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Retirement Saving Plans: Answers to Frequently Asked Questions

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Summary

Individuals who participate in retirement saving plans sponsored by their employers or have savings in individual retirement accounts (IRAs) frequently raise questions about the federal laws and regulations that govern their plans. Individual account plans are particularly affected by the federal income tax code, which has grown considerably more complex over the past two decades. The retirement saving provisions of the tax code have been written in pursuit of three major policy goals: (1) to implement in tax law the standards for employee benefit plans set forth in the Employee Retirement Income Security Act (ERISA) of 1974; (2) to assure that employer-sponsored retirement plans benefit a broad spectrum of a firm's work force in a fair and nondiscriminatory manner; and (3) to encourage retirement saving while limiting the federal income tax revenue foregone through deferred taxation on plan contributions and earnings. Pursuit of these goals by Congress has led to a complicated web of rules with which plan sponsors and participants must comply. This report provides answers to 10 of the most frequently asked questions about these rules. It will be updated when laws and regulations change.

Frequently Asked Questions About Individual Account Retirement Plans

The following questions address federal rules for the types of retirement plans that allow participants to make contributions and accumulate investment earnings in individual accounts on a tax-advantaged basis. Except for individual retirement accounts (IRAs), which can be started independently by an employee and a financial institution, these retirement savings plans are sponsored by employers for the benefit of their employees. Three of these plan types are known by the section number of the Internal Revenue Code which authorizes them: §401(k) salary deferral plans; §403(b) tax-deferred annuities; and §457 nonqualified deferred compensation plans. Other employer-sponsored arrangements use IRAs to accumulate assets for employees in **s**implified **e**mployee **p**ensions (SEP plans) and **s**avings **i**ncentive **m**atch **pl**ans for **e**mployees of small employers (SIMPLE plans). SIMPLE plans also can be established as §401(k) plans.

The questions answered below are often raised by individual participants who seek an explanation of federal law, regulation, or congressional intent. They deal with limits on contributions, options for withdrawals, applicable taxes, and information disclosure. (For a more complete discussion of the federal rules for retirement plans, see: CRS Report for Congress 98-171, *Retirement Plans With Individual Accounts: Federal Rules and Limits*.)

1. Why does my plan limit contributions to less than the maximum allowed by federal law? Employers offer retirement plans to their employees voluntarily. There is no federal requirement that plans be offered, or that plan offerings meet a minimum threshold of generosity. Thus, plan sponsors can set limits of their own choosing on contributions to their plans so long as those limits do not exceed the limits set in federal law.

Section 415 of the tax code limits the sum of annual contributions from employer and employee to the lesser of 25% of annual pay or $35,000 (adjusted for inflation in $5,000 intervals). In addition, a $10,500 limit (inflation-adjusted in $500 intervals) applies to an employee's annual elective salary deferrals. Other limits may apply because of nondiscrimination tests that federal law applies to elective salary deferrals and employer matching contributions. (These tests are discussed in answering question #2 below.) A plan may set more stringent limits on contributions. The federal limits are only *ceilings* that plans cannot allow to be exceeded, not required contribution levels. Any contributions made in excess of these limits are immediately taxable and generally must be distributed by the plan to participants as taxable income within a certain time period after the end of the plan year.

2. Why are the contribution limits for highly paid employees and owners more restrictive than for other employees? Tax-qualified retirement plans sponsored by employers must provide benefits to a broad sector of workers in a fair, nondiscriminatory manner. To enforce this standard in plans that accept voluntary elective salary deferrals, Congress has adopted what pension experts term "nondiscrimination tests" that limit the deferrals of the highly paid and "5% owners"[1] based on the level of deferrals by other covered workers. This test, known as the "actual deferral percentage" or ADP test, compares the average salary deferral as a percent of salary for the highly compensated group to the corresponding average for the nonhighly compensated group. The ADP for the highly paid for the plan year cannot exceed the lesser of: (1) two times the ADP for the nonhighly paid; or (2) the greater of (a) 125% of the ADP for the nonhighly paid, or (b) the ADP for the nonhighly paid plus 2 percentage points. For example, if the ADP for the nonhighly paid is 1%, the ADP for the highly paid must not exceed twice that amount (2%). If the ADP for the nonhighly paid is 6%, the ADP for the highly paid is limited to 8% or less (6% plus 2%). If the ADP for the nonhighly paid is 12%, the ADP for the highly paid cannot exceed 15% (125% of 12%). These same mathematical relationships are applied to employer matching of elective deferrals to prevent this source of funds from bestowing excessive benefits on the highly paid.

