>27</sup> Sec. 414(q). At the election of the employer, employees who are highly compensated based on compensation may be limited to the top 20 percent highest paid employees. A non-highly compensated employee is an employee other than a highly compensated employee.

and employees covered by a collective bargaining agreement are generally disregarded.<sup>28</sup> If a plan does not satisfy the nondiscrimination requirements on its own, it may in some circumstances be aggregated with another plan, and the two plans tested together as a single plan.

#### Minimum coverage requirement

Under the minimum coverage requirement, the plan's coverage of employees must be nondiscriminatory. This is determined by calculating the plan's ratio percentage, that is, the ratio of the percentage of non-highly compensated employees (of all non-highly compensated employees in the workforce) covered under the plan to the percentage of highly compensated employees covered. If the plan's ratio percentage is 70 percent or greater, the plan satisfies the minimum coverage requirement. If the plan's ratio percentage is less than 70 percent, a multi-part test applies. First, the plan must cover a group (or "classification") of employees that is reasonable and established under objective business criteria, such as hourly or salaried employees (referred to as a reasonable classification), and the plan's ratio percentage must be at or above a specific level specified in the regulations. In addition, the average benefit percentage test must be satisfied. Under the average benefit percentage test, the average rate of contributions or benefit accruals for all non-highly compensated employees in the workforce (taking into account all plans of the employer) must be at least 70 percent of the average contribution or accrual rate of all highly compensated employees.

#### General nondiscrimination requirements

Under a general nondiscrimination requirement, a qualified retirement plan may not discriminate in favor of highly compensated employees with respect to contributions or benefits. The general nondiscrimination requirements are met if (1) the amount of contributions or benefits provided under the plan are nondiscriminatory, (2) each benefit, right or feature under the plan is available to a nondiscriminatory group of employees, and (3) the timing of plan amendments does not have the effect of discriminating significantly in favor of highly compensated employees.<sup>29</sup>

In some circumstances, two or more plans may be aggregated and tested as a single plan for purposes the nondiscrimination requirements. In addition, the regulations implementing the general nondiscrimination requirements, allow a plan to be segmented into multiple plans, referred to as component plans, with each component plan tested separately. For example, a defined benefit plan may cover different divisions, with different benefit formulas for the employees of each division. For purposes of applying the general nondiscrimination requirements, the plan could be segmented into components, based on the portions of the plan

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<sup>28</sup> A plan or portion of a plan covering collectively bargained employees is generally deemed to satisfy the nondiscrimination requirements.

<sup>29</sup> Treas. Reg. sec. 1.401(a)(4)-1. With respect to the amount of contributions, employee elective deferrals under a section 401(k) plan and employer matching contributions and after-tax employee contributions to a defined contribution plan are subject to special testing rules, rather than being included in applying the general nondiscrimination requirements. In addition, the amount of employer contributions to an ESOP is tested separately from other employer contributions. Rules applicable to benefits, rights and features and the timing of plan amendments are provided in Treas. Reg. secs. 1.401(a)(4)-4 and -5 respectively.

covering employees of each division, and the requirements applied separately with respect to each component.

### Nondiscrimination in the amount of contributions or benefits<sup>30</sup>

There are three general approaches to testing the amount of contributions or benefits under a qualified retirement plan: (1) design-based safe harbors under which the benefit formula under a defined benefit plan, or the formula for allocating employer nonelective contributions under a defined contribution plan to participants' accounts, satisfies certain uniformity standards;<sup>31</sup> (2) a general test; and (3) cross-testing of equivalent accruals or allocations.<sup>32</sup> A plan is not discriminatory merely because benefit accruals or allocations for highly compensated and non-highly compensated employees are provided as a percentage of compensation (up to \$290,000 for 2021).<sup>33</sup> Thus, the various testing approaches are generally applied to the amount of contributions or benefits provided as a percentage of compensation.

The general test is generally satisfied by measuring the allocation rate (under a defined contribution plan) or accrual rate (under a defined benefit plan) of each highly compensated employee to determine if the group of employees with the same or higher rate of accrual or allocation (referred to as a rate group) is a nondiscriminatory group.<sup>34</sup> This test generally is satisfied if the ratio percentage of the rate group (that is, the percentage of non-highly employees in the rate group, compared with the percentage of highly compensated employees) satisfies the minimum coverage requirement. For this purpose, if the ratio percentage of the rate group is less than 70 percent, a simplified standard applies, which disregards the reasonable classification requirement and instead applies a minimum ratio percentage for the rate group (and still requires satisfaction of the average benefit percentage test). The minimum ratio percentage under this

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<sup>30</sup> A special rule under section 401(o) provides nondiscrimination relief with respect to benefits in a "closed" plan (a defined benefit plan that is amended to limit participation in the plan to individuals who are employees as of a certain date) or a "frozen" plan (a defined benefit plan that is amended to cease future accruals for all participants). For more information on this provision, see Joint Committee on Taxation, *Description of H.R. 1994, The "Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019"* (JCX-11-19), April 1, 2019. This document is available at [www.jct.gov](http://www.jct.gov).

<sup>31</sup> Sections 401(a)(5)(C)-(D) and 401(l) and Treas. Reg. secs. 1.401(l)-1 through -6 provide rules under which the benefit or allocation formula may take into account the employer-paid portion of social security taxes or benefits, referred to as permitted disparity.

<sup>32</sup> These approaches are explained in Treas. Reg. secs. 1.401(a)(4)-2, -3 and -8. As discussed below, special nondiscrimination tests apply to elective deferrals under a section 401(k) plan and to employer matching contributions and after-tax employee contributions.

<sup>33</sup> Sec. 401(a)(5)(B).

<sup>34</sup> An employee's allocation rate generally is the amount of employer contribution allocated to an employee's account for the plan year, expressed as a percentage of the employee's compensation for the plan year. An employee's accrual rate generally is the amount of the annual payments under the employee's accrued benefit payable at normal retirement age in the form of a straight life annuity divided by the employee's years of service and expressed as a percentage of average annual compensation. Under the permitted disparity rules of section 401(l), allocation and accrual rates are then permitted to be increased by a factor to reflect the employer paid portion of social security taxes or benefits. If a defined benefit plan provides subsidized optional forms of benefit, the accrual rate for the actuarially most valuable benefit under the plan available to each employee is also calculated and tested.

simplified standard depends on the percentage of the employer's workforce that consists of non-highly compensated employees (the non-highly compensated employee percentage) and ranges from (1) a minimum ratio percentage of 45 percent if the non-highly compensated employee percentage is 60 percent (or less) to (2) a minimum ratio percentage 20.375 percent if the non-highly compensated employee percentage is 99 percent.

Cross-testing involves the conversion of allocations or accruals to actuarially equivalent accruals or allocations, with the resulting equivalencies tested under the general test.

### Top heavy requirements

Top-heavy requirements apply to limit the extent to which accumulated benefits or account balances under a qualified retirement plan can be concentrated with key employees.<sup>35</sup> Whereas the general nondiscrimination requirements are designed to test annual contributions or benefits for highly compensated employees, compared to those of non-highly compensated employees, the top-heavy rules test the portion of the total plan contributions or benefits that have accumulated for the benefit of key employees as a group. If a plan is top-heavy, minimum contributions or benefits must be provided for non-key employees and, in some cases, faster vesting is required.

For this purpose, a key employee is an officer with annual compensation greater than \$185,000 (for 2021), a five-percent owner, or a one-percent owner with compensation in excess of \$150,000. A defined benefit plan generally is top-heavy if the present value of cumulative accrued benefits for key employees exceeds 60 percent of the cumulative accrued benefits for all employees. A defined contribution plan is top-heavy if the aggregate of accounts for key employees exceeds 60 percent of the aggregate accounts for all employees. The nature of the top-heavy test is such that a plan of a large business with many employees is unlikely to be top-heavy. The top-heavy requirements are therefore viewed as primarily affecting plans of smaller employers in which the owners participate.

### Prohibited transactions

The Code prohibits certain transactions between qualified retirement plans and a disqualified person.<sup>36</sup> If a prohibited transaction occurs, the disqualified person is subject to a two-tier excise tax.<sup>37</sup> The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved. Amount involved generally means the greater

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<sup>35</sup> Secs. 401(a)(10)(B) and 416.

<sup>36</sup> Sec. 4975. The prohibited transaction rules under the Code also apply to IRAs, health savings accounts (section 223), medical savings accounts (section 220), and Coverdell education savings accounts (section 530). The prohibited transaction rules do not apply to governmental plans or church plans. However, under section 503, a governmental or church plan that engages in a prohibited transaction as defined under that section may lose its tax-exempt status.

<sup>37</sup> Sec. 4975(a)-(b).

of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received.<sup>38</sup>

Prohibited transactions include certain direct or indirect transactions between a plan and a disqualified person: (1) the sale, exchange, or leasing of property; (2) the lending of money or other extension of credit; and (3) the furnishing of goods, services, or facilities. Prohibited transactions also include any direct or indirect: (1) transfer to, or use by or for the benefit of a disqualified person of the income or assets of the plan; (2) in the case of a fiduciary, an act that deals with the plan's income or assets for the fiduciary's own interest or account; and (3) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

In general, "disqualified person" means: (1) a fiduciary; (2) a person providing services to the plan; (3) an employer any of whose employees are covered by the plan; (4) an employee organization any of whose members are covered by the plan; (5) a direct or indirect owner of a specified interest in such an employer or employee organization; (6) a member of the family of an individual which meets certain definitions of a disqualified person; (7) a corporation, partnership, or trust or estate of which (or in which) a specified interest is owned by certain other disqualified persons; (8) officers and directors (or individuals having powers or responsibilities similar to those of officers or directors), 10-percent or more shareholders, or highly compensated employees (earning 10 percent or more of the yearly wages of the employer) of certain other disqualified persons; or (9) a 10-percent or more (in capital or profits) partner or joint venturer of certain other disqualified persons. Disqualified persons also include corporations of which 50 percent or more of: (1) the combined voting power of all classes of stock entitled to vote; or (2) the total value of shares of all classes of stock of such corporation, is owned directly or indirectly, or held by certain other disqualified persons.

A fiduciary includes any person who: (1) exercises any authority or control respecting management or disposition of the plan's assets; (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so; or (3) has any discretionary authority or responsibility in the administration of the plan.

The Code exempts certain transactions that meet specified conditions from the definition of prohibited transaction. Examples of exempt transactions are plan loans to participants, the acquisition of qualifying employer securities or employer real property, and loans to a leveraged ESOP.<sup>39</sup>

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<sup>38</sup> Sec. 4975(f)(4).

<sup>39</sup> Sec. 4975(c)(2), (d), and (f).

## **ERISA**

Qualified retirement plans are also subject to regulation under ERISA, which generally is under the jurisdiction of DOL.<sup>40</sup> The ERISA rules generally relate to the rights of plan participants and beneficiaries, reporting and disclosure, and the obligations of plan fiduciaries. Some of the provisions of the Code and ERISA that apply to qualified retirement plans are identical or very similar.<sup>41</sup> For example, ERISA includes minimum participation and vesting requirements and prohibited transaction rules that parallel those under the Code.

ERISA contains general fiduciary duty standards that apply to all fiduciary actions, including investment decisions.<sup>42</sup> ERISA requires that a plan fiduciary generally must discharge its duties solely in the interests of participants and beneficiaries and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. With respect to plan assets, ERISA requires a fiduciary to diversify the investments of the plan so as to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so.

A plan fiduciary that breaches any of the fiduciary responsibilities, obligations, or duties imposed by ERISA is personally liable to make good to the plan any losses to the plan resulting from such breach and to restore to the plan any profits the fiduciary has made through the use of plan assets.<sup>43</sup> A plan fiduciary may be liable also for a breach of responsibility by another fiduciary (a “co-fiduciary”) in certain circumstances, for example, if the fiduciary’s failure to fulfill its own fiduciary duties enabled the co-fiduciary to commit the breach.<sup>44</sup>

### **Enforcement of requirements**

Enforcement of a qualified retirement plan requirement depends on the source of the requirement. The qualification requirements under the Code are enforced by the IRS. If a plan fails to meet the qualification requirements, the favorable tax treatment for such plans may be denied; that is, the employer may lose tax deductions and employees may have current income inclusion. As a practical matter, the IRS rarely disqualifies a plan. Instead, the IRS generally

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<sup>40</sup> Governmental plans and church plans are generally exempt from ERISA and from the Code requirements that correspond to ERISA requirements. The PBGC has jurisdiction over the defined benefit plan insurance program under Title IV of ERISA.

<sup>41</sup> Reorganization No. 4, Pub. L. No. 99-524, divides interpretive jurisdiction between Treasury and DOL with respect to these provisions so that generally only one agency has interpretative jurisdiction with respect to each provision that is in both the Code and ERISA.

<sup>42</sup> ERISA sec. 404(a).

<sup>43</sup> ERISA sec. 409. Under ERISA section 502(a)(2), an action for a breach of fiduciary responsibility may be brought by DOL, a plan participant or beneficiary, or another fiduciary.

<sup>44</sup> ERISA sec. 405.

may impose sanctions short of disqualification and require the employer (or other plan sponsor) to correct any violation of the qualification rules.<sup>45</sup>

Certain Code requirements for qualified plans, such as the prohibited transaction rules, are enforced through an excise tax rather than through disqualification. Employees do not have a right to sue to enforce the qualified retirement plan requirements under the Code.

ERISA's requirements generally may be enforced through administrative actions by DOL or by lawsuits brought by DOL, plan participants or beneficiaries, or plan fiduciaries. Certain violations of ERISA may result in the imposition of a civil penalty.<sup>46</sup>

### **Qualified annuity plans**

A qualified annuity plan is a type of retirement plan that is subject to the same requirements as qualified retirement plans and receives comparable tax-favored treatment, but plan assets consist of annuity contracts, rather than investments held in a trust or custodial account.<sup>47</sup>

## **3. Special types of plans for governmental and tax-exempt employers**

### **Tax-sheltered annuities (section 403(b) plans)**

Section 403(b) plans are another form of tax-favored employer-sponsored plan that provides tax benefits similar to qualified retirement plans. Investments in section 403(b) plans are limited to annuity contracts and custodial accounts that satisfy certain requirements.<sup>48</sup> Section 403(b) plans may be maintained only by (1) charitable organizations tax-exempt under section 501(c)(3), and (2) educational institutions of State or local governments (*i.e.*, public schools, including colleges and universities). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans.

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<sup>45</sup> The IRS has established the Employee Plans Compliance Resolution System ("EPCRS"), a formal program under which employers and other plan sponsors may correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis. EPCRS has three components, providing for self-correction, voluntary correction with IRS approval, and correction on audit. The Self-Correction Program ("SCP") generally permits a plan sponsor that has established compliance practices and procedures to correct certain insignificant failures at any time (including during an audit), and certain significant failures generally within a 3-year period, without payment of any fee or sanction. The Voluntary Correction Program ("VCP") permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program ("Audit CAP") provides for a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit. Rev. Proc. 2021-30, 2021-31 I.R.B. \_\_\_\_ (July 16, 2021).

<sup>46</sup> DOL also has a correction program entitled the Voluntary Fiduciary Correction Program (VFCP), 71 Fed. Reg. 20261 (May 19, 2006), designed to encourage the voluntary correction of fiduciary violations under Title I of ERISA.

<sup>47</sup> Secs. 403(a) and 404(a)(2). Except when otherwise indicated, references herein to a qualified retirement plan include a qualified annuity plan.

