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Retirement Plans With Individual Accounts: Federal Rules and Limits

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Summary

As the federal income tax grew in importance during the 1940s, 1950s, and 1960s, employers devised ways in which employees could defer receipt of a part of their pay to postpone taxation of that income. These salary deferrals often were intended to be used in retirement. Most such plans now penalize cash withdrawals before a certain age, with exceptions for circumstances such as death, disability, or financial hardship. Thus, they often are called salary reduction *retirement* plans.

The manner in which deferred compensation plans were initially established varied among employment sectors. Business firms' plans differed from those of educational organizations, which in turn differed from government plans. The various plan types were codified over the years as Congress responded to regulatory initiatives by the Internal Revenue Service and to concerns about loss of revenue and the fairness and integrity of these plans. The resulting statutes reflected the unique history of each plan type.

Congress began to move toward more uniformity in the rules governing the different types of salary reduction plans in 1986 with passage of the Tax Reform Act of 1986 (P.L. 99-514), which contained several provisions that reduced disparities in plan rules. In 1996, Congress made additional changes in plan rules in the Small Business Job Protection Act of 1996 (P.L. 104-188), and further changes were made a year later by the Taxpayer Relief Act of 1997 (P.L. 105-34). In 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) raised contribution limits substantially, liberalized the rules permitting tax-free transfers of assets among different types of plans, shortened the maximum service required for employees to become vested in employer contributions, established a nonrefundable income tax credit for retirement plan contributors with income below specified levels, and made numerous other changes.

This report describes each type of salary reduction retirement plan authorized by federal law: individual retirement accounts (IRAs), §401(k) plans, the Federal Employees' Thrift Savings Plan, §403(b) plans, §457 plans, salary reduction simplified employee pension (SARSEP) plans, and savings incentive match plans for employees of small employers (SIMPLE). The rules governing these plans are then presented in regard to: eligibility, vesting, tax treatment of contributions, limits on contributions, limits on investments, withdrawal options, and tax treatment of withdrawals. Exceptions to the general rules are noted for specific plan types.

Appendix A to this report compares the rules for each plan type in chart form. Appendix B explains the abbreviated terms used in this report. Appendix C lists the major provisions of law by statute and section number. *This report is updated annually.*

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Background

Numerous tax incentives have been established in federal law for voluntary retirement saving. Each type of incentive plan was begun for a specific purpose with its own set of rules. While the different plan types shared one trait in common — a deferral of current income taxation on salary contributed to a retirement plan — rules governing eligibility, contributions, and withdrawals varied significantly, reflecting the variety of practices that had developed among employers in different sectors of the economy.

The Tax Reform Act of 1986 (P.L. 99-514) introduced a greater degree of uniformity to the rules for the various plan types and made their use for nonretirement purposes less attractive. Extensive changes were also made by the Small Business Job Protection Act of 1996 (P.L. 104-188) to encourage wider plan coverage. Further changes were made in the Taxpayer Relief Act of 1997 (P.L. 105-34). Most recently, the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) raised contribution limits, liberalized the rules governing tax-free transfers of assets among plan types, shortened the maximum service required for employees to become vested in employer contributions, and made other important changes in law.

This report provides a general description of the rules under which individual account retirement saving plans operate. First, it describes each of the following plan types:

- individual retirement accounts (IRAs);
- §401(k) plans;
- the Federal Employees' Thrift Savings Plan;
- §403(b) plans;
- §457 plans;
- salary reduction arrangements in simplified employee pension (SARSEP) plans; and
- savings incentive match plans for employees of small employers (SIMPLE).

The report then summarizes the federal rules for these plans. These rules, which vary by type of plan, set standards that plans must meet to qualify for tax advantages. A plan's specific rules may differ from those described here so long as they are not in conflict with the relevant federal requirements.

Readers interested in a brief summary of how a particular type of plan works will find that information in the next section. For more detail on specific provisions, readers should locate topics of interest in the *Plan Rules* section, which first sets forth the *general* rules regarding eligibility, vesting, contribution limits and tax treatment, investment limits, withdrawal options, and taxation of withdrawals. *Exceptions* to the general rules pertaining to each plan type are then noted.

Appendix A presents a series of charts that compare the rules by plan type. Appendix B identifies the abbreviations used in this report. Appendix C specifies the sections of federal statutes in which the various rules are located.

Summary Description of Retirement Plans With Individual Accounts

If an employer offers an individual account retirement plan, employees may instruct the employer to withhold payment of a specified portion of current salary for investment in the plan. The employer often contributes to the plan as well. Employees usually have a choice of several investment vehicles within the plan to which they may direct contributed funds.