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[1] The restricted group consists of owners with at least a 5% interest in the firm and employees whose annual compensation exceeds $85,000 (adjusted for inflation in $5,000 intervals). The group with pay above $85,000 can be narrowed by applying an optional rule that they must also fall within the top 20% of the firm's employees ranked by pay.

An ADP test first appeared in law when §401(k) was added to the tax code in 1978 by P.L. 95-600. The allowable gap in ADP between the two employee groups was narrowed in 1984 by P.L. 98-369 and in 1986 by P.L. 99-514. SIMPLE §401(k) plans are exempt from the ADP test. Also, the 1996 law (P.L. 104-188) that authorized SIMPLE plans allows a waiver of the ADP test beginning in 1999 for §401(k) plans that meet a "safe harbor" plan design with respect to employer contributions. A §401(k) plan that receives employer funding at rates at least as generous as those called for in the safe harbor design options will be regarded as having met the nondiscrimination tests.[2]

3. How long can a plan sponsor take to release my money after I leave a plan? An employer-sponsored retirement plan is required by ERISA to distribute funds to participants no later than the 60th day after the latest of: (1) the date that the participant attains the earlier of age 65 or the plan's normal retirement age; (2) completion of 10 years of plan participation; or (3) separation from service. Thus, plans are not required to distribute funds to a separated employee until 60 days after the later of normal retirement age or completion of 10 years of service in most cases. However, most §401(k) plans do provide for distribution soon after an employee's separation at any age.

Once a participant is eligible to receive a distribution and has initiated action to do so, the plan sponsor is obligated to act on that request in a timely manner. However, federal law does not specify a definite time limit within which a plan sponsor must complete action on a distribution to a participant.

4. Why was 59½ selected as the age for penalty-free withdrawals of retirement savings? In creating tax-advantaged opportunities for individual retirement saving, Congress wanted to assure that the tax benefits conferred on these accounts were in fact mainly supporting individual saving for retirement. Thus, Congress placed a restriction on pre-retirement use of these funds. A primary decision in this regard was to establish an age beyond which the use of tax-deferred retirement savings would be presumed to be for the purpose of providing retirement income. Age 60 was selected as the appropriate minimum age for this policy. Because the insurance industry played a prominent role in the drafting of the first law in 1962 (P.L. 87-792) that implemented such a policy, a custom of insurance companies to apply an "insurance age" to policyholders in determining age-related premiums was adopted in the legislation. A person's insurance age is determined by the birthdate that is within 6 months of the present date. Thus, a person's insurance age first becomes 60 when age 59½ is attained.

5. Under what circumstances can I withdraw money from my retirement plan without a penalty before age 59½? A 10% excise tax generally applies to premature withdrawals of retirement funds that are subject to the income tax when distributed.[3] This excise tax is additional to any income tax owed on the withdrawn

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[2] There are two safe harbor designs for §401(k) employer contributions. The first requires the employer to contribute at least 3% of pay for every eligible nonhighly compensated employee. The second requires the employer to match employee salary deferrals at a rate at least as generous as the following: 100% of the first 3% of salary deferred, plus 50% of the next 2% of salary deferred.

[3] The early withdrawal penalty is 25% for withdrawals from SIMPLE retirement accounts within the accountholder's first 2 years of plan participation. There is no early withdrawal allowed from

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amount. The penalty tax applies to withdrawals from §401(k) and §403(b) plans before age 59½ with the following exceptions: (1) upon the accountholder's death; (2) in case of permanent disability; (3) in the event of early retirement after age 55; (4) to pay medical expenses large enough to qualify for itemized deduction treatment under the federal income tax; or (5) if withdrawals are received in the form of a lifetime annuity.

Penalty-free withdrawals are allowed before 59½ from IRAs if the accountholder: (1) dies; (2) becomes permanently disabled; (3) pays medical expenses large enough to qualify for itemized deduction treatment under the federal income tax; (4) makes withdrawals in the form of a lifetime annuity; (5) pays health insurance premiums while unemployed at least 12 weeks; (6) pays higher education expenses for him(her)self or a family member; or (7) purchases a home. (Qualified withdrawals for home purchase are subject to a lifetime limit of $10,000 and can be used only by persons with no homeownership interest in the prior 2 years.)