<sup>48</sup> Sec. 403(b)(1) and (b)(7).

Employers may make nonelective or matching contributions to such plans on behalf of their employees, and the plan may provide for employees to make elective deferrals, designated Roth contributions or other after-tax contributions.

Contributions to a section 403(b) plan are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the special limits for elective deferrals (\$19,500 for 2021) and catch-up contributions (\$6,500 for 2021) under a section 401(k) plan, or, if less, the employee's compensation. If elective deferral and catch-up contributions are made to both a qualified defined contribution plan and a section 403(b) plan for the same employee,<sup>49</sup> a single limit applies to the elective deferrals under both plans. Special contribution limits apply to certain employees under a section 403(b) plan maintained by a church. In addition, under a special catch-up rule, an increased elective deferral limit applies under a plan maintained by an educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches in the case of employees who have completed 15 years of service. In this case, the limit is increased by the least of (1) \$3,000, (2) \$15,000, reduced by the employee's total elective deferrals in prior years, and (3) \$5,000 times the employee's years of service, reduced by the employee's total elective deferrals in prior years.<sup>50</sup>

Section 403(b) plans are generally subject to the minimum coverage and nondiscrimination rules that apply to qualified defined contribution plans.<sup>51</sup> However, pretax contributions and designated Roth contributions made by an employee under a salary reduction agreement (*i.e.*, elective deferrals) are not subject to nondiscrimination rules similar to those applicable to elective deferrals under section 401(k) plans. Instead, all employees of the employer generally must be eligible to make salary reduction contributions. Certain employees may be disregarded for purposes of this rule.

### **Governmental section 457(b) plans**

Special rules apply with respect to deferred compensation arrangements of State and local government and tax-exempt employers.<sup>52</sup> Amounts deferred under an eligible deferred compensation plan, *i.e.*, a section 457(b) plan, are not currently included in income. In the case of a State or local government employer, a section 457(b) plan is generally limited to elective deferrals and provides tax benefits similar to a section 401(k) or section 403(b) plan in that deferrals are contributed to a trust or custodial account for the exclusive benefit of participants,

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<sup>49</sup> Certain employers may offer both a section 401(a) defined contribution plan and a section 403(b) plan to their employees.

<sup>50</sup> Because contributions to a defined contribution plan cannot exceed an employee's compensation, contributions for an employee are generally not permitted after termination of employment. However, under a special rule, a former employee may be deemed to receive compensation for up to five years after termination of employment for purposes of receiving employer nonelective contributions under a section 403(b) plan.

<sup>51</sup> As in the case of a qualified retirement plan, a governmental section 403(b) plan is not subject to these nondiscrimination rules.

<sup>52</sup> Sec. 457.

but are not included in income until distributed (and may be rolled over to another tax-favored plan).<sup>53</sup>

Deferrals under a governmental section 457(b) plan are subject to the same limits as elective deferrals (\$19,500 for 2021) and catch-up contributions (\$6,500 for 2021) under a section 401(k) plan or a section 403(b) plan, or, if less, the employee's compensation. However, the section 457(b) plan limits apply separately from the combined limit applicable to section 401(k) and section 403(b) plan contributions, so that an employee covered by a governmental section 457(b) plan and a section 401(k) or section 403(b) plan can contribute the full amount to each plan. In addition, under a special catch-up rule, for one or more of the participant's last three years before normal retirement age, the otherwise applicable limit is increased to the lesser of (1) two times the normal annual limit (\$39,000 for 2021) or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

A governmental section 457(b) plan may include a qualified Roth contribution program, allowing a participant to elect to have all or a portion of the participant's deferrals under the plan treated as designated Roth contributions.

#### **4. Taxation of distributions**

##### **In general**

Distributions from qualified retirement plans and annuities, section 403(b) plans, and governmental section 457(b) plans (other than distributions from designated Roth accounts, discussed below) are generally includible in gross income (to the extent the distribution exceeds basis) as ordinary income in the year in which distributed.<sup>54</sup> The part of any distribution that represents the participant's investment in the contract (*i.e.*, basis) is not includible in gross income. A participant generally has basis under the plan to the extent that the participant has made after-tax contributions to the plan that have not been recovered. The basis recovery rules differ depending on whether or not the distribution is received as an annuity payment.

As discussed below, an additional 10-percent tax applies to distributions before age 59½ from qualified retirement plans and annuities and section 403(b) plans unless an exception applies. In addition, participants in qualified retirement plans and annuities, section 403(b) plans, and governmental section 457(b) plans are required to begin receiving distributions at the later of age 72 or retirement.

##### **Rollovers**

A distribution from a qualified retirement plan, section 403(b) plan, or a governmental section 457(b) plan that is an eligible rollover distribution may be rolled over to another such plan or an IRA. The rollover generally can be achieved by direct rollover (direct payment from the

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<sup>53</sup> In the case of a tax-exempt employer, sections 457(b) and 457(f) limit the amount of unfunded nonqualified deferred compensation that can be provided on a tax-deferred basis.

<sup>54</sup> Secs. 72, 402(a)(1), 403(a)(1), 403(b)(1), and 457(a).

distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution (“60-day rollover”).<sup>55</sup> Amounts that are rolled over are usually not included in gross income. Generally, any distribution of the balance to the credit of a participant is an eligible rollover distribution with exceptions, for example, certain periodic payments, required minimum distributions, and hardship distributions.<sup>56</sup>

Any distribution to a beneficiary other than the participant’s surviving spouse is only permitted to be rolled over to an IRA using a direct rollover; 60-day rollovers are not available to nonspouse beneficiaries.<sup>57</sup>

Qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans are required to offer a direct rollover with respect to any eligible rollover distribution before paying the amount to the participant or beneficiary.<sup>58</sup> If an eligible rollover distribution is not directly rolled over into an eligible retirement plan, the taxable portion of the distribution generally is subject to mandatory 20 percent income tax withholding.<sup>59</sup> Participants who do not elect a direct rollover but who roll over eligible distributions within 60 days of receipt also defer tax on the rollover amounts; however, the 20-percent withheld will remain taxable unless the participant substitutes funds within the 60-day period.<sup>60</sup> The direct rollover and 20-percent withholding rules are designed to encourage tax-free rollovers, and thereby, to keep retirement funds in eligible retirement plans.

Distributions from qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans may be rolled into a Roth IRA. Distributions from these plans that are rolled over into a Roth IRA and that are not distributions from a designated Roth account (discussed below) must be included in gross income.

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<sup>55</sup> The deadline for a rollover of a qualified plan loan offset amount is the due date for the participant’s income tax return (including extensions) for the taxable year in which the offset amount is distributed.

<sup>56</sup> Section 402(c)(4). Treas. Reg. sec. 1.402(c)-1 identifies certain other payments that are not eligible for rollover, including, for example, certain corrective distributions, loans that are treated as deemed distributions under section 72(p), and dividends on employer securities as described in section 404(k).

<sup>57</sup> Sec. 402(c)(11).

<sup>58</sup> Sec. 401(a)(31). Unless a participant elects otherwise, a mandatory cash-out of more than \$1,000 must be directly rolled over to an IRA chosen by the plan administrator or the payor.

<sup>59</sup> Treas. Reg. sec. 1.402(c)-2, Q&A-1(b)(3).

<sup>60</sup> For example, if Adam receives an eligible rollover distribution of \$10,000 and elects to have the entire amount paid directly to him, he will receive \$8,000 since \$2,000 would have been withheld as income tax. If within 60 days of receiving the distribution Adam decides to roll over the distribution into an IRA, he will need to contribute an additional \$2,000 to the IRA in order to defer taxes on the entire distributed amount.

## **B. Defined Contribution Plans**

### **1. General description and rules**

As discussed above, benefits under a defined contribution plan are based solely on the contributions, earnings, and losses credited to the separate accounts maintained for plan participants. For defined contribution plans, a participant's accrued benefit is the participant's account balance. Accordingly, the participant benefits from investment gains and bears the risk of investment losses on the account.

A defined contribution plan may provide for various types of contributions by employees or the employer. In the case of a section 401(k) plan, employees may elect to have pretax contributions made to the plan, referred to as elective deferrals, rather than receive the same amount as current compensation. A section 401(k) plan may also allow employees to designate some or all of their elective deferrals as after-tax Roth contributions. A defined contribution plan may also allow employees to make other after-tax contributions. Possible employer contributions consist of two types: nonelective contributions and matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes pretax or after-tax contributions. Matching contributions are employer contributions that are made only if the employee makes contributions and can relate to pretax elective deferrals, designated Roth contributions, or other after-tax contributions.

The total contributions made to an employee's account for a year cannot exceed the lesser of \$58,000 (for 2021) or the employee's compensation.<sup>61</sup> Contributions made to more than one plan for an employee are aggregated for purposes of this limit, and employee contributions to a defined benefit plan, if any, are taken into account in applying the limit. However, catch-up contributions (discussed below) are not taken into account in applying the limit.

A defined contribution plan can use one of two alternative minimum vesting schedules with respect to the portion of a participant's account balance that is attributable to employer contributions, including investment returns on employer contributions. Under the first vesting schedule, the account balance attributable to employer contributions must be 100 percent vested upon completion of no more than three years of service (often referred to as "three-year cliff vesting"). Under the second vesting schedule (referred to as "graduated vesting"), the participant's account balance attributable to employer contributions must become vested at a rate of no less than 20 percent, 40 percent, 60 percent, 80 percent, and 100 percent, respectively, over the period from two to six years of service.

Defined contribution plans often provide for loans to participants, subject to certain conditions. Defined contribution plans generally provide for distributions on severance from employment and, depending on the type of plan, may provide for distributions before severance

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<sup>61</sup> Sec. 415(c). Under a special rule, for purposes of the contribution limit for defined contribution plans, an individual's compensation may be increased in certain circumstances by the amount of qualified foster payments that are difficulty of care payments that an individual excludes from gross income. Sec. 415(c)(8). Thus, for example, an individual who receives such difficulty of care payments but otherwise has no compensation for a taxable year may nevertheless be permitted to contribute to a defined contribution plan.

from employment (“in-service” distributions). Defined contribution plans may provide for distributions to be made in a lump sum or installments. Defined contribution plans may also provide for distributions in the form of a life annuity (through the purchase of an annuity contract), but generally are not required to provide annuity distributions.

The deduction for employer contributions to a defined contribution plan for a year is generally limited to 25 percent of the participant’s compensation.<sup>62</sup> For this purpose, a participant’s compensation in excess of \$290,000 (for 2021) is not taken into account. Elective deferrals (including designated Roth contributions) and employee contributions are not counted in applying the 25 percent limit. Special deduction rules apply to an ESOP (discussed below), or if an employer maintains both a defined contribution plan and a defined benefit plan. An excise tax may apply if contributions in excess of the deduction limits are made.<sup>63</sup>

## **2. General types of defined contribution plans**

Defined contribution plans fall into three general types: profit-sharing plans, stock bonus plans, and money purchase pension plans. The type of plan must be specified in the plan document. Within the three general types of defined contribution plans are plan designs that contain special features, such as a section 401(k) plan or an ESOP.

Profit-sharing plans were originally intended as a means of enabling employees to share in the profits of the employer’s business. However, under present law, contributions to a profit-sharing plan are permitted regardless of whether the business has profits. A profit-sharing plan may provide for regular employer contributions each year or may provide that contributions are made each year at the discretion of the employer (called a “discretionary” profit-sharing plan). A profit-sharing plan must provide a definite formula under which contributions are allocated to participant accounts and must specify the events upon which distributions will be made to participants, such as severance from employment.

A stock bonus plan is similar to a profit-sharing plan except that benefits are distributable in stock of the employer. The plan may provide for cash distributions, but must also allow participants to take distributions in the form of employer stock. In the case of employer stock that is not publicly traded, participants generally must be given the right to require the employer to repurchase the stock under a fair valuation formula.

A money purchase pension plan must provide for a set level of required employer contributions, generally as a specified percentage of participants’ compensation. A money purchase pension plan is subject to the minimum funding requirements, and the employer is generally subject to an excise tax if it fails to make the contributions required under the plan. A

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<sup>62</sup> Sec. 404.

<sup>63</sup> Sec. 4972.

money purchase pension plan may not provide for in-service distributions before age 59½ (or normal retirement age, if earlier),<sup>64</sup> except in the case of plan termination.

Certain spousal protections apply to qualified retirement plans.<sup>65</sup> In the case of a pension plan (that is, a money purchase pension plan or a defined benefit plan), these protections generally require that benefits be paid in the form of a qualified joint and survivor annuity (“QJSA”) unless the participant elects a different form of distribution and the participant’s spouse consents in writing to the election. A QJSA is generally a life annuity for the participant with an annuity of at least 50 percent of the participant’s annuity amount payable to the surviving spouse after the participant’s death.<sup>66</sup> If a married participant dies before benefits begin, the plan must offer a survivor benefit for the spouse in the form of a qualified preretirement survivor annuity (“QPSA”), which is a survivor annuity for the spouse that is at least 50 percent of the employee’s accrued benefit.

Profit-sharing plans and stock bonus plans are generally not subject to these spousal protection requirements unless the participant elects an annuity form of distribution. However, a profit-sharing or stock bonus plan must provide that a participant’s entire vested account balance under the plan will be paid to the participant’s surviving spouse unless the spouse consents in writing to a different beneficiary.

### **3. Section 401(k) plans**

#### **In general**

A section 401(k) plan legally is not a separate type of plan, but is a profit-sharing or stock bonus plan that contains a qualified cash or deferred arrangement.<sup>67</sup> Thus, such arrangements are subject to the rules generally applicable to qualified defined contribution plans. In addition, special rules apply to such arrangements.

An employee may make elective deferrals to a section 401(k) plan. The maximum annual amount of elective deferrals that can be made by an employee for a year is \$19,500 (for 2021) or, if less, the employee’s compensation.<sup>68</sup> An employee who will attain age 50 by the end of the

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<sup>64</sup> In-service distributions may be provided at age 55 under a multiemployer plan in the case of certain employees in the building or construction industry. Sec. 401(a)(36)(B).

<sup>65</sup> Sec. 401(a)(11); ERISA sec. 205.

<sup>66</sup> A married participant must also be offered a qualified optional survivor annuity (“QOSA”), which is also a life annuity for the participant with an annuity payable to the surviving spouse as a percentage of the participant’s annuity, with the required percentage depending on the QJSA percentage.

<sup>67</sup> Certain pre-ERISA money purchase plans and rural cooperative plans may also include a qualified cash or deferred arrangement. In addition, certain small employers may adopt a SIMPLE section 401(k) plan similar to a SIMPLE IRA plan discussed in Part I.C.3. Except for certain grandfathered plans, a State or local governmental employer may not maintain a section 401(k) plan.

<sup>68</sup> Sec. 402(g).

year may also make catch-up contributions to a section 401(k) plan.<sup>69</sup> As a result, the dollar limit on elective deferrals is increased by \$6,500 (for 2021) for an individual who has attained age 50. An employee's elective deferrals must be fully vested.

Elective deferrals, and attributable earnings, generally cannot be distributed from the plan before the earliest of the employee's severance from employment, death, disability, or attainment of age 59½ or termination of the plan.<sup>70</sup> However, subject to certain conditions, these amounts can be distributed in the case of hardship.