Salary deferral arrangements are intended to help employees accumulate assets that can be used to provide retirement income. For most employees, the income from these plans will supplement benefits from Social Security. Some are covered also by an employer-sponsored defined benefit pension plan and/or another defined contribution plan,[1] but, for 52% of workers covered by a §401(k) plan, that plan is the only tax-deferred retirement arrangement made available by employers to employees.[2]

To participate in a salary deferral plan, an employee elects to give up a part of current wages and have those foregone earnings contributed to the plan by the employer. These "elective" contributions often are supplemented by "matching" and/or "nonelective" contributions from the employer. Employee and employer contributions that are in compliance with the law are not subject to the federal income tax in the year that the funds are contributed. Investment earnings on contributions also receive tax-deferred treatment.[3] However, when tax-deferred

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[1] A defined benefit plan promises a retirement benefit amount that is usually determined by salary level and length of service. A defined contribution plan specifies the contributions to be made, but the benefits depend on investment performance. Salary reduction plans are defined contribution plans.

[2] The proportion with only a §401(k) plan rose from 41% in 1994 to 52% in 1998. Source: U.S. Dept. of Labor. Pension and Welfare Benefits Administration. Abstract of 1998 Form 5500 Annual Reports. *Private Pension Plan Bulletin*, no. 11, winter 2001-2002. (Hereafter cited as Pension and Welfare Benefits Administration, *Private Pension Plan Bulletin*.)

[3] When an amount of income is "tax-deferred," that amount is not included in the taxpayer's adjusted gross income for the year of deferral. Although the mechanism through which

(continued...)

funds eventually are withdrawn from the plan, they are then subject to the federal income tax.[4] If withdrawals are premature or tardy, as defined in tax law, special excise taxes may also apply.

Tax deferral offers two possible advantages to an employee. First, compound interest accrues on the portion of savings that would have been used to pay taxes, thus yielding a larger after-tax asset in retirement. Second, the employee may be in a lower tax bracket in retirement and pay a smaller tax than would have been due if tax had been paid at the time the deferred wages were actually earned. To obtain these potential tax advantages, an employee must be willing to give up the current use of the wages contributed to the plan and abide by the plan's rules regarding investments and withdrawals.

A brief description of each plan type is given below.

Individual Retirement Accounts (IRAs)

Individual retirement accounts (IRAs) were authorized by the Employee Retirement Income Security Act (ERISA) of 1974 (P.L. 93-406) for persons not covered by employer pension plans. Eligibility was broadened to all employed individuals and their spouses by the Economic Recovery Tax Act of 1981 (P.L. 97-34). The Tax Reform Act of 1986 restricted the tax advantage of IRAs for certain taxpayers with income above specified levels. The Taxpayer Relief Act of 1997 relaxed those restrictions somewhat and authorized Roth IRAs, which are funded from after-tax contributions and provide tax-free income in retirement. The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) significantly increased the IRA contribution limit and indexed it for inflation.

The IRA is not a true salary deferral plan, since it is available to workers without any involvement of the employer and does not directly reduce the salary received by the worker. However, IRAs are included in this report since they are similar to salary deferral plans (i.e., they are based on elective contributions from tax filers with earned income), they serve as the investment vehicle for two types of employer plans (SEPs and SIMPLE IRAs), and they are widely used as "successor plans" to which individuals transfer assets from employer plans after retirement or job separation occurs.

In 1985, 16.2 million tax filing units (19% of all units with wage or salary income) reported IRA deductions, but the number actively contributing fell after the

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[3] (...continued)
deferral is achieved may be called a "deduction" or an "exclusion," the amount on which tax is deferred eventually will be subject to taxation when it is withdrawn from the retirement plan.

[4] An exception is the Roth IRA, which accepts only after-tax contributions but permits tax-free withdrawals of both principal and investment earnings. P.L. 107-16 authorizes "Roth 401k" and "Roth 403b" plans as well, effective in 2006.

1986 law took effect.[5] Only 3.5 million tax filers (3.2% of all units with wage or salary income) reported deductible IRA contributions for 2000. Participation rates have fallen at all income levels, the decline being greater, the higher the income. However, this trend undoubtedly has been altered since 1998 by contributions to Roth IRAs.

Traditional IRAs. Anyone with wage income can contribute the lesser of $3,000 a year or 100% of annual earnings to an IRA. An IRA can be established for a nonworking spouse, whose annual contribution cannot exceed the lesser of (1) $3,000, or (2) 100% of the couple's combined earnings less the working spouse's IRA contribution.[6]

P.L. 107-16 raised the old limit ($2,000) to $3,000 in 2002. Further increases are scheduled, to $4,000 in 2005 and $5,000 in 2008. The contribution limit will rise automatically with inflation in $500 increments in subsequent years. This law also authorized "catch-up" contributions for individuals age 50 and older of up to $500 a year for 2002 through 2005 and up to $1,000 annually thereafter.

While any worker (and spouse) can contribute to an IRA, contributions are assured of income tax deferral only if at least one of two conditions is met: (1) the contributor is not eligible to participate in an employer-sponsored retirement plan;[7] or (2) the contributor has adjusted gross income (AGI) below $40,000 ($60,000 for a joint filer). A deduction for contributions of less than $3,000 is allowed if AGI falls between this level and $50,000 ($70,000 for a joint filer).[8] These rules are arrayed in **Table 1**. Nondeductible contributions are tax-free when withdrawn, but deductible contributions are taxed upon withdrawal. Taxes are deferred on IRA investment earnings until withdrawal occurs, whether or not the contributions that produced these investment earnings were deductible.