6. Why can't I roll over money from my §457 plan to my new employer's plan or my IRA? The tax code generally allows tax-deferred transfers, or "rollovers," of retirement funds from one employer-sponsored plan to another, from an employer plan to an IRA, or from one IRA to another. The statutory language on rollover eligibility for employer plans limits rollovers to funds held in "qualified plans." Qualified plans are plans that the Internal Revenue Service (IRS) has determined to be in compliance with federal laws regarding coverage, vesting, funding, nondiscrimination, reporting, and disclosure. Section 457 plans are not qualified plans because they are not subject to the aforementioned rules. In fact, contributions to §457 plans would be immediately taxable except for the exemption granted to plans that meet the specifications of §457 of the tax code. When Congress first established §457 (P.L. 95-600), it did not choose to impose the requirements of plan qualification on §457 plans, nor did it choose to extend the concept of tax-deferred rollovers to nonqualified plans such as §457 plans.

7. Why do I have to withdraw funds from my retirement plan after age 70½? The tax code requires that minimum annual withdrawals begin after the later of: (1) separation from employment; or (2) attainment of age 70½.[4] This minimum required withdrawal must be large enough to use up the account balance over the expected remaining lifetime(s) of accountholder and beneficiary deemed to be 10 years younger, unless the beneficiary is a spouse who is more than 10 years younger. It must begin by April 1 of the calendar year following the calendar year in which the triggering event occurs.

A minimum required withdrawal provision was first put into law in 1962 with the beginning of Keogh plans for the self-employed (P.L. 87-792). Its purpose is to assure that tax-deferred savings and the associated investment earnings are subject to taxation as income when the accountholder is retired and/or reaches old age. The rationale for the

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[3] (...continued)
§457 plans and, hence, no early withdrawal penalty. Withdrawals from §457 plans are allowed upon separation from employment, attainment of age 70½, "unforeseeable emergencies," or death.

[4] Accountholders must begin IRA withdrawals after attaining age 70½ regardless of their employment status. The option to delay withdrawals until actual retirement, authorized by P.L. 104-188, applies only to employer-sponsored plans.

tax-deferred status accorded retirement saving is to help workers accumulate retirement assets for later use as a source of income. It is not intended as a means to realize a lifetime tax exemption for assets that are held until death and bequeathed to the accountholder's heirs.

8. Why must contributions to my IRA come only from earned income? The public policy purpose of the IRA is to assure that all workers have some opportunity for tax-advantaged retirement saving. It is not the intent of the IRA to facilitate asset accumulation for the future income needs of persons who already live on asset income or who depend on public income transfer payments. Annual contributions to IRAs are limited to the lesser of: (1) $2,000; or (2) the current year's earnings.

There are two exceptions to the rule that IRA contributions must come from current wage, salary, or self-employment income. First, a nonworking spouse can contribute to an IRA, the annual limit being the lesser of: (1) $2,000; or (2) the filing unit's combined earnings, reduced by the working spouse's IRA contribution. Second, an IRA contribution can be made from alimony income received under a court-ordered divorce settlement.

9. How can I get information about my retirement plan? Questions about particular provisions of your employer's plan may be answered by reference to the Summary Plan Description (SPD) each plan is required to submit to the IRS. The employer is supposed to distribute the SPD to participants. Information on a plan's financial transactions is filed regularly with the IRS on Form 5500 and must be made available to participants upon request. The status of a participant's benefit account must be reported annually by the plan to each participant who requests a report. More frequent reports may be made at the plan's discretion. An IRA accountholder can obtain documentation regarding the rules governing the IRA and its investment performance from the financial institution that holds the account in trust.

10. Where should I seek help if I think I may have a problem with my retirement plan? The U.S. Department of Labor (DoL) is responsible for enforcing the plan requirements set forth in ERISA. An individual may contact DoL at the following address:

U.S. Department of Labor
Pension and Welfare Benefits Administration
Division of Technical Assistance and Inquiries
200 Constitution Avenue N.W.
Washington, DC 20210-0999

This office may be reached by telephone at (202) 219-8776. The agency has an internet home page at the following address:

[http://www.dol.gov/dol/pwba/]

The office responsible for enforcing tax code requirements for retirement plans is:

U.S. Department of the Treasury
Internal Revenue Service
Employee Plans and Technical and Actuarial Division
1111 Constitution Avenue N.W.
Washington, DC 20224

Telephone assistance regarding tax-related problems plans may be obtained by calling the Taxpayers' Assistance Service at (202) 283-9516. The IRS internet address is:

[http://www.irs.gov/]