Elective deferrals are generally made on a pretax basis. However, a section 401(k) plan is permitted to include a "qualified Roth contribution program" that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as designated Roth contributions. Designated Roth contributions are elective deferrals that the participant designates as not excludable from the participant's gross income. The annual dollar limit on a participant's designated Roth contributions is the same as the limit on elective deferrals, reduced by the participant's elective deferrals that are not designated Roth contributions. Designated Roth contributions are generally treated the same as any other elective deferral for certain purposes, including the restrictions on distributions.

Qualified distributions from a designated Roth account are excluded from income, even though they include earnings not previously taxed. A qualified distribution is a distribution made after the end of a specified period (generally five years after the participant's first designated Roth contribution) and that is (1) made on or after the date on which the participant attains age 59½, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled.

A section 401(k) plan that includes a designated Roth program may permit participants to transfer amounts from a non-Roth account under the plan to a designated Roth account, whether or not the amounts in the non-Roth account are permitted to be distributed from the plan at the time of the transfer.<sup>71</sup> In effect, this transfer is a Roth conversion (discussed below), with related income recognition, for any non-Roth amounts within the plan.

Section 401(k) plans are not required to provide for matching contributions, but often do. Many employers provide matching contributions because doing so encourages lower-paid employees to make elective deferrals, which makes it easier for the plan to satisfy the applicable nondiscrimination rules. A section 401(k) plan may also provide for employer nonelective contributions.

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<sup>69</sup> Sec. 414(v).

<sup>70</sup> An exception also applies for lifetime income investments; see discussion in Part I.B.6.

<sup>71</sup> Prior to 2013, transfers of non-Roth amounts to a designated Roth account were permitted only for amounts that were available for distribution from the plan at the time of the transfer.

## **Automatic enrollment**

Section 401(k) plans may be designed so that the employee will receive cash compensation unless the employee affirmatively elects to make elective deferrals to the section 401(k) plan. Alternatively, a plan may provide that elective deferrals are made at a specified rate (when the employee becomes eligible to participate) unless the employee elects otherwise (*i.e.*, affirmatively elects not to make contributions or to make contributions at a different rate). This plan design is referred to as automatic enrollment.

Under a section 401(k) plan, an employee must have an effective opportunity to elect to receive cash in lieu of contributions. Whether an employee has an effective opportunity to receive cash is based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.<sup>72</sup>

Automatic enrollment was originally authorized by IRS guidance<sup>73</sup> and has been furthered by subsequent statutory changes providing special rules for automatic enrollment.<sup>74</sup> Use of these special rules is generally predicated on automatic contributions at a uniform rate (as a percentage of compensation) for all participants. These rules include a nondiscrimination safe harbor for a section 401(k) plan that includes a qualified automatic contribution arrangement. In addition, if a section 401(k) plan includes an eligible automatic contribution arrangement, elective deferrals that were automatically contributed to the plan (*i.e.*, without an affirmative deferral election by an employee) may be distributed to the employee in accordance with an election by the employee within 90 days after the first automatic contribution.<sup>75</sup> Such a distribution is permitted, despite the general restriction on in-service distributions of elective deferrals, and the amount distributed is not subject to the 10-percent early distribution tax. In addition, in the case of an eligible automatic contribution arrangement, a notice must be provided to participants explaining the choice between making or not making contributions and identifying the default contribution rate and investment, and each participant must be given a reasonable period of time after receipt of the notice to make an affirmative election with respect to contributions and investments.<sup>76</sup>

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<sup>72</sup> Treas. Reg. sec. 1.401(k)-1(e)(2). Similar rules apply to elective deferrals under section 403(b) plans and section 457(b) plans.

<sup>73</sup> Rev. Rul. 2000-8, 2000-7 I.R.B. 617; Rev. Rul. 2000-33, 2000-31 I.R.B. 142; Rev. Rul. 2000-35, 2000-31 I.R.B. 138; and Treas. Reg. sec. 1.401(k)-1(a)(3)(ii).

<sup>74</sup> The Pension Protection Act of 2006 (“PPA”), Pub. L. No. 109-280, added a number of special rules to the Code and ERISA with respect to automatic enrollment in section 401(k) plans. The Code rules generally apply also to section 403(b) plans and governmental section 457(b) plans.

<sup>75</sup> Sec. 414(w).

<sup>76</sup> Treas. Reg. sec. 1.414(w)-1(b)(3).

## **Special nondiscrimination tests for section 401(k) plans**

### General rule

A special annual nondiscrimination test, called the actual deferral percentage test (the “ADP” test) applies to elective deferrals under a section 401(k) plan.<sup>77</sup> The ADP test generally compares the average rate of deferral for highly compensated employees to the average rate of deferral for non-highly compensated employees. The ADP test allows the average deferral rate for highly compensated employees to exceed that for non-highly compensated employees within limits: (1) the average deferral rate for highly compensated employees can be up to 125 percent of the average deferral rate for non-highly compensated employees; or (2) the average deferral rate for highly compensated employees can be two percentage points greater than the average deferral rate for non-highly compensated employees or, if less, twice the average deferral rate for non-highly compensated employees. Employer matching contributions and after-tax employee contributions are subject to a similar special nondiscrimination test (the actual contribution percentage test or “ACP test”) which compares the average rate of matching and after-tax contributions to the plan of the two groups.<sup>78</sup>

If the ADP test is not satisfied, a mechanism is provided for the employer to make immediately vested additional contributions for non-highly compensated employees (and certain other corrections) or to distribute deferrals of highly compensated employees to such employees, so that the ADP test is satisfied. Similar correction mechanisms apply for purposes of satisfying the ACP test.

### Design-based safe harbor nondiscrimination tests

There are also designed-based safe harbor methods of satisfying the ADP and ACP tests. These safe harbors are based on the premise that, for a section 401(k) plan with certain design features with respect to contributions (elective, matching, and nonelective) and enrollment, satisfaction of the minimum coverage requirement is a sufficient test of whether the amount of elective deferrals and matching contributions are nondiscriminatory.<sup>79</sup> Under one safe harbor, a section 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and, if applicable, satisfies a notice requirement. A plan generally satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee’s compensation on behalf of each non-highly compensated employee who is eligible to participate in the plan. The matching contribution requirement under the safe harbor is 100 percent of elective contributions of the employee for contributions not in excess of three percent of compensation, and 50 percent of

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<sup>77</sup> Sec. 401(k)(3).

<sup>78</sup> Sec. 401(m)(2).

<sup>79</sup> The safe harbors that only require certain matching contributions potentially allow satisfaction of the nondiscrimination requirement with respect to elective and matching contributions under a 401(k) plan for a year even though no contributions are ultimately provided to non-highly compensated employees under the plan for the year due to a lack of voluntary participation.

elective contributions for contributions that exceed three percent of compensation but do not exceed five percent, for a total matching contribution of up to four percent of compensation. The required matching contributions and the three percent nonelective contribution must be immediately nonforfeitable (*i.e.*, 100 percent vested) when made. A notice requirement applies in the case of a plan satisfying the matching contribution requirement, but not the nonelective contribution requirement.<sup>80</sup> Other requirements also apply, including requirements for satisfying the ACP test on a safe harbor basis.<sup>81</sup>

Another safe harbor applies for section 401(k) plans that include a qualified automatic contribution arrangement.<sup>82</sup> Under a qualified automatic contribution arrangement, unless an employee elects otherwise, the employee is treated as electing to make elective deferrals equal to a percentage of compensation as stated in the plan, not in excess of 15 percent (10 percent during the first year the deemed election applied) and at least (1) three percent of compensation for the first year the deemed election applies to the participant, (2) four percent during the second year, (3) five percent during the third year, and (4) six percent during the fourth year and thereafter.<sup>83</sup> Under the safe harbor, the matching contribution requirement is 100 percent of elective contributions of the employee for contributions not in excess of one percent of compensation, and 50 percent of elective contributions for contributions that exceed one percent of compensation but do not exceed six percent (for a total matching contribution of up to 3.5 percent of compensation). The rate of the safe harbor nonelective contribution is three percent, as under the regular safe harbor. However, under a qualified automatic contribution arrangement, the matching and nonelective contributions are allowed to become 100 percent vested only after two years of service (rather than being immediately vested).

#### 4. ESOPs

##### In general

An ESOP is a stock bonus plan that is designated as an ESOP and is designed to invest primarily in stock of the employer, referred to as “qualifying employer securities.”<sup>84</sup> An ESOP

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<sup>80</sup> Sec. 401(k)(12). The plan satisfies the notice requirement if, within a reasonable time before the beginning of the plan year, the plan provides written notice to each eligible employee of the employee’s rights and obligations under the plan. Note that plans that satisfy the nonelective contribution requirement are still subject to the general rule that applies to section 401(k) plans that the plan must provide an employee with an effective opportunity to make (or change) a cash or deferred election at least once during each plan year. Whether or not an effective opportunity is provided is determined based on all the relevant facts and circumstances, including the adequacy of notice of the availability of a cash or deferred election. Treas. Reg. sec. 1.401(k)-1(e)(2)(ii); Notice 2020-86, 2020-53 I.R.B. 1786.

<sup>81</sup> Sec. 401(m)(11).

<sup>82</sup> Secs. 401(k)(13) and (m)(12).

<sup>83</sup> These automatic increases in default contribution rates are required for plans using the safe harbor. Rev. Rul. 2009-30, 2009-39 I.R.B. 391, provides guidance for including automatic increases in other plans using automatic enrollment, including under a plan that includes an eligible automatic contribution arrangement.

<sup>84</sup> Sec. 4975(e)(7). Participant accounts in other types of defined contribution plans can also be invested in employer stock.

can be maintained by either a C corporation or an S corporation.<sup>85</sup> For purposes of ESOP investments, a “qualifying employer security” is generally defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP.

An ESOP can be a standalone plan or it can be a portion of another type of defined contribution plan. An ESOP may provide for different types of contributions, including employer nonelective contributions. For example, an ESOP may include a section 401(k) feature that permits employees to make elective deferrals. ESOPs are subject to additional requirements that do not apply to other plans that hold employer stock. For example, voting rights must generally be passed through to ESOP participants and employees must generally have the right to receive benefits in the form of stock.

### **Diversification requirements for ESOPs**

ESOPs are generally subject to a requirement that a participant who has attained age 55 and who has at least 10 years of participation in the plan must be permitted to diversify the investment of the participant’s account in assets other than employer securities.<sup>86</sup> The diversification requirement applies to a participant for six years, starting with the year in which the individual first meets the eligibility requirements (*i.e.*, age 55 and 10 years of participation). The participant must be allowed to elect to diversify up to 25 percent of the participant’s account (50 percent in the sixth year), reduced by the portion of the account diversified in prior years.

The participant must be given 90 days after the end of each plan year in the election period to make the election to diversify. In the case of participants who elect to diversify, the plan satisfies the diversification requirement if: (1) the plan distributes the applicable amount to the participant within 90 days after the election period; (2) the plan offers at least three alternative investment options and, within 90 days of the election period, invests the applicable amount in accordance with the participant’s election; or (3) the applicable amount is transferred within 90

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<sup>85</sup> A C corporation is so named because its tax treatment is governed by subchapter C of the Code. An S corporation is so named because its tax treatment is governed by subchapter S of the Code. An S corporation is a pass-through entity for income tax purposes. That is, income tax does not apply at the S corporation level. Rather, items of income, gain, or loss are taken into account for tax purposes by the S corporation shareholders on their own tax returns.

<sup>86</sup> Sec. 401(a)(28). Different diversification requirements apply to certain ESOPs under section 401(a)(35). The section 401(a)(35) diversification requirements apply to ESOPs holding publicly-traded employer securities, except that they do not apply to an ESOP that is a standalone plan (that is, a separate plan under section 414(l) with respect to any other defined benefit or defined contribution plan of the employer) and that does not include any contributions (or earnings thereunder) that are subject to sections 401(k) or 401(m).

days of the election period to another qualified defined contribution plan of the employer providing investment options in accordance with (2).<sup>87</sup>

### **Special ESOP rules**

Certain benefits are available to ESOPs that are not available to other types of qualified retirement plans that hold employer stock. Under an exception to the prohibited transaction rules, an employer maintaining an ESOP may lend money to the ESOP, or the employer may guarantee a loan made by a third-party lender to the ESOP, to finance the ESOP's purchase of employer securities.<sup>88</sup> An ESOP that borrows funds to acquire employer securities is generally called a leveraged ESOP.

In the case of an ESOP maintained by a C corporation, payments of principal on the ESOP loan are deductible to the extent permitted under the general deduction limits for contributions to qualified retirement plans (which generally limit the deduction for contribution to a defined contribution plan for a year to 25 percent of the participant's compensation), and interest payments are deductible without regard to the limitation.<sup>89</sup> In addition, a C corporation may deduct dividends paid on employer stock held by an ESOP if the dividends are used to repay a loan, if they are distributed to plan participants, or if the plan gives participants the opportunity to elect either to receive the dividends or have them reinvested in employer stock under the ESOP and the dividends are reinvested at the participants' election.<sup>90</sup> This deduction is also allowed without regard to the general deduction limits on contributions to qualified plans. Moreover, subject to certain requirements, a taxpayer may elect to defer the recognition of long-term capital gain on the sale of qualified securities to an ESOP maintained by a C corporation.<sup>91</sup>

ESOPs maintained by S corporations are subject to special rules. Generally, if a tax-exempt entity, including a trust holding qualified retirement plan assets, holds S corporation stock, it is treated as holding an interest in an unrelated trade or business and is subject to unrelated business income tax ("UBIT").<sup>92</sup> However, an ESOP holding employer securities issued by an S corporation is exempt from UBIT.

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<sup>87</sup> Notice 88-56, 1988-1 C.B. 540, Q&A-16.

<sup>88</sup> Sec. 4975(d)(3). To qualify for the loan exemption, the loan must be primarily for the benefit of participants and beneficiaries of the plan, the interest on the loan must be at a reasonable rate, and any collateral given to a disqualified person by the plan must consist only of qualifying employer securities.

<sup>89</sup> Sec. 404(a)(9).

<sup>90</sup> Sec. 404(k). If a dividend is paid with respect to stock allocated to a participant's account and is used to make a payment on an ESOP loan, the plan must allocate employer securities with a fair market value of not less than the amount of such dividend to the participant's account for the year in which such dividend would have been allocated to such participant. Distributions with respect to S corporation stock held in an ESOP may also be used to repay an ESOP loan under similar conditions, but the distribution is not deductible by the S corporation.

<sup>91</sup> Sec. 1042.

<sup>92</sup> Sec. 512(e). Section 511 imposes UBIT on a tax-exempt entity's income from an unrelated trade or business.

In part to prevent interests in income attributable to employer stock of an S corporation held by an ESOP (and thus not subject to current taxation) from being concentrated in a small group of persons, a number of adverse tax consequences may apply if a “nonallocation year” occurs with respect to an ESOP maintained by an S corporation. If any “disqualified person” has an interest in the S corporation in the form of “synthetic equity”<sup>93</sup> during a nonallocation year, an excise tax is imposed on the S corporation equal to 50 percent of the amount of such synthetic equity. If there are “prohibited allocations”<sup>94</sup> for the benefit of disqualified persons during a nonallocation year, the amount of the prohibited allocations is treated as distributed to the disqualified persons; an excise tax equal to 50 percent of the amount of the prohibited allocation applies to the S corporation; the qualified plan ceases to be an ESOP; and there is a potential for disqualification of the plan.