Roth IRAs. A Roth IRA can receive after-tax contributions of up to $3,000 annually.[9] Qualified withdrawals are tax free. Contributions up to $3,000 are allowed only for taxpayers with AGI not in excess of $95,000 ($150,000 for joint filers). Allowable contributions are phased out at an AGI of $110,000 ($160,000 for joint filers). Traditional IRAs can be converted to Roth IRAs by payment of income

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[5] U.S. Internal Revenue Service. *Statistics of Income*. Washington, various years.

[6] Before 1997, the combined annual contribution to the IRAs of a working and a nonworking spouse could not exceed $2,250. This provision was changed by P.L. 104-188.

[7] A person's eligibility for a deductible IRA may be limited by a spouse's employer plan coverage as well. Under new rules established in P.L. 105-34, a person whose spouse is in an employer plan can still deduct a full $3,000 IRA contribution from taxable income if the couple's AGI does not exceed $150,000. Partial deductibility is allowed if AGI is less than $160,000.

[8] The limits on the income thresholds for tax deferral are not indexed for inflation. However, the tax deferral thresholds will rise until 2007 according to a schedule adopted in P.L. 105-34.

[9] The annual limit on Roth IRA contributions began to rise in 2002 in tandem with the limit for traditional IRAs as explained above.

tax on the IRA assets that have not been taxed. Eligibility for conversion is limited to tax filing units (single or joint) with AGI not in excess of $100,000.

Table 1. Determinants of Eligibility to Deduct Contribution to Traditional IRA in 2003

Tax filing unit/ work status of accountholder	Eligibility of account-holder (and spouse) for employer pension plan	2003 adjusted gross income (AGI)	Eligibility to deduct IRA contribution
Single/employed	Not eligible	Any amount	Full
Single/employed	Eligible	$0-$40,000	Full
Single/employed	Eligible	$40,001-$49,999	Limited[a]
Single/employed	Eligible	$50,000 or more	None
Joint/employed	Not eligible	Any amount	Full
Joint/employed	Eligible	$0-$60,000	Full
Joint/employed	Eligible	$60,001-$69,999	Limited[a]
Joint/employed	Eligible	$70,000 or more	None
Joint/nonworking spouse	Not eligible (nor is spouse)	Any amount	Full
Joint/nonworking spouse	Not eligible (spouse eligible)	$0-$150,000	Full
Joint/nonworking spouse	Not eligible (spouse eligible)	$150,001-$159,999	Limited[a]
Joint/nonworking spouse	Not eligible (spouse eligible)	$160,000 or more	None

[a] The ceiling on deductible contributions declines proportionately from $3,000 at the lower end of the AGI range to $0 at the upper end.

Section 401(k) Plans[10]

The §401(k) plan, also called a cash-or-deferred arrangement (CODA), was formally authorized by the Revenue Act of 1978 (P.L. 95-600) as a salary reduction arrangement for employees of profitmaking firms, although such plans had existed earlier under Internal Revenue Service (IRS) revenue rulings. Subsequently, certain nonprofit organizations were permitted to establish §401(k) plans. This authority was rescinded in the 1986 Tax Reform Act, with the following exceptions: rural electric cooperatives and associations of such cooperatives; rural telephone cooperatives; the Tennessee Valley Authority; government plans started before May 6, 1986; and private tax-exempt organizations' plans started before July 2, 1986.

[10] Treatment similar to that for §401(k) plans is granted to employee contributions to certain trusts by §501(c)(18) of the tax code. That section, added by the Tax Reform Act of 1969 (P.L. 91-172), allows tax deferrals for contributions to trusts that were established as retirement saving plans for union members before June 25, 1959.

Effective in 1997 (P.L. 104-188), authority to establish §401(k) plans was regained by all nonprofit employers but not by governments. This authority was restored to government agencies that operate water conservation and irrigation districts by P.L. 105-34.

In 1998, 42.7 million workers were covered by §401(k) plans. Most of the covered group (37.1 million) were active participants.[11] Participation rates rise as earnings levels increase. While 90% of §401(k) plans are the primary retirement plans offered by employers, many of these are small firms. Only 52% of §401(k) active participants are in §401(k) plans that are their firms' primary retirement plans.[12]

These plans permit employees to elect to contribute a part of wages on a tax-deferred basis. If participants have control over investment of their contributions, the plans must offer several options for investment with a range of risk/return characteristics. Many employers make contributions as well, which also are treated as tax-deferred income of the employees. In a typical plan, the employer puts in 50 cents for each dollar of employee contributions up to 6% of salary. (Beginning in 2006, participants in §401(k) plans can elect to have their contributions taxed and receive their distributions, including investment income, tax free. These "Roth 401k" arrangements were authorized by P.L. 107-16.)