A “nonallocation year” is a plan year of an ESOP maintained by an S corporation in which disqualified persons own (directly or indirectly) at least 50 percent of the S corporation shares. For this purpose, a person’s interest in the S corporation in the form of synthetic equity is treated as ownership of S corporation shares and is taken into account, but only if taking it into account causes a plan year to be a nonallocation year or a person to be a disqualified person.<sup>95</sup> Thus, both determinations are done with and without synthetic equity. “Disqualified persons” generally are persons who have at least a 10-percent interest (or who are a member of a family group having at least a 20-percent interest) in the portion of the S corporation shares held by the ESOP, either by having shares of S corporation employer stock allocated to the person’s account under the ESOP (or being treated as having a portion of unallocated shares), or by having an interest in the S corporation in the form of synthetic equity.

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<sup>93</sup> Pursuant to Sec. 409(p)(5) and (6)(C), and Treas. Reg. sec. 1.409(p)-1(f), “synthetic equity” is any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest that gives the holder the right to acquire or receive stock of the S corporation in the future; a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value; and rights to nonqualified deferred compensation (even though it is neither payable in, nor calculated by reference to, stock in the S corporation) and rights to acquire interests in certain related entities. A person can be a disqualified person, and a nonallocation year can occur based solely on interests in the S corporation in the form of synthetic equity, even if the person is not a participant in the ESOP. Synthetic equity is an interest in income attributable to employer stock held by an ESOP, and reduces the ESOP’s economic ownership of the S corporation. On the other hand, it is possible in certain circumstances to grant options or warrants for S corporation stock (or other synthetic equity) to a single person that, when combined with the outstanding shares of the S corporation, are options for up to 49 percent of the S corporation stock without causing a nonallocation year.

<sup>94</sup> Generally a “prohibited allocation” for the benefit of a disqualified person occurs during a nonallocation year to the extent that S corporation employer stock owned by the ESOP (and any assets attributable to such stock) is held for the benefit of a disqualified person during the nonallocation year (whether the stock is allocated to the person’s account under the ESOP during the nonallocation year or an earlier year).

<sup>95</sup> An ESOP maintained by an S corporation may be able prevent a nonallocation year (or a prohibited allocation during a nonallocation year) by transferring S corporation employer stock allocated to the account of disqualified persons (or persons expected to become disqualified persons) to a separate portion of the qualified plan (or another qualified retirement plan of the S corporation) that is not designated as an ESOP and allocate it to the accounts of those persons under the separate portion (or other plan). In that case, the qualified retirement plan is subject to UBIT with respect to those transferred shares of S corporation stock.

## 5. Plan loans and hardship distributions

### In general

The rules for tax-favored retirement savings include provisions aimed at limiting or discouraging withdrawals before retirement (referred to as “leakage”), which deplete the assets available to provide retirement income. Such provisions include the 10-percent early distribution tax, discussed in Part I.D.1, and restrictions on distributions before termination of employment (referred to as “in-service” distributions). However, restrictions on access to tax-favored savings before retirement may discourage individuals from making contributions out of concern that funds will not be available in the case of financial need. This concern is addressed by allowing plan loans and exceptions to the restrictions on in-service distributions, including in the case of hardship, as well as exceptions to the 10-percent early distribution tax.

### Plan loans

Defined contribution plans, section 403(b) plans, and governmental section 457(b) plans generally are permitted, but are not required, to offer plan loans to participants. Plan loans must comply with certain conditions so that the loan is not treated as a taxable distribution to the participant.<sup>96</sup> Generally, a loan that does not satisfy all of the requirements will be treated as a deemed distribution, resulting in current income taxation and, for participants younger than 59½, a 10-percent early distribution tax. The requirements both limit the amount of the loan and the repayment terms. If the actual repayment of the loan does not satisfy the required repayment terms during the period the loan is outstanding, a deemed distribution of the loan outstanding occurs at that time.

In order not to be treated as a deemed distribution, a plan loan may not exceed the lesser of (1) \$50,000 reduced by the excess of the highest outstanding loan balance from the plan during the one-year period ending on the day before the date on which the loan is made over the outstanding loan balance on the date on which the loan is made, or (2) the greater of (a) 50 percent of the present value of the vested accrued benefit of the participant or (b) \$10,000.<sup>97</sup> Generally, a plan loan is treated as a deemed distribution unless it provides for repayment within

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<sup>96</sup> Sec. 72(p). Generally, if a participant or beneficiary assigns or pledges any portion of his or her interest in a qualified plan as security for a loan, the assigned or pledged portion is treated as a loan from the plan to the participant for purposes of section 72(p). A plan loan that is made through the use of a credit card or similar arrangement does not meet the requirements for loan treatment applicable to qualified retirement plans and is treated as a deemed distribution.

<sup>97</sup> There are certain exceptions to these rules; for example, individuals eligible to receive a coronavirus-related distribution under section 2202 of the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, March 27, 2020, may take a loan during a specified period of time equal to the lesser of the present value of the nonforfeitable accrued benefit of the employee under the plan or \$100,000 and certain other rules apply to such loans. Special rules for loans also apply for certain individuals impacted by specified disasters, see, e.g., section 302 of Div. EE of the Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, December 27, 2020.

five years of the loan date<sup>98</sup> and for substantially equal payments of both principal and interest no less frequently than quarterly over the term of the loan. Repayment on an accelerated schedule is permitted, and plan terms may require full repayment on termination of employment.

Deemed distributions, resulting from a failure to comply with the loan requirements, are treated as actual distributions for tax purposes. They are not, however, treated as actual distributions for purposes of plan qualification or rollovers requirements.

Distribution of a plan loan offset amount occurs when, pursuant to plan terms, the accrued benefit of a participant or beneficiary is reduced in order to repay a loan. For example, it is common for plans to provide that, if a participant requests a plan distribution while a loan is outstanding, the loan must be repaid immediately or treated as in default. In the event of a loan offset, the amount of the account balance that is offset against the loan is an actual, not a deemed, distribution. In contrast to a deemed distribution, a loan offset amount can be an eligible rollover distribution. A plan is not, however, required to offer a direct rollover with respect to the loan offset amount and the amount is generally not subject to mandatory 20-percent withholding.

The deadline for a rollover of a distributed plan loan offset amount is generally within 60 days of receiving the distribution; however, for a qualified plan loan offset amount, the deadline is the due date for the participant's income tax return (including extensions) for the taxable year in which the offset amount is distributed.<sup>99</sup> A qualified plan loan offset amount is a plan loan offset amount that is distributed when a plan that is in good standing is offset because the plan terminates or the participant severs from employment.

### **Hardship distributions**

Hardship distributions are an exception to the general prohibition on in-service distributions before age 59½ of amounts in a section 401(k) plan or section 403(b) plan that are attributable to elective deferrals.<sup>100</sup> Section 401(k) and section 403(b) plans are permitted, but are not required, to permit participants to take hardship withdrawals, provided two conditions are met. First, the distribution must be made on account of an immediate and heavy financial need of the employee. Second, the distribution must be necessary to satisfy that financial need. Determinations regarding whether an immediate and heavy financial need exists, and whether a distribution is necessary to meet that need, must be made in accordance with nondiscriminatory and objective standards set forth in the plan.<sup>101</sup> There are, however, regulatory safe harbors whereby certain requirements may be deemed to have been met, such as for the purchase of a home or the payment of education expenses.<sup>102</sup> For section 401(k) plans, hardship distributions

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<sup>98</sup> An exception to the five-year rule applies in the case of a loan used to purchase the participant's principal residence. Rules also allow the suspension of repayment of a loan while the participant is performing services in the uniformed services of the United States. Treas. Reg. sec. 1.72(p)-1, Q&A-9(b) and (c).

<sup>99</sup> Sec. 402(c)(3)(C).

<sup>100</sup> Sec. 401(k)(2)(B)(i)(IV).

<sup>101</sup> Treas. Reg. sec. 1.401(k)-1(d)(3)(i).

<sup>102</sup> Treas. Reg. secs. 1.401(k)-1(d)(3) and 1.403(b)-6(d)(2).

may be made from the employee's total elective deferrals as of the date of the distribution, earnings on such elective deferrals, as well as qualified nonelective contributions and qualified matching contributions (and associated earnings), reduced by the amount of any previous hardship distributions. A similar rule applies to section 403(b) plans, except that hardship distributions may not be made from earnings on elective deferrals, and amounts attributable to qualified nonelective contributions and qualified matching contributions may be distributed on account of hardship only if the amounts are in a custodial account.

Section 457(b) plans may provide for distributions in the case of an unforeseeable emergency.<sup>103</sup> The concept of unforeseeable emergency is narrower than the concept of hardship under the section 401(k) and section 403(b) rules and the regulatory safe harbors do not apply.

## **6. Lifetime income under defined contribution plans**

Pension plans (defined benefit and money purchase pension plans) are required to provide participants with life annuity forms of benefit, including forms that provide life annuity benefits for surviving spouses. However, profit-sharing and stock bonus plans are not required to offer annuity forms of distribution; instead, a participant's (or surviving spouse's) benefit consists of an account balance, which can be depleted during the participant's (or surviving spouse's) lifetime.<sup>104</sup>

Lifetime income concerns have been a focus of the Department of the Treasury and the IRS in collaboration with DOL to facilitate, and expand, the availability of options that enable a participant or surviving spouse to take distributions in a form that is more likely to last over his or her lifetime ("lifetime income").<sup>105</sup> The following guidance has been provided:<sup>106</sup>

- Special rules for applying the Code nondiscrimination requirements to a series of target date funds that include deferred annuities among their assets and are offered as investment options under a defined contribution plan, even if some of the target date funds within the series are available only to older participants;<sup>107</sup>

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<sup>103</sup> Sec. 457(d)(1)(iii).

<sup>104</sup> Although defined benefit plans are required to offer annuities, they may also offer lump sums, and many participants elect to receive a lump sum (perhaps rolling it over to an IRA), rather than an annuity.

<sup>105</sup> A life annuity by definition provides lifetime income, but lifetime income options also include, for example, installment payments over an individual's lifetime.

<sup>106</sup> As part of the same lifetime income project, the IRS issued guidance to increase annuity distributions from defined benefit plans. Final regulations under section 417(e), relating to the calculation of minimum lump sums, address the situation in which a participant's accrued benefit under a defined benefit plan is bifurcated and the bifurcated portions paid in separate forms, such as an annuity and a lump sum. Treasury Decision 9783, 81 FR 62359-01 (Sept. 9, 2016) and Treas. Reg. sec. 1.417(e)-(1). In addition, Rev. Rul. 2012-4, 2012-8 I.R.B. 386, provides guidance on transferring a participant's account balance under a defined contribution plan to a defined benefit plan in order to provide an increased annuity under the defined benefit plan.

<sup>107</sup> Notice 2014-66, 2014-46 I.R.B. 820.

- Regulations relating to minimum required distributions under the Code (discussed further below), providing special rules for annuity contracts under which payments may begin at age 85;<sup>108</sup>
- Clarification of the application of the spousal consent and QJSA and QPSA requirements when a deferred annuity contract is offered as an investment option under a profit-sharing plan.<sup>109</sup>

Recent legislative efforts also have addressed a number of statutory barriers to promoting and offering lifetime income investment options in defined contribution plans as described below.

#### Portability of lifetime income options

Qualified retirement plans that offer lifetime income investments may change these investment options over time. The terms of some investments impose a charge or fee when the investment is liquidated. For example, a lifetime income product, such as an annuity contract, may impose a surrender charge if the investment is discontinued. If an employee must liquidate an investment held in an employer-sponsored retirement plan because of a change in investment options or a limit on investments held in the plan, the employee may be subject to such a charge or fee when the investment is discontinued. In addition, restrictions on in-service distributions may prevent the employee from preserving the investment through a rollover.

Instead of requiring an employee to liquidate such an investment, if a lifetime income investment is no longer authorized to be held as an investment option under a qualified defined contribution plan (including a section 401(k) plan, a section 403(b) plan, or a governmental section 457(b) plan, except as otherwise provided in guidance), the plan does not fail to satisfy the Code requirements applicable to the plan solely by reason of allowing (1) qualified distributions of a lifetime income investment,<sup>110</sup> or (2) distributions of a lifetime income investment in the

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<sup>108</sup> Treasury Decision 9673, 79 Fed. Reg. 37633, July 2, 2014. and Treas. Reg. secs. 1.401(a)(9)-5, A-3 and 1.401(a)(9)-6, A-12. Because the annuity is scheduled to begin at a time when an individual's life expectancy has declined, such an annuity contract generally costs much less than a contract providing an annuity with an earlier start date. Because the individual's retirement account balances are likely to have been at least partially depleted by the time the annuity is scheduled to begin, such an annuity is sometimes referred to as a longevity annuity or longevity insurance.

<sup>109</sup> Rev. Rul. 2012-3, 2012-8 I.R.B. 383.

<sup>110</sup> Prior to the enactment of this provision, restrictions on in-service distributions prevented the employee from preserving the investment for the employee through a rollover. For purposes of this rule, a qualified distribution is a direct trustee-to-trustee transfer to another employer-sponsored retirement plan or IRA (meaning a plan or IRA that is an eligible retirement plan under section 402(c)(8)(B)). A lifetime income investment is an investment option designed to provide an employee with election rights (1) that are not uniformly available with respect to other investment options under the plan, and (2) that are rights to a lifetime income feature available through a contract or other arrangement offered under the plan (or under another employer-sponsored retirement plan or IRA through a direct trustee-to-trustee transfer). A lifetime income feature is (1) a feature that guarantees a minimum level of income annually (or more frequently) for at least the remainder of the life of the employee or the joint lives of the employee and the employee's designated beneficiary, or (2) an annuity payable on behalf of the employee under which payments are made in substantially equal periodic payments (not less frequently than annually) over the life of the employee or the joint lives of the employee and the employee's designated beneficiary. Finally, a qualified plan

form of a qualified plan distribution annuity contract. Such a distribution must be made within the 90-day period ending on the date when the lifetime income investment is no longer authorized to be held as an investment option under the plan.

#### Benefit statement disclosures regarding lifetime income

A new disclosure requirement<sup>111</sup> provides that information about lifetime income must be included in (at least) one benefit statement provided to a defined contribution plan participant during any 12-month period.<sup>112</sup> A lifetime income disclosure is required to set forth the lifetime income stream equivalent of the participant's total account balance under the plan. The lifetime income stream equivalent of the total account balance is the amount of monthly payments the participant or beneficiary would receive if the total account balance were used to provide lifetime income streams. The required lifetime income streams are (1) a qualified joint and survivor annuity for the participant and the participant's surviving spouse (or beneficiary and the beneficiary's surviving spouse) and (2) a single life annuity. The DOL interim final rule sets forth various assumptions that are to be used in preparing the lifetime income disclosure as well as providing model language and model benefit statement supplements.<sup>113</sup>

#### Fiduciary safe harbor for selection of lifetime income provider

DOL regulations provide a safe harbor for a fiduciary to satisfy the prudent man requirement in selecting an annuity provider and a contract for benefit distributions from a defined contribution plan.<sup>114</sup>

A new safe harbor provides a means by which a fiduciary will be considered to satisfy the prudent man requirement with respect to the selection of insurers for guaranteed retirement

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distribution annuity contract is an annuity contract purchased for a participant and distributed to the participant by an employer-sponsored retirement plan or an employer-sponsored retirement plan contract. (For this purpose, an employer-sponsored retirement plan contract is an annuity contract distributed from an eligible retirement plan described in section 402(c)(8)(B) other than an IRA or individual retirement annuity).

<sup>111</sup> Section 203 of the Setting Every Community Up for Retirement ("SECURE") Act, Pub. L. No. 116-94, Division O, December 20, 2019, amended section 105 of ERISA to provide for this lifetime income disclosure. DOL issued an interim final rule with a request for comments regarding the information that must be provided in such disclosures. "Pension Benefit Statements—Lifetime Income Illustrations," 85 Fed. Reg. 59132, September 18, 2020.

<sup>112</sup> Pursuant to ERISA section 105, a benefit statement provided with respect to a defined contribution plan generally must also include (1) the participant's total benefits accrued, that is, the participant's account balance; (2) the vested portion of the account balance or the earliest date on which the account balance will become vested; and (3) the value of each investment to which assets in the participant's account are allocated. A quarterly benefit statement provided to a participant who has the right to direct investments must provide additional information, including information relating to investment principles. Benefit statements are required also with respect to defined benefit plans. A civil penalty may apply for a failure to provide a required benefits statement.

<sup>113</sup> No plan fiduciary, plan sponsor, or other person has any liability under ERISA solely by reason of the provision of lifetime income stream equivalents that are derived in accordance with the DOL guidance. This protection applies without regard to whether the lifetime income stream equivalent is required to be provided.

<sup>114</sup> 29 C.F.R. sec. 2550.404a-4.

income contracts.<sup>115</sup> It applies to the selection of the insurance company for purposes of determining if the insurer is financially capable of satisfying its obligations under the guaranteed retirement income contract. The provision does not extend to the underlying insurance contract, and therefore the fiduciary must conduct a separate fiduciary analysis of the prudence and terms and conditions of the guaranteed retirement income contract based on present law and guidance.

A fiduciary will be deemed to meet the prudent man requirement, with respect to the selection of an insurer for a guaranteed retirement income contract, if the fiduciary: (1) engages in an objective, thorough, and analytical search for the purpose of identifying insurers from which to purchase guaranteed retirement income contracts; (2) with respect to each insurer identified through the search, considers the financial capability of the insurer to satisfy its obligations under the guaranteed retirement income contract and considers the cost (including fees and commissions) of the guaranteed retirement income contract offered by the insurer in relation to the benefits and product features of the contract and administrative services to be provided under the contract; and (3) on the basis of the foregoing, concludes that, at the time of the selection, the insurer is financially capable<sup>116</sup> of satisfying its obligations under the guaranteed retirement income contract and that the cost (including fees and commissions) of the selected guaranteed retirement income contract is reasonable in relation to the benefits and product features of the contract and the administrative services to be provided under the contract.

A fiduciary that satisfies the requirements of the provision is not liable following the distribution of any benefit, or the investment by or on behalf of a participant or beneficiary pursuant to the selected guaranteed retirement income contract, for any losses that may result to the participant or beneficiary due to an insurer's inability to satisfy its financial obligations under the terms of the contract.

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<sup>115</sup> For this purpose, an insurer is an insurance company, insurance service, or insurance organization qualified to do business in a State including affiliates of those entities to the extent the affiliate is licensed to offer guaranteed income contracts. A guaranteed retirement income contract is an annuity contract for a fixed term or a contract (or provision or feature thereof) designed to provide a participant guaranteed benefits annually (or more frequently) for at least the remainder of the life of the participant or joint lives of the participant and the participant's designated beneficiary as part of a defined contribution plan.

<sup>116</sup> A fiduciary is deemed to satisfy the requirements with respect to the financial capability of the insurer if: (1) the fiduciary obtains a written representations from the insurer that the insurer (a) is licensed to offer guaranteed retirement income contracts; (b) at the time of selection and for each of the immediately preceding seven years operates under a certificate of authority from the Insurance Commissioner of its domiciliary State that has not been revoked or suspended, has filed audited financial statements in accordance with the laws of its domiciliary State under applicable statutory accounting principles, maintains (and has maintained) reserves that satisfy all the statutory requirements of all States where the insurer does business, and is not operating under an order of supervision, rehabilitation, or liquidation; and (c) that at least every five years, the insurer undergoes a financial examination (within the meaning of the law of its domiciliary State) by the Insurance Commissioner of the domiciliary State (or representative, designee, or other approved party); (2) following the issuance of the insurer representations, there is any change in circumstances that would preclude the insurer from making the same representations at the time of issuance of the guaranteed retirement income contract, the insurer is required to notify the fiduciary, in advance of the issuance of any guaranteed retirement income contract, that the fiduciary can no longer rely on one or more of the representations; and (3) the fiduciary has not received such a notification and has no other facts that would cause it to question the insurer representations.

## C. Individual Retirement Arrangements

### 1. Traditional and Roth individual retirement arrangements

#### In general

There are two basic types of IRAs under present law: traditional IRAs,<sup>117</sup> to which both deductible and nondeductible contributions may be made,<sup>118</sup> and Roth IRAs, to which only nondeductible contributions may be made.<sup>119</sup> The principal difference between these two types of IRAs is the timing of income tax inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, but distributions are includible in gross income to the extent attributable to earnings on the account and the deductible contributions. For a Roth IRA, all contributions are after-tax (that is, no deduction is allowed) but, if certain requirements are satisfied, distributions are not includible in gross income.

#### Contribution and AGI limits

##### Annual contribution limit

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth) for a taxable year is generally the lesser of a certain dollar amount (\$6,000 for 2021) or the individual's compensation.<sup>120</sup> In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount.

An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. For this purpose, the aggregate dollar limit is increased by \$1,000. Thus, for example, if an individual over age 50 contributes \$7,000 to a Roth IRA for 2021 (\$6,000 plus \$1,000 catch-up), the individual will not be permitted to make any contributions to a traditional IRA for that year. In addition, deductible contributions to traditional IRAs and after-tax contributions to Roth IRAs generally are subject to AGI limits. IRA contributions generally must be made in cash.

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<sup>117</sup> Sec. 408.

<sup>118</sup> Sec. 219.

<sup>119</sup> Sec. 408A.

<sup>120</sup> Under a special rule, the contribution limit for nondeductible contributions to an IRA may be increased in certain circumstances by the amount of qualified foster payments that are difficulty of care payments that an individual excludes from gross income. Sec. 408(o)(5). Thus, for example, an individual who receives such difficulty of care payments but has no compensation for a taxable year may nevertheless be permitted to contribute to an IRA.

## Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income ("AGI") for the taxable year over certain indexed levels. In the case of an individual who is an active participant in an employer-sponsored plan, the AGI phase-out ranges for 2021 are: (1) for single taxpayers, \$66,000 to \$76,000; (2) for married taxpayers filing joint returns, \$105,000 to \$125,000; and (3) for married taxpayers filing separate returns, \$0 to \$10,000. If an individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with AGI for 2021 between \$198,000 and \$208,000.

To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible contributions to a traditional IRA (that is, no AGI limits apply), subject to the same contribution limits as the limits on deductible contributions, including catch-up contributions.

## Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels. The AGI phase-out ranges for 2021 are: (1) for single taxpayers, \$125,000 to \$140,000; (2) for married taxpayers filing joint returns, \$198,000 to \$208,000; and (3) for married taxpayers filing separate returns, \$0 to \$10,000.

## **Separation of traditional and Roth IRA accounts**

Contributions to traditional IRAs and to Roth IRAs must be segregated into separate IRAs, meaning arrangements with separate trusts, accounts, or contracts, and separate IRA documents. Except in the case of a conversion or recharacterization, amounts cannot be transferred or rolled over between the two types of IRAs.

Taxpayers generally may convert a traditional IRA into a Roth IRA through a distribution from a traditional IRA and rollover to a Roth IRA as discussed below. The amount converted is includible in the taxpayer's income as if a withdrawal had been made, except that the early distribution tax (discussed below) does not apply. However, the early distribution tax is imposed if the taxpayer withdraws the amount within five years of the conversion.

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize (in a trustee-to-trustee transfer) the amount of that contribution as a contribution to the other type of IRA (traditional or Roth) before the due date for the individual's income tax return for that year.<sup>121</sup> In the case of a recharacterization, the

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<sup>121</sup> Sec. 408A(d)(6).

contribution will be treated as having been made to the transferee plan (and not the transferor plan). The amount transferred must be accompanied by any net income allocable to the contribution and no deduction is allowed with respect to the contribution to the transferor plan. Unlike regular contributions, conversion contributions to a Roth IRA cannot be recharacterized as having been made to a traditional IRA.<sup>122</sup> In addition, Treasury regulations limit the number of times a regular contribution for a taxable year may be recharacterized.<sup>123</sup>

### **Excise tax on excess contributions**

To the extent that contributions to an IRA exceed the contribution limits, the individual is subject to an excise tax equal to six percent of the excess amount.<sup>124</sup> This excise tax generally applies each year until the excess amount is distributed. Any amount contributed for a taxable year that is distributed with allocable income by the due date for the taxpayer's return for the year will be treated as though not contributed for the year.<sup>125</sup> To receive this treatment, the taxpayer must not have claimed a deduction for the amount of the distributed contribution.

## **2. Taxation of distributions from IRAs**

### **Traditional IRAs**

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent that the withdrawal is a return of the individual's basis.<sup>126</sup> All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs. The portion of the individual's basis that is recovered with any distribution is the ratio of the amount of the aggregate basis in all the individual's traditional IRAs to the amount of the aggregate account balances in all the individual's traditional IRAs.

### **Roth IRAs**

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income. A qualified distribution is a distribution that (1) is made after the five-taxable-year period beginning with the first taxable year for which the individual first made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to \$10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings; amounts that are attributable to a return of contributions to the Roth IRA are not includible in income. All Roth IRAs are treated as a single contract for

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<sup>122</sup> The restrictions on conversion contributions were enacted as part of Pub. L. 115-97.

<sup>123</sup> Treas. Reg. sec. 1.408A-6.

<sup>124</sup> Secs. 4973(b) and (f).

<sup>125</sup> Sec. 408(d)(4).

<sup>126</sup> Basis results from after-tax contributions to the IRA or a rollover to the IRA of after-tax amounts from another eligible retirement plan.

purposes of determining the amount that is a return of contributions. To determine the amount includible in income, a distribution that is not a qualified distribution is treated as made in the following order: (1) regular Roth IRA contributions (including contributions rolled over from other Roth IRAs); (2) conversion contributions (on a first in, first out basis); and (3) earnings. To the extent a distribution is treated as made from a conversion contribution, it is treated as made first from the portion, if any, of the conversion contribution that was required to be included in income as a result of the conversion. Thus, nonqualified distributions from all Roth IRAs are excludable from gross income until all amounts attributable to contributions have been distributed.

## **Rollovers**

Distributions from IRAs are permitted to be rolled over tax-free to another IRA or any other eligible retirement plan. The general 60-day rollover rule (discussed above) applies to IRA rollovers as well as rollovers from qualified retirement plans, section 403(b) annuities, and governmental section 457(b) plans. There is no provision for direct rollovers from an IRA, but direct payment to another eligible retirement plan generally satisfies the requirements. Distributions from an inherited IRA (except in the case of an IRA acquired by the surviving spouse by reason of the IRA owner's death) and required minimum distributions are not permitted to be rolled over.<sup>127</sup> The portion of any distribution from an IRA that is not includible in gross income is only permitted to be rolled over to another IRA. Generally, distributions from a traditional IRA may only be rolled over tax-free to another IRA and distributions from a Roth IRA may only be rolled over tax-free to another Roth IRA. However, a distribution from a traditional IRA may be rolled over to a Roth IRA as a Roth conversion with the required income inclusion (as discussed above).

### **3. Employer retirement plans using IRAs**

#### **SIMPLE IRA plan**

A small employer that employs no more than 100 employees who earned \$5,000 or more during the prior calendar year can establish a simplified tax-favored retirement plan, which is called the SIMPLE retirement plan. A SIMPLE IRA plan is generally a plan under which contributions are made to an IRA for each employee (a "SIMPLE IRA"). A SIMPLE IRA plan allows employees to make elective deferrals to a SIMPLE IRA, subject to a limit of \$13,500 (for 2021). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions under a SIMPLE IRA plan up to a limit of \$3,000 (for 2021).

In the case of a SIMPLE IRA plan, the group of eligible employees generally must include any employee who has received at least \$5,000 in compensation from the employer in any two preceding years and is reasonably expected to receive \$5,000 in the current year. A SIMPLE IRA

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<sup>127</sup> A trustee-to-trustee transfer between IRAs is not treated as a distribution and rollover. Thus, nonspouse beneficiaries of IRAs can move funds to another inherited IRA established as a beneficiary of the decedent IRA owner. In contrast, a surviving spouse is permitted to roll over a distribution to his or her own IRA.

plan is not subject to the nondiscrimination rules generally applicable to qualified retirement plans.

Employer contributions to a SIMPLE IRA must satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to three percent of the employee's compensation. Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a nonelective contribution of two percent of compensation on behalf of each eligible employee with at least \$5,000 in compensation for such year, whether or not the employee makes an elective contribution.

The employer must provide each employee eligible to make elective deferrals under a SIMPLE IRA plan a 60-day election period before the beginning of the calendar year and a notice at the beginning of the 60-day period explaining the employee's choices under the plan.<sup>128</sup>

No contributions other than employee elective contributions, required employer matching contributions, or employer nonelective contributions can be made to a SIMPLE IRA plan, and the employer may not maintain any other qualified retirement plan.

### **Simplified employee pensions**

A simplified employee pension ("SEP") is an IRA to which the employer may make contributions for an employee up to the lesser of 25 percent of the employee's compensation or the dollar limit applicable to contributions to a qualified defined contribution plan (\$58,000 for 2021).<sup>129</sup> All contributions must be fully vested. Any employee must be eligible to participate in the SEP if the employee has (1) attained age 21, (2) performed services for the employer during at least three of the immediately preceding five years, and (3) received at least \$650 (for 2021) in compensation from the employer for the year. Contributions to a SEP generally must bear a uniform relationship to compensation.

Effective for taxable years beginning before January 1, 1997, certain employers with no more than 25 employees could maintain a salary reduction SEP ("SARSEP") under which employees could make elective deferrals. The SARSEP rules were generally repealed with the enactment of the SIMPLE IRA plan rules. However, contributions may continue to be made to SARSEPs that were established before 1997. Salary reduction contributions to a SARSEP are subject to the same limit that applies to elective deferrals under a section 401(k) plan (\$19,500 for 2021). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SARSEP up to a limit of \$6,500 (for 2021).

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<sup>128</sup> Notice 98-4, 1998-1 C.B. 269.

<sup>129</sup> Sec. 408(k).