An individual's elective contributions are limited to $12,000 in 2003. (The limit was set at $7,000, effective in 1987, and has since been adjusted annually for price inflation.)[13] Further restrictions apply to "highly compensated" participants under "nondiscrimination" rules, which are intended to assure that plans benefit rank-and-file workers.[14] P.L. 107-16 raised the 2001 limit of $10,500 to $11,000 in 2002, $12,000 in 2003, $13,000 in 2004, $14,000 in 2005, and $15,000 in 2006, after which inflation indexing in $500 increments will again apply. This law also authorized "catch-up contributions" for participants age 50 and older of up to $1,000 in 2002, $2,000 in 2003, $3,000 in 2004, $4,000 in 2005, and $5,000 in 2006. This catchup contribution limit also will be indexed for inflation in subsequent years in $500 increments. Total contributions from both employee and employer are also

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[11] Pension and Welfare Benefits Administration, *Private Pension Plan Bulletin*, p. 47. Active participants are those who are current employees of the plan sponsor and eligible to contribute to the plan.

[12] Ibid., p. 49.

[13] The §401(k) employee contribution limit is adjusted annually. The adjustment is made by comparing the average Consumer Price Index (CPI-U) figure for the third quarter of the preceding calendar year to the corresponding figure for one year earlier. The adjusted figure is rounded down to the nearest multiple of $500. The statutory increases specified for 2002 through 2006 by P.L. 107-16 will override this indexation feature, but yearly adjustments in $500 increments will resume after 2006.

[14] Beginning in 1999, a §401(k) plan that meets a "safe harbor" plan design set forth in P.L. 104-188 is exempt from nondiscrimination testing. In tax law, taxpayers who meet *safe harbor* criteria generally are presumed to be in compliance with the tax law related to those criteria.

subject to an overall limit on all retirement contributions on behalf of an employee. (In 2003, this limit is $40,000.)

The Federal Employees' Thrift Savings Plan

The Federal Employees' Retirement System Act of 1986 (P.L. 99-335), in establishing the Federal Employees' Retirement System (FERS) for federal civilian employees covered by Social Security, created a salary reduction retirement plan modeled on the §401(k) plan. This plan (the Thrift Savings Plan, or TSP) also was made available, on different terms, to employees under the predecessor Civil Service Retirement System (CSRS). According to Federal Thrift Board data, as of March 31, 2002, there were 2.8 million federal employees contributing to the TSP through salary reductions.[15] Contributing employees represented 87% of FERS enrollees and 66% of CSRS enrollees.[16] The plan's assets totaled $104 billion.

Before July 2001, federal employees under FERS could contribute up to 10% of salary, but no more than $10,500 in 2001. Employees under CSRS could contribute up to 5% of salary. The percentage limits on employee contributions rose in July 2001 based on a provision included in P.L. 106-554. The FERS and CSRS limits increased to 11% and 6%, respectively, at that time. Further one-percentage-point increases are scheduled to occur in 2002 and each succeeding year until the limits reach 15% and 10%, respectively. In 2006, the percentage limits on employee contributions will be abolished, but dollar limits will still apply. The dollar limit in 2003 is $12,000. Effective in 2002, military personnel became eligible to contribute to the TSP on the same basis as civilian employees covered by CSRS.

Each federal agency contributes an automatic 1% of pay to the thrift savings accounts of employees covered by FERS. The agencies also make matching contributions on a dollar for dollar basis for the first 3% of salary their FERS-covered employees contribute and on a 50 cents per dollar basis for the next 2%. No federal agency contributions are made to the accounts of CSRS-covered workers; only selected military personnel are eligible for federal contributions to their accounts.

The thrift plan offers participants a choice among five funds that track broad portfolios of: government securities, common stocks of large firms, fixed-income securities, small capitalization stocks, and international stocks.

Section 403(b) Plans

These plans, which are tax-sheltered annuities that permit employee salary deferrals, were established in law in 1958 (P.L. 85-866). They provide annuities for employees of public educational organizations and organizations that qualify for tax-exempt status under §501(c)(3) of the Internal Revenue Code. This latter group

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[15] Another 0.2 million FERS enrollees received a government contribution to their thrift accounts equal to 1% of salary but chose not to make elective contributions.

[16] CRS Report RL30387, *Federal Employees' Retirement System: The Role of the Thrift Savings Plan*, by Patrick J. Purcell, September 19, 2002.

generally consists of nonprofit research, scientific, educational, and charitable organizations.

Employee tax-deferred contributions are generally subject to an annual ceiling of $12,000 in 2003. This ceiling is adjusted for inflation in tandem with the indexed ceiling for §401(k) plans. (It was fixed at $9,500 from 1987 through 1997, however. It will rise yearly through 2006 on the same schedule as set forth above for §401(k) plans as a result of P.L. 107-16.) Beginning in 2006, participants can have their deferrals taxed and receive tax-free distributions from "Roth 403b" plans, as authorized by P.L. 107-16.