## **Deemed IRAs**

Certain types of employer-sponsored retirement plans are permitted to provide IRAs to employees as a part of the plan.<sup>130</sup> This option is available to qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans. The Code permits these plans to allow employees to elect to make contributions to a separate account or annuity under the plan that are treated as contributions to a traditional IRA or a Roth IRA. To receive this treatment, under the terms of the plan, the account or annuity must satisfy the requirements of the Code for being a traditional or Roth IRA. Implementing the basic provision that the account satisfy the requirements to be an IRA, Treasury regulations require that the trustee with respect to the account be a bank or a nonbank trustee approved by the IRS.<sup>131</sup>

## **Payroll deduction IRA**

An employer is permitted to establish a program under which each employee can elect to have the employer withhold an amount each pay period and contribute the amount to an IRA established by the employee. In the Conference report to the Taxpayer Relief Act of 1997,<sup>132</sup> Congress indicated that “employers that chose not to sponsor a retirement plan should be encouraged to set up a payroll deduction system to help employees save for retirement by making payroll deduction contributions to their IRAs.” Congress encouraged the Secretary of the Treasury to “continue his efforts to publicize the availability of these payroll deduction IRAs.”<sup>133</sup> In response to that directive, the IRS published guidance to remind employers of the availability of this option for their employees.<sup>134</sup>

In 1975, DOL issued a regulation describing circumstances under which the use of an employer payroll deduction program for forwarding employee monies to an IRA will not constitute an employee pension benefit plan subject to ERISA.<sup>135</sup> In 1999, DOL restated and updated its positions on these programs.<sup>136</sup> Under the DOL guidance, the general rule is that, in order for an IRA payroll program not to be a pension plan subject to ERISA, the employer must not endorse the program. To avoid endorsing the program the employer must maintain neutrality with respect to an IRA sponsor in its communication to its employees and must otherwise make clear that its involvement in the program is limited to collecting the deducted amounts and

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<sup>130</sup> Sec. 408(q).

<sup>131</sup> Treas. Reg. sec. 1.408(q)-1. Special rules apply in the case of deemed IRAs under plans of State and local government employers.

<sup>132</sup> Pub. L. No. 105-34.

<sup>133</sup> H. Rep. No. 102-220, p. 775 (1997).

<sup>134</sup> Announcement 99-2, 1999-1 C.B. 305. The IRS also includes information on its website concerning the rules for this option and the pros and cons for an employer adopting a payroll deduction IRA program.

<sup>135</sup> 29 C.F.R. sec. 2510.3-2(d).

<sup>136</sup> Interpretive Bulletin 99-1, 64 Fed. Reg. 32999 (June 18, 1999); 29 C.F.R. sec. 2509.99-1.

remitting them promptly to the IRA sponsor and that it does not provide any additional benefit or promise any particular investment return on the employee's savings.

## D. Early Distributions and Required Minimum Distributions

### 1. Early distributions

The Code imposes an early distribution tax on distributions made from qualified retirement plans, 403(b) plans and IRAs before an employee or an IRA owner attains age 59½.<sup>137</sup> The tax is equal to 10 percent of the amount of the distribution that is includible in gross income unless an exception applies. The 10-percent tax is in addition to the taxes that would otherwise be due on distribution. This additional tax is designed to help ensure that distributions from qualified retirement plans are preserved for retirement.

There are a number of exceptions to the early distribution tax. Some exceptions apply to all plans and others apply only to IRAs or only to qualified retirement plans and section 403(b) annuities. The exceptions that apply to all plans include distributions due to death or disability; distributions made in the form of certain periodic payments; distributions made on account of a tax levy on the plan; distributions to the extent that they do not exceed the amount allowable as a deduction for amounts paid during the taxable year due to medical care (determined without regard to whether the employee itemizes deductions for such year);<sup>138</sup> distributions made to a member of a reserve unit called to active duty for 180 days or longer; and distributions in the case of birth or adoption.<sup>139</sup>

The exceptions that only apply to distributions from IRAs include distributions used to purchase health insurance for certain unemployed individuals; for higher education expenses; and for first-time homebuyer expenses of up to \$10,000. The exceptions that only apply to distributions from qualified retirement plans and section 403(b) plans include distributions made subsequent to the employee's separation from service after attaining age 55;<sup>140</sup> distributions made to an alternate payee pursuant to a qualified domestic relations order; and distribution of dividends paid with respect to stock held by an ESOP.<sup>141</sup>

### 2. Minimum distribution requirements

#### In general

Minimum distribution rules apply to tax-favored employer-sponsored retirement plans and IRAs, and limit the tax deferral allowed for these plans and arrangements. By requiring that minimum annual distributions begin at a required beginning date (generally at age 72), the rules

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<sup>137</sup> Sec. 72(t). The early distribution tax does not apply to distributions from governmental section 457(b) plans.

<sup>138</sup> Sec. 213.

<sup>139</sup> The exception for distributions in the case of birth or adoption does not apply to defined benefit plans. Sec. 72(t)(2)(H).

<sup>140</sup> Age 50 is substituted for age 55 in the case of distributions to certain public employees.

<sup>141</sup> An exception also applies to payments under annuities for Federal employees relating to phased retirement. Sec. 72(t)(2)(A)(viii).

are designed to ensure that these plans are used to provide funds for retirement. Distributions to an employee are generally required to begin no later than the required beginning date and to be distributed, in accordance with regulations, over the life of the employee or over the lives of the employee and a designated beneficiary (or over a period not extending beyond the life expectancy of the employee or the life expectancy of the employee and a designated beneficiary).<sup>142</sup> Minimum distribution rules also apply to benefits payable with respect to an employee or IRA owner who has died. In the case of Roth IRA, minimum distributions are required only after the death of the IRA owner (that is, the lifetime requirements do not apply to a Roth IRA).

The regulations provide a methodology for calculating the required minimum distribution from an individual account under a defined contribution plan or from an IRA. In the case of annuity payments under a defined benefit plan or an annuity contract, the regulations provide requirements that the annuity stream of payments must satisfy. Failure to comply with the minimum distribution requirement may result in an excise tax imposed on the individual who was required to be the distributee equal to 50 percent of the required minimum distribution not distributed for the year.<sup>143</sup> The tax may be waived if the failure to distribute is reasonable error and reasonable steps are taken to remedy the violation.<sup>144</sup>

## **Lifetime rules**

### **General rules**

While an employee or IRA owner is alive, distributions of the individual's interest starting from the required beginning date are required to be made (in accordance with regulations) over the life or life expectancy of the employee or IRA owner, or over the joint lives or joint life expectancy of the employee or IRA owner and a designated beneficiary.<sup>145</sup> For IRAs and defined contribution plans, the required minimum distribution for each year generally is determined by dividing the account balance as of the end of the prior year by the number of years in the distribution period.<sup>146</sup> The distribution period is generally derived from the Uniform Lifetime Table.<sup>147</sup> This table is based on the joint life expectancies of the individual and a hypothetical beneficiary 10 years younger than the individual. For an individual with a spouse as designated beneficiary who is more than 10 years younger, the joint life expectancy of the couple is used (because the couple's remaining joint life expectancy is longer than the length provided in the Uniform Lifetime Table). There are special rules in the case of annuity payments from an insurance contract.

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<sup>142</sup> Sec. 401(a)(9)(A).

<sup>143</sup> Sec. 4974.

<sup>144</sup> Sec. 4974(d).

<sup>145</sup> Sec. 401(a)(9)(A).

<sup>146</sup> Treas. Reg. sec. 1.401(a)(9)-5.

<sup>147</sup> Treas. Reg. sec. 1.401(a)(9)-9.

### Required beginning date

For traditional IRAs, the required beginning date is April 1 following the calendar year in which the IRA owner attains age 72. For tax-favored employer-sponsored retirement plans, for an employee other than an employee who is a five-percent owner in the year the employee attains age 72, the employee's required beginning date is April 1 after the later of the calendar year in which the employee attains age 72 or retires. For an employee who is a five-percent owner under a tax-favored employer-sponsored retirement plan in the year the employee attains age 72, the required beginning date is the same as for IRAs even if the employee continues to work past age 72.

### Lifetime income rule for annuities commencing at age 85

Under regulations, the value of a qualifying longevity annuity contract held in a defined contribution plan account or traditional IRA may be disregarded in some circumstances in determining required minimum distributions for years before annuity payments under the contract are scheduled to begin.<sup>148</sup> Among the conditions on such disregard, the regulations limit the portion of an account that can be invested in a longevity annuity contract (the lesser of 25 percent or \$125,000), require the annuity to begin no later than age 85, and include reporting requirements for the annuity issuer.

## **Distributions after death**

### Defined contribution plans

The after-death rules vary depending on whether the plan is a defined contribution plan or defined benefit plan.<sup>149</sup> The rules also depend on whether there is a designated beneficiary for the benefit. A designated beneficiary is an individual designated as a beneficiary under the plan.<sup>150</sup> In a defined contribution plan, if an individual dies before the individual's entire interest is distributed, and the individual has a designated beneficiary, unless the designated beneficiary is an eligible designated beneficiary, the individual's entire account must be distributed within 10

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<sup>148</sup> Treas. Reg. secs. 1.401(a)(9)-5, A-3 and 1.401(a)(9)-6, A-12. The regulations, and the conditions on longevity annuity contracts, do not apply to Roth IRAs because an individual is not required to take distributions from a Roth IRA at age 72. The regulations also do not apply to defined benefit plans but the preamble to the final regulation requests comments regarding the desirability of making available in defined benefit plans a form of benefit that replicates the structure for qualified longevity annuity contracts.

<sup>149</sup> Sec. 401(a)(9)(H). For this purpose, a defined contribution plan includes an IRA, a qualified trust (section 401(a)) or annuity (section 403(a)), a governmental eligible deferred compensation plan (section 457(b)), and a tax-deferred annuity (section 403(b)), except that it does not include a qualified trust that is part of a defined benefit plan, or a qualified annuity or governmental eligible deferred compensation plan that is a defined benefit plan.

<sup>150</sup> Treas. Reg. sec. 1.401(a)(9)-4, A-1. The individual need not be named as long as the individual is identifiable under the terms of the plan. There are special rules for multiple beneficiaries and for trusts named as beneficiary (where the beneficiaries of the trust are individuals). However, if an individual is named as beneficiary through the employee or IRA owner's will or the estate is named as beneficiary, there is no designated beneficiary for purposes of the minimum distribution requirements.

years after the individual's death. This rule applies regardless of whether the individual dies before or after the individual's required beginning date.

In the case of an eligible designated beneficiary, the remaining required minimum distributions may generally be distributed over the life of the beneficiary (or over a period not extending beyond the life expectancy of such beneficiary). Such distributions must begin no later than December 31 of the calendar year immediately following the calendar year in which the individual dies. An eligible designated beneficiary is a designated beneficiary who is (1) the surviving spouse of the individual; (2) a child of the individual who has not reached majority;<sup>151</sup> (3) disabled; (4) chronically ill; or (5) not more than 10 years younger than the individual.<sup>152</sup> If the eligible designated beneficiary is the individual's spouse, commencement of distributions is permitted to be delayed until December 31 of the calendar year in which the deceased individual would have attained age 72.<sup>153</sup> The required minimum distribution for each year is determined by dividing the account balance as of the end of the prior year by a distribution period, which is determined by reference to the beneficiary's life expectancy.<sup>154</sup> Special rules apply in the case of trusts for disabled or chronically ill beneficiaries.<sup>155</sup>

In the case of an individual who does not have a designated beneficiary, if an individual dies on or after the individual's required beginning date, the distribution period for the remaining required minimum distributions is equal to the remaining years of the deceased individual's single life expectancy, using the age of the deceased individual in the year of death.<sup>156</sup> If an individual dies before the required beginning date, the individual's entire account must be distributed no later than December 31 of the calendar year that includes the fifth anniversary of the individual's death.<sup>157</sup>

### Defined benefit plans

In the case of a defined benefit plan, the after-death rules depend on (1) whether an employee dies on or after the required beginning date, and (2) whether there is a designated beneficiary for the benefit. If an employee dies on or after the required beginning date, the statutory rule is that the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death.<sup>158</sup>

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<sup>151</sup> Once the child reaches the age of majority, the account must be distributed within 10 years.

<sup>152</sup> Sec. 401(a)(9)(E)(ii).

<sup>153</sup> If the surviving spouse dies before distributions begin, the after-death rules for death before distributions have begun apply as though the spouse were the employee or IRA owner. Sec. 401(a)(9)(B)(iv).

<sup>154</sup> Treas. Reg. sec. 1.401(a)(9)-5, A-5.

<sup>155</sup> Sec. 401(a)(9)(H)(iv).

<sup>156</sup> Treas. Reg. sec. 1.401(a)(9)-5, A-5(a).

<sup>157</sup> Treas. Reg. sec. 1.401(a)(9)-3, Q&As 1, 2.

<sup>158</sup> Sec. 401(a)(9)(B)(i).

If an employee dies before the required beginning date and any portion of the benefit is payable to a designated beneficiary, distributions are permitted to begin within one year of the employee's death (or such later date as prescribed in regulations) and to be paid (in accordance with regulations) over the life or life expectancy of the designated beneficiary.<sup>159</sup>

If an employee dies before the required beginning date and there is no designated beneficiary, then the entire remaining interest of the employee must generally be distributed by the end of the fifth year following the individual's death.<sup>160</sup>

### **Additional rules for defined benefit plans and annuity distributions**

The regulations provide rules for annuity distributions from a defined benefit plan or an annuity purchased from an insurance company paid over life or life expectancy. Annuity distributions are generally required to be nonincreasing with certain exceptions, which include, for example, increases to the extent of certain specified cost of living indexes, a constant percentage increase (for a qualified plan, the constant percentage cannot exceed five percent per year), certain accelerations of payments, increases to reflect when an annuity is converted to a single life annuity after the death of the beneficiary under a joint and survivor annuity or after termination of the survivor annuity under a QDRO.<sup>161</sup> If distributions are in the form of a joint and survivor annuity and the survivor annuitant both is not the surviving spouse and is younger than the employee or IRA owner, the survivor annuitant is limited to a percentage of the life annuity benefit for the employee or IRA owner.<sup>162</sup> The survivor benefit as a percentage of the benefit of the primary annuitant is required to be smaller (but not required to be less than 52 percent) as the difference in the ages of the primary annuitant and the survivor annuitant become greater.

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<sup>159</sup> Sec. 401(a)(9)(B)(iii). As under defined contribution plans, special rules apply if the beneficiary of the employee is the individual's surviving spouse. In that case, distributions are not required to commence until the year in which the employee would have attained age 72. If the surviving spouse dies before the employee would have attained age 72, the after-death rules for death before distributions have begun are applied as though the spouse were the employee.

<sup>160</sup> Sec. 401(a)(9)(B)(ii); Treas. Reg. sec. 1.401(a)(9)-3, A-2.

<sup>161</sup> Treas. Reg. sec. 1.401(a)(9)-6, A-14.

<sup>162</sup> Treas. Reg. sec. 1.401(a)(9)-6, A-2.

## II. DATA RELATING TO RETIREMENT SAVINGS

### A. Overview

A retired individual generally has three primary sources of funds to support him or herself in retirement: distributions or benefits from qualified retirement plans<sup>163</sup> or individual retirement arrangements (IRAs); Social Security and/or railroad retirement benefits; and other assets held outside of qualified plans. Some taxpayers who consider themselves to be retired may supplement these sources with earned income. Some retired individuals may also receive Supplemental Security Income (SSI),<sup>164</sup> Medicaid, certain Veteran's benefits, and other public assistance.<sup>165</sup>

Table 1 displays tabulations of the percentage of individuals, aged 65 and above, who draw on each particular source of income.<sup>166</sup> Examining individuals rather than households may understate the overall income and standard of living for households that have two or more members since each source of income is attributed to only one member of the household. Based on these data, a large majority of individuals aged 65 and above draws on Social Security income. Far fewer rely on earned income. Only 3.7 percent of individuals in the lowest income quartile report earned income, whereas 48.4 percent of individuals in the highest income quartile continue to have earned income after the age of 65. These estimates change after the age of 70 and 75 as the majority of individuals eventually retire.<sup>167</sup>

There is a similar difference across the income distribution in the percentage of individuals who draw on pensions as a source of income after the age of 65. Only 5.0 percent of individuals in the lowest income quartile, compared to 62.4 percent of individuals in the highest income quartile draw on pension income, which includes interest, dividends, and capital gains on retirement saving, such as savings in IRAs and 401(k) accounts. As might be expected, a large portion of high income individuals (85.1 percent) have available income from assets outside of qualified plans. Lower income individuals are more likely to draw income from SSI and public assistance programs than are higher income individuals.