Total contributions from both employee and employer are subject to the overall $40,000 limit on all retirement contributions on behalf of an employee. The nondiscrimination rules apply to contributions made by the employer to §403(b) plans and may limit contributions for highly compensated employees.

A large number of §403(b) plans are invested with the Teachers Insurance Annuity Association and the College Retirement Equity Fund (TIAA-CREF). At the end of 2001, TIAA-CREF managed assets worth $267 billion for 2.4 million participants from more than 12,000 institutions.[17]

Section 457 Plans

Section 457 was added to the Internal Revenue Code by the Revenue Act of 1978. This legislation codified a practice of state and local governments that had developed over the years. These plans provide for salary deferrals by employees of state and local governments and other tax-exempt organizations. All states now offer §457 plans, but these plans generally are not offered to all their employees. At the end of 2000, §457 plans held more than $90 billion in assets.[18]

Unlike §401(k) plans, which are considered retirement plans "qualified" for preferred treatment under federal tax law, §457 plans are not "qualified" plans.[19] Thus, the conditions for tax deferral of contributions to §457 plans are specified only in §457, and some of these rules differ from those of qualified plans.

Contributions are limited in 2003 to $12,000. The limit had been fixed at $7,500 from 1986 through 1997, but it became subject to inflation adjustments in $500 intervals in 1997 and received its first increase (to $8,000) in 1998. P.L. 107-16 raised the annual deferral limit to $11,000 in 2002, $12,000 in 2003, $13,000 in 2004, $14,000 in 2005, and $15,000 in 2006, and indexes it for inflation thereafter

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[17] *College Retirement Equities Fund Prospectus*. CREF, New York. May 1, 2002.

[18] *Pensions and Investments,* June 11, 2001, p. 21.

[19] The term "qualified plan" refers to a plan that is qualified as a tax-deferred plan by an Internal Revenue Service (IRS) determination and is, therefore, eligible for certain advantages under the tax laws. Of the plans described in this report, §403(b) plans, the TSP, SIMPLE retirement accounts, SARSEPs, §457 plans, and IRAs are not qualified plans. The tax treatment of these plans is specified separately in the law.

in $500 increments. These limits are doubled for participants in their last 3 years prior to retirement. P.L. 107-16 also eliminated the one-third of compensation limit on deferrals that applied prior to 2002.

Salary Reduction Arrangements in Simplified Employee Pension Plans (SARSEPs)

A simplified employee pension (SEP) consists of IRAs that are funded completely by the employer on behalf of all eligible employees.[20] Contributions are allowed up to the lesser of 25% of earnings or $40,000 annually and must apply to each employee account uniformly as a percent of salary. SEPs were authorized to provide small businesses with a simple means for offering pension coverage to employees.

This arrangement was expanded by a provision of the Tax Reform Act of 1986 to permit employees to make elective tax-deferred contributions to SEPs through salary reduction (SAR). However, the authority to establish new SARSEPs expired on December 31, 1996, because of provisions in P.L. 104-188 authorizing SIMPLE (discussed below). Plans already in existence were allowed to continue in operation. SARSEPs are allowed only for firms with 25 or fewer employees. An employee with this option can make elective contributions that are in addition to amounts contributed by the employer, but total contributions from both sources are limited to the lesser of 25% of earnings or $40,000. Elective contributions are subject to the same $12,000 limit in 2003 as a §401(k) plan. This limit will rise yearly through 2006 according to the same schedule detailed above for §401(k) plans.

Savings Incentive Match Plans for Employees of Small Employers (SIMPLE)

P.L. 104-188 authorized employers with 100 or fewer employees and no employer-sponsored retirement plan to offer "salary incentive match plans for employees of small employers" (SIMPLE) in years beginning on or after January 1, 1997. These plans can be set up as either: (1) SIMPLE retirement accounts for all eligible employees; or (2) §401(k) plans operating under special rules. Employees can defer up to $8,000 a year in 2003 from salary as contributions to the plan, which the employer must either match according to a specified formula or augment with a contribution of 2% of each participant's wages. SIMPLEs are exempt from certain nondiscrimination rules and reporting requirements.[21]

The $8,000 annual deferral limit will increase under the provisions of P.L. 107-16 to $9,000 in 2004 and $10,000 in 2005. Inflation indexing in $500 increments will apply for subsequent years.

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[20] An employee may make annual contributions up to the limit for a traditional IRA to the same account as the SEP-IRA.

[21] For more information, see: CRS Report 96-758, *Pension Reform: SIMPLE Plans for Small Employers,* by James R. Storey (updated by Celinda Franco).

Plan Rules

The Tax Reform Act of 1986 and the Economic Growth and Tax Relief Reconciliation Act of 2001 made great strides toward bringing the different types of salary reduction plans under uniform rules. However, there still are significant variations by plan type. This section reviews the current rules for eligibility, vesting, contributions, investments, and withdrawals. *The general rules are stated first; important exceptions that pertain to particular types of plans are then provided.*

Eligibility Requirements

A plan offered by an employer must be available to all employees on a nondiscriminatory basis. Employees can be excluded on the basis of age (under 21) and length of service with the employer (less than 1 year). A 2-year eligibility limit can be imposed if benefits are fully vested at that time. No maximum age for eligibility is permitted.

There are also rules relating to a plan's breadth of coverage of the employer's workforce. A plan must cover either: (1) at least 70% of all "nonhighly compensated" employees; or (2) a percentage of such employees that equals at least 70% of the percentage of "highly compensated" employees the plan covers. If neither of these tests is met, the plan must meet the "average benefits test." This test requires that employer contributions for the nonhighly compensated, expressed as a percent of total employee compensation, equal at least 70% of the corresponding percentage figure for the highly compensated.

A highly compensated employee includes anyone who falls into one of two categories: (1) those who own at least 5% of the firm (5% owners); or (2) those with annual compensation above $90,000 in 2003 (adjusted annually for price inflation in $5,000 intervals). Employers can restrict the latter group further by requiring that they also fall within the top 20% of employees ranked by pay.[22] (The history of these inflation-adjusted amounts is shown in **Table 2**.)

Exceptions. In the case of a *SEP*, accounts must be established for all employees except those in categories that are excludible under federal law. A *SARSEP* may be offered only by employers with 25 or fewer employees. At least half of the employees must make elective salary deferrals.

An *IRA* is not subject to these eligibility rules since it is not employer-sponsored. To be eligible to contribute to an IRA, the only requirement is that the taxpayer either have earned income or have a spouse with earned income. (Whether or not IRA contributions are eligible for tax-deferral is discussed below under *Tax Treatment of Contributions*.)

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[22] This definition of highly compensated was included in P.L. 104-188 to simplify provisions of prior law.

Table 2. Limits Defining Highly Compensated Group, 1987-2003

Year(s)	Minimum annual salary to be in highly compensated group:[a] For employees generally	For employees with pay in top 20% of workforce
1987	$75,000	$50,000
1988	78,353	52,235
1989	81,720	54,480
1990	85,485	56,990
1991	90,803	60,535
1992	93,518	62,345
1993	96,368	64,245
1994	99,000	66,000
1995-96	100,000	66,000[b]
1997-99	80,000[c]	80,000[c]
2000-01	85,000	85,000
2002-03	90,000	90,000

[a] Prior to 1987, there were no statutory limits defining the highly compensated group.
[b] The 1994 limit remained unchanged from year to year because of a new rounding rule that allows the limits to rise only in $5,000 intervals.
[c] The 1997 limits were set by P.L. 104-188. They are indexed in $5,000 intervals.

A *SIMPLE* must extend eligibility to all employees who were paid at least $5,000 in any 2 prior years and are expected to earn at least $5,000 in the current year.

Federal eligibility requirements do not apply to *§457 plans*. However, the state and local governments and the nonprofit organizations that sponsor §457 plans apply their own eligibility rules.

A special set of rules applies to eligibility for elective deferrals under *§403(b) plans*. The opportunity to make deferrals of more than $200 must be available to all employees on a basis that does not favor the highly compensated. Employees may be excluded from the plan only if they are: (1) nonresident aliens with no U.S. income; (2) students in the employing institution who work for the institution fewer than 20 hours per week; or (3) employees who participate in another deferred compensation arrangement offered by the employer. A §403(b) plan maintained for church employees is exempt from rules for coverage and nondiscrimination. An educational institution may exclude all employees under age 26 in a §403(b) plan with vesting of 1 year or less.

A plan that has received no employer contributions since September 2, 1974, is not subject to these eligibility rules if it met the corresponding rules that were in effect before that date. This exception covers *§501(c)(18) plans*.

Vesting

Employer contributions deposited in a retirement plan may not become the property of the individual concerned until some condition of job tenure is met. When an individual does gain legal ownership of retirement funds, those funds are said to be "vested" in that individual.

All salary deferral contributions by an *employee* must vest at once. Employer contributions must vest at least as quickly as one of the following schedules requires: 100% after 3 years (3-year cliff vesting); or 20% a year beginning with 2 years of service and reaching full vesting after 6 years (graded vesting). Before 2002, the maximum terms for vesting were 5 years (cliff) and 7 years (graded). (The effective date for the shorter vesting periods may be delayed for collectively bargained plans until the earlier of the bargaining agreement's termination date or January 1, 2006.) Both current and past vesting standards are displayed in **Table 3**.

Exceptions. Employer contributions to *SIMPLEs* must vest at once. Federal vesting standards do not apply to *§457 plans.* Vesting rules are not needed for *IRAs* since all contributions are from the participant.

Table 3. Minimum Requirements for Vesting of Employer Contributions to Qualified Retirement Plans

	Minimum percentage of employer contribution that must be vested			
	Cliff vesting		Graded vesting	
Completed years of participation	in 2002 and later years[a]	in prior years[b]	in 2002 and later years[a]	in prior years[b]
1	0	0	0	0
2	0	0	20	0
3	100	0	40	20
4	100	0	60	40
5	100	100	80	60
6	100	100	100	80
7 or more	100	100	100	100

[a] The new vesting rules may be delayed for collectively bargained plans until the earlier of the bargaining agreement termination date or January 1, 2006.
[b] The old rules were in force from 1989 through 2001. Multiemployer plans were able to use 10-year cliff vesting until it was eliminated by P.L. 104-188.