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<sup>163</sup> The term "qualified retirement plans" refers to defined benefit or defined contribution plans, or both.

<sup>164</sup> Supplemental Security Income is a Federal income supplement program funded by general tax revenues and designed to help aged, blind, and disabled people who have little or no income to meet basic needs for food, clothing, and shelter.

<sup>165</sup> Some individuals may also receive gifts from relatives or others to provide financial support in retirement.

<sup>166</sup> Calculations in James M. Poterba, "Retirement Security in an Aging Population," *American Economic Review*, May 2014, Vol. 104, No. 5.

<sup>167</sup> Census data show that a significant percentage of men and women aged 62 or older work in paid employment. For example, in 2009, 33 percent of men and 42 percent of women aged 65 to 69 worked in paid employment. Patrick P. Purcell, "Older workers: Employment and retirement trends," 2009, *Congressional Research Service*.

**Table 1.—Income Sources for Individuals Aged 65+ by Total Income Quartile, 2018  
(percentage of all individuals)**

Income Type	Income Quartile			
	Lowest 25 percent	Second 25 percent	Third 25 percent	Highest 25 percent
Social Security <sup>1</sup>	65.9 <sup>168</sup>	93.8	88.3	76.7
Earnings	3.7	9.0	24.3	48.4
Pension Income <sup>2</sup>	5.0	21.0	53.8	62.4
Asset Income <sup>3</sup>	38.0	52.6	70.5	85.1
SSI/Public Assistance <sup>4</sup>	8.2	2.8	1.2	0.5
Other Income <sup>5</sup>	2.1	4.3	9.0	12.8

Source: Current Population Survey, 2018. Calculations in Poterba, 2014, updated for 2018 by Poterba. Columns may not add to 100 percent because some individuals have multiple sources of income.

**Note:** Data is categorized by quartiles based on individual income. <sup>1</sup> “Social Security” includes retired-worker benefits, dependents’ or survivor benefits, and disability benefits made by Social Security. Medicare reimbursements are not included. <sup>2</sup> “Pension income” includes income from employer pensions, government employee pensions, private pensions and annuities (including IRAs and 401(k) accounts). <sup>3</sup> “Asset income” includes interest, dividends, income from estates or trusts, and net rental income or royalties. <sup>4</sup> “SSI and public assistance” includes Federal, state and local welfare agency SSI payments as well as cash public assistance payments including temporary assistance to needy families (TANF), general assistance, and emergency assistance. <sup>5</sup> “Other income” includes unemployment and workers’ compensation, veterans’ payments, and personal contributions.

Table 2 displays tabulations of the size of various sources of income for individuals aged 65 and above, as a percentage of total income. For individuals in the lowest income quartile, Social Security benefits are the predominant source of income (they constitute 84.6 percent of total income), whereas individuals in the highest income quartile rely on a much more varied mix of income sources. This reflects both the progressivity of Social Security benefits as well as the higher participation rates of high income individuals in employer sponsored retirement plans (see Table 4 below) and their greater ability to save over the life cycle.

<sup>168</sup> In general, survey data may contain significant reporting errors. If lower income households are more likely to understate their Social Security income, this estimate may understate the true percentage of individuals in the lowest income quartile who receive Social Security benefits. See for example, Howard Iams and Patrick Purcell, “Social Security Income Measurement in Two Surveys,” *Social Security Bulletin*, 2013, Vol. 73, No. 3.

**Table 2.—Percentage of Total Income by Source for Individuals Aged 65+, 2018**

Income Type	Income Quartile			
	Lowest 25 percent	Second 25 percent	Third 25 percent	Highest 25 percent
Social Security <sup>1</sup>	84.6	82.4	52.5	17.0
Earnings	2.5	5.0	15.1	42.4
Pension Income <sup>2</sup>	2.5	6.7	22.4	24.9
Asset Income <sup>3</sup>	2.7	3.6	6.8	13.2
SSI/Public Assistance <sup>4</sup>	6.7	0.9	0.3	0.1
Other Income <sup>5</sup>	1.0	1.4	3.0	2.4

Source: Current Population Survey, 2018. Calculations in Poterba, 2014, updated for 2018.

**Note:** Data is categorized by quartiles based on individual income. <sup>1</sup> “Social Security” includes retired-worker benefits, dependents’ or survivor benefits, and disability benefits made by Social Security. Medicare reimbursements are not included. <sup>2</sup> “Pension income” includes income from employer pensions, government employee pensions, private pensions and annuities (including IRAs and 401(k) accounts). <sup>3</sup> “Asset income” includes interest, dividends, income from estates or trusts, and net rental income or royalties. <sup>4</sup> “SSI and public assistance” includes Federal, state and local welfare agency SSI payments as well as cash public assistance payments including temporary assistance to needy families (TANF), general assistance, and emergency assistance. <sup>5</sup> “Other income” includes unemployment and workers’ compensation, veterans’ payments, and personal contributions.

Tables 1 and 2 above are estimated using the Current Population Survey, which some research suggests is prone to under-counting pension income relative to that reported on administrative records.<sup>169</sup> It may therefore be useful to supplement Tables 1 and 2 with an examination of other sources of data, including tax data which may contain other types of measurement error but is less susceptible to reporting errors.

The subsequent sections of this pamphlet provide additional data that is descriptive of the sources of retirement income for current retirees and the potential of such sources to provide income for the next generation of retirees.

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<sup>169</sup> Chris E. Anguelov, Howard M. Iams, and Patrick Purcell, “Shifting Income Sources of the Aged,” *Social Security Bulletin* 2012, Vol. 72, No. 3.; Adam Bee and Joshua Mitchell, “Do Older Americans Have More Income Than We Think?” 2017, SEHSD Working Paper 2017-39.

## B. General Data on Qualified Retirement Plan Participation

Data show that a significant share of workers is not covered by any employer-provided retirement plan. However, there are disparities in the reported magnitude of coverage, depending on the data source, the definition of coverage, and the population considered. Coverage under a retirement plan may refer to whether an employee is offered access to a retirement plan (“access”), whether an employee chooses to participate in a retirement plan when offered (“take-up”), and whether any employee with access or not participates in a retirement plan (“employee participation”). The available sources of retirement coverage data include four household surveys (the Current Population Survey (“CPS”), the Survey of Income and Program Participation (“SIPP”), the Panel Study on Income Dynamics (“PSID”), and the Survey of Consumer Finances (“SCF”)), along with an employer survey (the National Compensation Survey (“NCS”)), and tax data.

Household surveys often provide a rich source of detail about household characteristics. However, they may be subject to serious individual reporting error. The four household surveys listed above suggest estimated participation in an employer-provided defined benefit or defined contribution plan for private sector employees ranging between 40 and 55 percent over the period 1991-2012.<sup>170</sup> In contrast to the NCS, household surveys report that employers offer retirement plans and employees choose to participate in these retirement plans at significantly lower rates, suggesting significant respondent error in the surveys.<sup>171</sup> Researchers attempt to correct for possible respondent errors through a variety of methods, including using matched tax data from W-2 records.<sup>172</sup> However, a lack of information about access, take-up, and participation in defined benefit plans in the W-2 records necessitates assumptions about such coverage, leading to estimates of access, take-up, and participation rates that are significantly higher than in the NCS.

According to the NCS,<sup>173</sup> in 2020, 67 percent of U.S. workers employed in the private sector had access to a qualified retirement plan and 51 percent of workers employed in the private sector participated in a qualified retirement plan (see Table 3).<sup>174</sup> This translates to a take-up rate

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<sup>170</sup> Alicia Munnell and Dina Bleckman, “Is Pension Coverage a Problem in the Private Sector?” *Boston College Center for Retirement Research*, April 2014, Number 14-7.

<sup>171</sup> See tabulations by Munnell and Bleckman, 2014. In 2012, the CPS reports that employers offered coverage under a retirement plan to 52 percent of private, part-time and full-time workers, while the NCS reports 64 percent. The CPS reports that 43 percent of private, part-time and full-time employees participated in these plans, while the NCS reports 48 percent.

<sup>172</sup> Irena Dushi, Howard M. Iams, and Jules Lichtenstein, “Assessment of Retirement Plan Coverage by Firm Size, Using W-2 Tax Records,” *Social Security Bulletin*, 2011, Vol. 71, No. 2.

<sup>173</sup> The NCS is an annual survey conducted by the U.S. Department of Labor, Bureau of Labor Statistics (“BLS”). Each release contains data categorized as civilian, private industry, and State and local government workers in the United States. Data on the private sector refers to workers in private industry, not including State and local government workers. Also excluded are Federal government workers, the military, agricultural workers, private household workers, and the self-employed.

<sup>174</sup> Employees are considered to have access to a qualified retirement plan if at least one type of plan is available for their use and they are participants if they have fulfilled requirements, including making required contributions.

of 76 percent, meaning 76 percent of those with access participated.<sup>175</sup> Take-up rates were stable at between 74 and 77 percent over the seven-year period, 2014 to 2020. These take-up rates indicate that while a large percentage of employees participate in an employer plan if available to them, some employees do not.

**Table 3.—Retirement Benefits: Access, Participation and Take-Up Rates in the Private Sector by Year (percentage of all workers)**

Year	Access Rate	Employee Participation Rate	Take-Up Rate
2014	65	48	75
2015	66	49	74
2016	66	49	75
2017	66	50	75
2018	68	51	76
2019	67	52	77
2020	67	51	76

Source: Bureau of Labor Statistics, National Compensation Survey Data, 2014-2020.

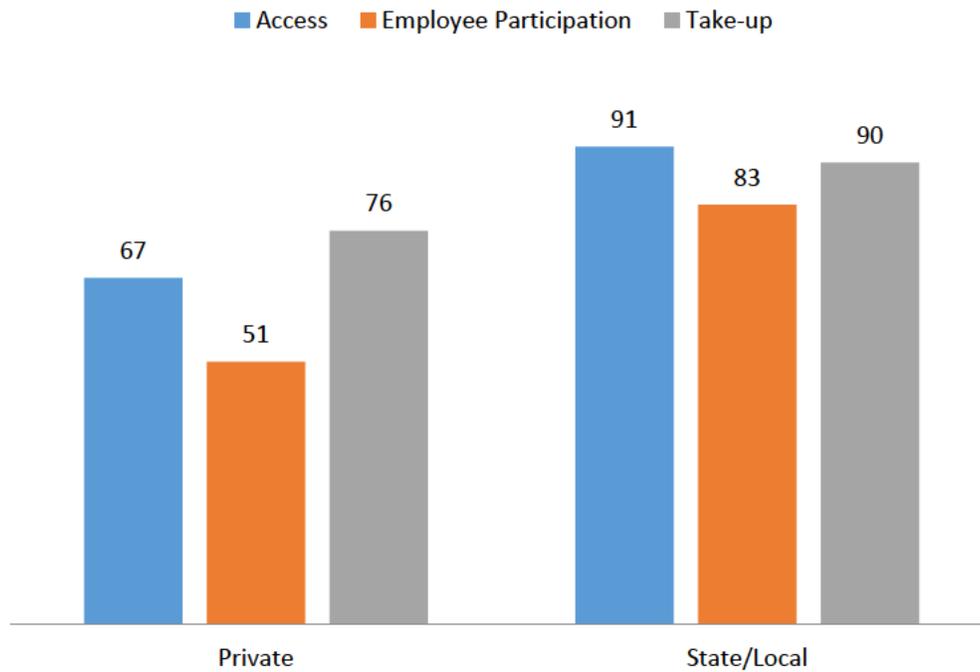
Note: All workers = 100 percent. Rates are rounded to the nearest percent. As a result, take-up rates may not be exactly equal to the employee participation rate divided by the access rate as presented in this table.

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<sup>175</sup> Take-up rates are calculated to be participation among those employees who are offered access to an employer plan. Therefore,  $Take\ Up = \frac{Employee\ Participation}{Access}$ .

Rates of access, participation, and take-up in qualified retirement plans vary by a number of worker and industry characteristics. Figure 1 shows that access rates are lower in the private sector than they are in the State and local government sector. In addition, the take-up rate in the private sector is 76 percent compared to a 90 percent take-up rate in the State and local government sector. The lower access and take-up imply lower participation rates in the private sector relative to the State and local government sector (51 percent versus 83 percent).

**Figure 1.—Access, Participation, and Take-up Rates by Sector in 2020 (percentage)**

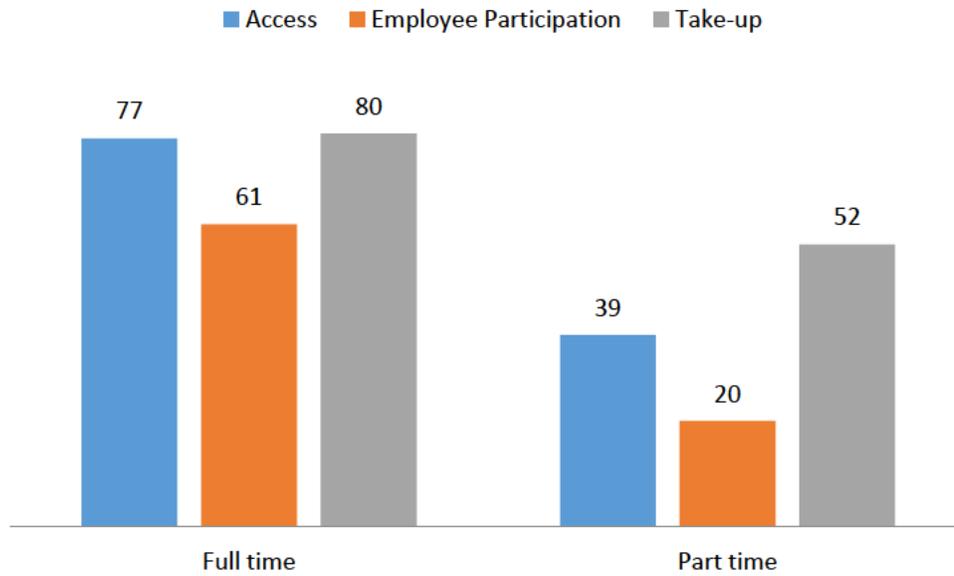


Source: Bureau of Labor Statistics, National Compensation Survey Data, 2020.

Note: All workers=100 percent.

The data in Figure 2 show that access, employee participation, and take-up rates are significantly higher for full time workers than for part time ones. Overall participation rates are only 20 percent for part time workers, compared to a 61 percent participation rate for full time workers.