Tax Treatment of Contributions

Amounts contributed by employees and employers that fall within the allowable limits discussed below (see *Limits on Contributions*) are not subject to the federal income tax in the year in which they are made. Taxation occurs in the year that the funds are withdrawn from the plan. Investment earnings on the contributions also receive tax-deferred treatment. However, contributions *are* subject to FICA (Social Security and Medicare) and FUTA (Unemployment Insurance) taxes in the year the funds are contributed.

A 10% excise tax is applied against the employer for any contributions in excess of the allowable limits. The employer can avoid this excise tax by refunding the excess contributions, together with earnings on those contributions, to plan participants within 2½ months after the plan year's end.

Excess deferrals by an employee that are withdrawn to avoid a penalty, if withdrawn by the April 15 following the employee's taxable year, are not subject to penalties for early or excess withdrawals (discussed later in the section entitled *Tax Treatment of Withdrawals*).

Exceptions. Income tax deferral is not allowed for contributions to *Roth IRAs*. Beginning in 2006, there also will be no tax deferral allowed for salary deferrals to "Roth 401k" and "Roth 403b" plans, which were authorized by P.L. 107-16 to begin in that year.

Contributions to *traditional IRAs* are not tax-deferred if the contributor is an active participant[23] in an employer-sponsored plan and has AGI above a certain level. These AGI levels are not adjusted for inflation, but they will rise annually through 2007 according to a schedule adopted in P.L. 105-34. In 2003, if AGI is above $50,000 ($70,000 for a joint filer), no deduction is allowed. If AGI is between $40,000 and $50,000 ($60,000 and $70,000 for a joint filer), a deduction is allowed up to a ceiling. The deductible ceiling equals $3,000 times the following quantity: 1.0 minus the quotient of (1) the excess AGI over the lower end of the income range divided by (2) $10,000.

These AGI thresholds for deductibility of IRA contributions formerly applied to a noncovered spouse of a person who had employer plan coverage. However, a higher threshold was adopted for noncovered spouses by P.L. 105-34. Full deductibility for noncovered spouses is now allowed for AGI of $150,000 or less. Partial deductibility is permitted up to an AGI of $160,000.

The AGI thresholds for full deductibility of IRA contributions by a single filer will increase to $45,000 in 2004 and $50,000 in 2005 and thereafter. The phaseout interval for deductibility will continue to be $10,000. For joint filers, the AGI

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[23] An "active participant" in a particular year is anyone eligible to participate in a defined benefit plan in that year or anyone whose defined contribution account has funds contributed or allocated to it in that year. Neither the *amount* of money contributed nor the *length* of the eligibility period are considered in the determination of active participant status.

thresholds for full deductibility will increase to the following levels: $65,000 in 2004; $70,000 in 2005; $75,000 in 2006; and $80,000 in 2007 and thereafter. The phaseout interval for deductibility by joint filers will continue to be $10,000 until 2007, when it will increase to $20,000. Thus, in 2007, partial deductibility will be allowed for joint filers with AGI up to $100,000.

A contribution to an *IRA* in excess of the annual limit ($3,000 in 2003) is subject to a 6% excise tax if not withdrawn from the IRA before April 15 following completion of the tax year.

The FICA and FUTA taxes do not apply to *SARSEP* salary reduction contributions.

Excise taxes do not apply to *§457 plans*, but excess contributions are treated as the employee's taxable income in the current year.

Beginning in 2002, P.L. 107-16 authorized a temporary *nonrefundable tax credit* equal to a portion of retirement plan contributions for tax filers with AGI below specified levels. The credit can be applied to both IRA and employer plan contributions and may be taken in addition to the adjustment to AGI for the contributions. The credit amounts, which can be applied to up to $2,000 of contributions, are as follows: 50% of the contribution if the filer's AGI is no more than $15,000 (single), $22,500 (head of household), or $30,000 (joint); 20% of the contribution if AGI is between $15,000 and $16,250 (single), $22,500 and $24,375 (head of household), or $30,000 and $32,500 (joint); 10% of the contribution if AGI is between $16,250 and $25,000 (single), $24,375 and $37,500 (head of household), or $32,500 and $50,000 (joint). There is no credit available if AGI is above these stated ranges, and the credit is scheduled to expire December 31, 2006.

Limits on Contributions

Individual plans may set their own limits on the amounts that can be contributed. However, plan limits cannot exceed the limits established in the Internal Revenue Code. Employee contributions from salary deferrals are limited to $12,000 in 2003. P.L. 107-16 raises this ceiling yearly through 2006. (See **Table 7** for the scheduled increases.) Beginning in 2007, this limit will be indexed for inflation in $500 intervals.