**Figure 2.—Access, Participation, and Take-up Rates in the Private Sector by Full-time Status in 2020 (percentage)**

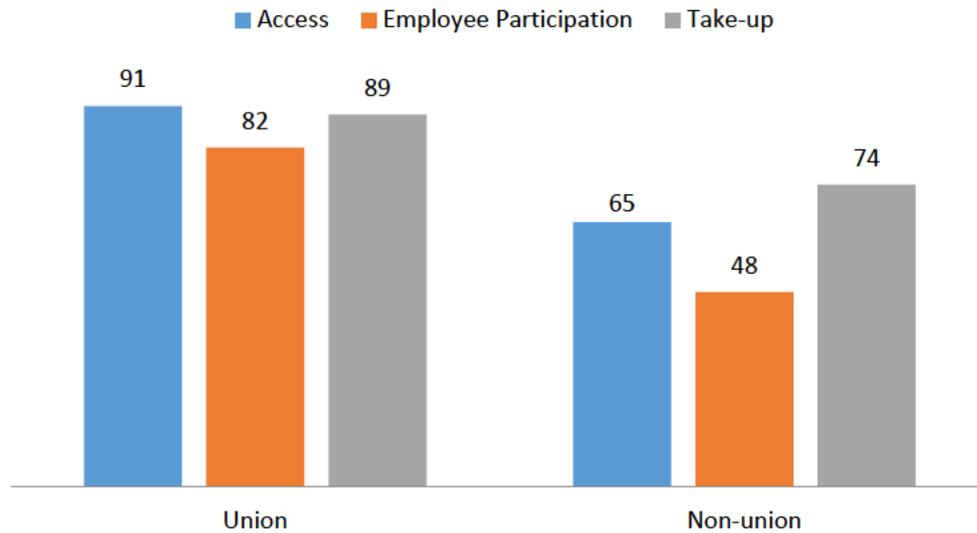


Source: Bureau of Labor Statistics, National Compensation Survey Data, 2020.

Note: All workers=100 percent.

There is also a disparity in take-up rates between union and non-union workers. As shown in Figure 3, access, employee participation, and take-up rates are significantly higher for union workers than they are for non-union workers.

**Figure 3.—Access, Participation, and Take-up Rates in the Private Sector by Union Status in 2020 (percentage)**



Source: Bureau of Labor Statistics, National Compensation Survey Data, 2020.

Note: All workers=100 percent.

The NCS also contains data on employee occupations, along with the average wage for each occupation. Table 4 uses NCS data, classifying individuals by the average wage for their occupation, to show access, employee participation, and take-up rates across the wage distribution. Participation rates are 22 percent for those employees with occupations in the lowest quartile of the wage distribution, and they are 78 percent for those in the highest quartile. Access and take-up rates also differ across the wage distribution, with all rates increasing as wages increase.

**Table 4.—Retirement Benefits: Access, Participation, and Take-Up Rates in the Private Sector by Wage Centile, 2020 (percentage of all workers)**

Wage Centile <sup>1</sup>	Access Rate	Employee Participation Rate	Take-Up Rate
Lowest 10 percent	29	14	48
Lowest 25 percent	42	22	52
Second 25 percent	67	48	72
Third 25 percent	79	64	81
Highest 25 percent	88	78	89
Highest 10 percent	90	81	90

Source: Bureau of Labor Statistics, National Compensation Survey Data, 2020.

Notes: All workers=100 percent.

As reported above, past participation in qualified plans, including accrued defined benefit plan benefits, and past saving in IRAs are important financial resources for many current retirees. Table 5 uses tax data to estimate the percentage of tax units<sup>176</sup> with primary taxpayer aged 65 and above that have a taxable IRA or pension distribution.<sup>177</sup> Keeping in mind that tabulations of

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<sup>176</sup> The unit of observation in the Joint Committee’s Individual Tax Model is a tax unit. A tax unit is the collection of individuals appearing on a Form 1040 as primary, secondary, or dependent filers. Tax units differ from households in that households can be comprised of multiple tax units. For example, unmarried cohabitating couples, multi-generational households, and roommates will generally be comprised of multiple tax units.

<sup>177</sup> Qualified Roth distributions that satisfy appropriate requirements are tax-free. As a result, information on distributions from Form 1040 will not account for Roth distributions, and the estimates in Table 5 will likely understate the amount of total IRA and pension distributions.

individuals will differ from tabulations of tax units, these estimates are consistent with the general pattern seen in Table 1, where the percent of tax units drawing on IRA or pension distributions increases through much of the income distribution. In addition, the data show that tax units with primary filers aged 65 and above with the highest levels of AGI (\$200,000 and above) draw on their taxable distributions and pensions at lower rates than those with AGI of \$30,000 to \$200,000. This is consistent with the ability of higher income tax units to delay drawing down IRA and pension income by relying on earned income (see Tables 1 and 2 above) and other income from assets held outside of qualified plans and IRAs.

**Table 5.—Tax Units Aged 65+ with Taxable IRA or Pension Distribution, 2021**

<b>AGI category</b>	<b>Percent of tax units with taxable IRA or pension distribution</b>
Less than \$10,000	33.5
\$10,000 to \$20,000	77.3
\$20,000 to \$30,000	78.7
\$30,000 to \$40,000	80.6
\$40,000 to \$50,000	81.7
\$50,000 to \$75,000	82.5
\$75,000 to \$100,000	84.4
\$100,000 to \$200,000	85.3
\$200,000 to \$500,000	81.4
\$500,000 to \$1,000,000	70.6
Greater than \$1,000,000	63.5

Source: JCT staff calculations based on the Individual Tax Model.

Note: These tabulations do not include distributions from Roth accounts.

Using data on annual distributions from retirement accounts reported on Form 1099-R, Table 6 provides information on the percent of individuals with distributions from defined contribution (“DC”) and IRA plans versus defined benefit (“DB”) plans.<sup>178</sup> With the exception of those in the highest AGI categories (\$200,000 and above), the percentage of individuals with distributions from IRAs or DC plans and DB plans and the average amount of these distributions generally increases with income. Furthermore, in AGI categories less than \$100,000, a larger percentage of individuals reports distributions from DB plans than they do from IRA or DC plans. For AGI categories greater than \$100,000, this pattern is reversed and a larger percentage of individuals report distributions from IRA or DC plans than they do from DB plans.

**Table 6.—Individuals Aged 65+ with Annual Distributions from Defined Contribution (DC) and IRA versus Defined Benefit (DB) Plans, 2018**

AGI category	Percent of individuals with IRA or DC distribution	Average distribution from IRA or DC Plan	Percent of individuals with DB distribution	Average distribution from DB Plan
Less than \$10,000	28	\$1,711	28	\$1,973
\$10,000 to \$20,000	37	\$2,557	45	\$4,557
\$20,000 to \$30,000	40	\$3,417	49	\$6,946
\$30,000 to \$40,000	42	\$4,092	51	\$8,956
\$40,000 to \$50,000	44	\$4,823	52	\$10,785
\$50,000 to \$75,000	47	\$6,452	54	\$14,000
\$75,000 to \$100,000	52	\$9,117	54	\$16,246
\$100,000 to \$200,000	56	\$15,370	52	\$19,427
\$200,000 to \$500,000	57	\$31,017	39	\$18,390
\$500,000 to \$1,000,000	50	\$42,384	24	\$10,326
Greater than \$1,000,000	43	\$44,628	21	\$8,883

Source: JCT staff calculations.

Notes: All individuals=100 percent. Data for this table are from distributions net of rollovers for accounts on Form 1099-R determined by Joint Committee Staff to be pension or IRA distributions, including Roth IRAs and Roth 401(k)s.

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<sup>178</sup> Form 1099-R does not separately identify defined benefit and defined contribution distributions. However, Joint Committee staff have developed an algorithm to classify the type of account on a Form 1099-R, which is used in the construction of Table 6. For more information, see JCX-20-21, “Estimating Leakage From Retirement Savings Accounts” and Lucas Goodman, Kathleen Mackie, Jacob Mortenson, and Heidi Schramm, “Leakage from Retirement Savings Accounts in the U.S.” *National Tax Journal*, forthcoming.

**C. Data Related to Social Security Benefits  
as a Source of Retirement Income**

Table 1, above, shows that nearly all individuals draw on Social Security benefits as a source of retirement income, and Table 2 documents that for many individuals, these benefits are an important source of retirement income.

Table 7, using tax data, shows tabulations of the percentage of tax units with primary taxpayer aged 66 to 75 and aged 76 to 85 that draw on Social Security income. Based on these data, nearly all tax units aged 65 and above rely on Social Security income as a source of income. Higher income tax units are more likely to delay drawing on this source of income, but by age 85, nearly all do so.

**Table 7.—Tax Units Aged 65+ with Social Security Income, 2021**

AGI category	Age 66 to 75		Age 76 to 85	
	Percent of tax units with Social Security income	Average value of annual Social Security income	Percent of tax units with Social Security income	Average value of annual Social Security income
Less than \$10,000	92.9	21,332	93.4	19,807
\$10,000 to \$20,000	92.5	24,569	97.0	24,321
\$20,000 to \$30,000	90.8	25,762	96.1	26,029
\$30,000 to \$40,000	90.7	26,740	97.3	26,575
\$40,000 to \$50,000	88.7	26,851	96.3	26,910
\$50,000 to \$75,000	91.1	26,944	96.6	26,423
\$75,000 to \$100,000	92.3	29,773	98.0	28,913
\$100,000 to \$200,000	90.9	34,326	97.5	35,090
\$200,000 to \$500,000	86.1	38,995	97.7	39,150
\$500,000 to \$1,000,000	80.3	40,735	99.5	42,377
Greater than \$1,000,000	73.3	42,787	98.8	44,772
Total, All Taxpayers	91.3	26,830	95.5	25,165

Source: JCT staff calculations based on the Individual Tax Model.

Note: Tabulations include Tier 1 Railroad Retirement benefits.

Table 8, using tax data, shows the percentage of tax units with a primary or secondary taxpayer between the ages of 50 and 59 who pays FICA or SECA taxes, by AGI category. While

an imperfect measure of future Social Security benefits to be paid,<sup>179</sup> this statistic offers some idea of the percentage of tax units that may be eligible for Social Security benefits in the future.

**Table 8.—Tax Units, Aged 50 to 59, that Pay FICA or SECA Tax, 2021  
(percentage)**

<b>AGI category</b>	<b>Percent of tax units that pay FICA/SECA</b>
Less than \$10,000	39.7
\$10,000 to \$20,000	88.9
\$20,000 to \$30,000	89.4
\$30,000 to \$40,000	92.1
\$40,000 to \$50,000	92.5
\$50,000 to \$75,000	93.1
\$75,000 to \$100,000	94.1
\$100,000 to \$200,000	94.2
\$200,000 to \$500,000	94.4
\$500,000 to \$1,000,000	92.0
Greater than \$1,000,000	89.1

Source: JCT staff calculations based on the Individual Tax Model.

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<sup>179</sup> For individuals born in 1929 or later, Social Security benefits are eligible to be paid at age 62 or later, and only after 40 quarters (10 years) of FICA or SECA tax payments. Whether an individual pays FICA/SECA at ages 50 to 59 does not necessarily indicate whether or not he or she attains 40 quarters of credits by the end of his or her work life.

#### **D. Assets Held Outside of Qualified Plans and Individual Retirement Arrangements**

Tables 1 and 2, above, document that in addition to qualified retirement plans, IRAs, Social Security and/or railroad retirement benefits, individuals may rely on other assets held outside of qualified plans and IRAs as sources of income in retirement. Assets accumulated in bank accounts, mutual funds, and stock held directly or in a brokerage account are examples of such additional sources of income for retirement. These assets can provide current income through regular payment of interest and dividends. These assets may also provide a source of income as the individual decumulates asset holdings. As the individual ages he or she may draw down bank balances and sell shares of mutual funds or other equities to finance current consumption.

Table 9, below, shows the percentage of tax units with interest and dividend income, for primary taxpayers aged 55 to 64, 65 to 74, and 75 and above. These data provide some information on the extent to which current retirees, generally tax units aged 65 or greater, and the next generation of retirees, tax units aged 55 to 64 in the table, have assets producing interest and dividend income. Generally, assets with a higher valuation will generate greater annual interest and dividend income for the tax unit. Table 9 provides some insight regarding the extent of asset holdings by both current retirees and the next generation of retirees by reporting statistics on interest and dividend income in three categories: tax units with less than \$100 in annual interest and dividend income; tax units with annual interest and dividend income of at least \$100 but less than \$500; and tax units with \$500 or more in annual interest and dividend income. For all age groups, tax units in higher AGI categories are more likely to have significant interest and dividend income.

**Table 9.—Percent of Tax Units with Interest and Dividend Income, 2021  
(percentage of returns)**

AGI category	Age 55 to 64			Age 65 to 74			Age 75 +		
	Less than \$100	\$100 and \$500	\$500 and Above	Less than \$100	\$100 and \$500	\$500 and Above	Less than \$100	\$100 and \$500	\$500 and Above
Less than \$10,000	90.5	4.5	5.0	86.0	6.7	7.3	78.8	10.7	10.5
\$10,000 to \$20,000	89.3	4.0	6.7	77.6	8.4	14.0	55.0	15.2	29.8
\$20,000 to \$30,000	88.4	4.5	7.1	70.5	10.7	18.9	47.6	14.0	38.3
\$30,000 to \$40,000	83.9	6.6	9.5	67.0	10.1	22.9	36.3	15.8	47.9
\$40,000 to \$50,000	82.3	7.7	10.0	64.3	12.2	23.5	38.0	15.9	46.3
\$50,000 to \$75,000	77.5	8.8	13.7	57.5	13.3	29.2	30.4	15.0	54.5
\$75,000 to \$100,000	69.1	11.4	19.5	48.8	16.2	35.0	21.2	12.7	66.1
\$100,000 to \$200,000	56.7	14.2	29.1	37.6	14.4	48.0	16.3	9.2	74.5
\$200,000 to \$500,000	30.4	14.6	55.0	20.4	11.6	68.1	6.3	4.8	88.7
\$500,000 to \$1,000,000	10.8	7.8	81.7	6.7	5.7	87.6	4.2	3.2	93.7
Greater than \$1,000,000	3.0	3.0	93.5	2.5	1.6	95.9	1.7	1.7	98.3
Total, All Taxpayers	73.0	8.7	18.3	63.7	10.5	25.8	53.7	11.9	34.4

Source: JCT staff calculations.

In addition to a lifetime of saving and the accumulation of financial assets, for many retired individuals, years of mortgage payments generate an important source of retirement income - the income they consume in kind by owning their own home. Home ownership means that some of the individual's other financial resources are not consumed by rental payments.<sup>180</sup> The value of their home provides an important source of additional financial wealth for many retired individuals. Similarly, homeownership by the next generation of retirees may provide both a source of in-kind income and financial wealth.

Table 10 shows the home ownership rates of those households with a householder aged 55 or above as well as the share of those owners that have no mortgage on their residence. Home ownership is relatively high for these households, with older households owning at slightly higher rates. Furthermore, the presence of a mortgage for owners drops significantly with age, with only 26 percent of owners aged 75 and above having mortgages compared to nearly 64 percent of owners aged 55 to 64. This suggests that as households enter and progress through retirement, a large share own their homes outright, allowing them to consume housing without regular housing payments (*i.e.*, rent or principal and interest on a loan) as well as possible significant equity in their property.

<sup>180</sup> The homeowner will incur maintenance expenses and property taxes.

**Table 10.—Home Ownership and Mortgage Status by Age Group, 2019**

<b>Age</b>	<b>Percent of households that own home</b>	<b>Percent of owners that have a mortgage</b>
55-64	68.7	59.8
65-74	71.9	42.8
75+	76.2	26.5

Source: JCT staff calculations using the 2019 Survey of Consumer Finances.

Note: These tabulations do not include those living on working farms and in mobile homes.