There is also an overall annual limit on combined contributions that can be made by employee and employer to an employee's account. That limit is $40,000 in 2003. The contribution limit is indexed for inflation in $1,000 intervals. (A 25% of salary limit was repealed effective in 2002 by P.L. 107-16. That law also raised the 2001 limit of $35,000 to $40,000 for 2002 and lowered the threshold amount for an inflation adjustment from $5,000 to $1,000.)

A further limit may apply to elective salary deferrals by highly compensated employees and to employer matching.[24] The actual deferral percentage of the highly compensated is limited by a formula tied to the actual deferral percentage for nonhighly compensated employees (**Table 4**). This formula is called the "nondiscrimination test." The history of salary deferral limits is shown in **Table 7**.

Table 4. Limits on Salary Deferrals by Highly Compensated Employees Under the Nondiscrimination Test

If avg. deferral rate[a] of nonhighly compensated is:	Limit on avg. deferral rate[a] of highly compensated[b] is:
between 0% and 8%	2 percentage points higher than rate for nonhighly compensated
between 9% and 80%	1.25 times rate for nonhighly compensated
between 81% and 100%	100%

[a] A group's deferral rate is determined by averaging the elective deferrals as a percent of salary for each employee in the group. A plan has the option to include qualified matching and nonelective contributions to the employee's account in performing this calculation.

[b] These limits on deferrals as a percent of salary apply to §401(k) and §501(c)(18) plans, to SARSEPs, and to employer contributions to §403(b) plans. However, they do not apply to SIMPLE §401(k) plans.

The level of annual compensation on which contributions can be based is limited to $200,000 in 2003. (See **Table 5** for the complete history of this limit.) The limit is indexed for inflation annually but can rise only in $5,000 steps. This limit on includible compensation constitutes an indirect limit on amounts that can be contributed by the highly compensated and, therefore, can affect a plan's nondiscrimination test calculations. (P.L. 107-16 increased the 2001 limit of $170,000 to $200,000 effective in 2002 and lowered the threshold for inflation adjustments from $10,000 to $5,000 increments.)

Beginning in 2002, P.L. 107-16 authorized individuals who have attained age 50 to make "catch-up" contributions to IRAs, §401(k) plans, §403(b) plans, §457 plans, and SIMPLEs. The additional catch-up amount started at $1,000 in 2002 and rises in $1,000 steps annually until it reaches $5,000 in 2006. This amount will be indexed for inflation in subsequent years in $500 intervals. (For SIMPLEs, the catch-up amount started at $500 and rises in $500 steps until it reaches $2,500 in 2006. Inflation indexing will then apply in $500 intervals. For IRAs, the catch-up amount is $500 for 2002 through 2005 and $1,000 in 2006. The IRA catch-up amount is not indexed for inflation.)

[24] The definition of a highly compensated employee is given in the section entitled *Eligibility Requirements*.

Table 5. Limits on Annual Compensation That Can Be Used to Determine Plan Contributions, 1989-2003

Year(s)	Maximum countable compensation[a]
1989	$200,000
1990	209,200
1991	222,220
1992	228,860
1993	235,840
1994-96	150,000[b]
1997-99	160,000
2000-01	170,000
2002-03	200,000[c]

[a] P.L. 99-514 extended to all qualified plans a $200,000 limit that had applied before 1989 only to SEPs and to collectively bargained plans.
[b] The 1993 limit was reduced to $150,000 for 1994 by P.L. 103-66. It remained unchanged in some years after 1994 because it was allowed to rise with inflation only in $10,000 intervals after enactment of P.L. 103-66.
[c] P.L. 107-16 established a $200,000 limit for 2002 and changed the indexing increment to $5,000.

Exceptions. Variations in limits on elective salary deferrals by plan type are shown in **Table 6**. *IRA* contributions are limited to the lesser of 100% of earnings or, in 2003, $3,000 (or a total of $6,000 for a worker and a nonworking spouse). The overall limit of $40,000 does not apply to IRAs. However, the $3,000 IRA limit governs contributions to all of the IRAs an individual owns. (The schedule of limits set by P.L. 107-16 beginning in 2002 is shown in **Table 7**.)

Higher salary deferral limits apply for *§403(b) plan* participants with more than 15 years of service. These "catch-up" contributions cannot exceed $3,000 in any 1 year or $15,000 in total. However, catch-up contributions cannot be made if an employee's lifetime salary reductions exceed $5,000 times years of service.

In *§457 plans*, unused deferrals from prior years may be contributed in one or more of an employee's last 3 years before attaining normal retirement age, not to exceed twice the otherwise applicable annual limit

The *Federal Employees' Thrift Savings Plan* originally limited salary deferrals to 10% of salary for employees covered by FERS and 5% of salary for those under CSRS, but these limits began to rise in July 2001 and are now 13% and 8%, respectively. They will rise annually by one percentage point until they reach 15% and 10% in 2005. In 2006, these percentage limits will be abolished. The limits established by the nondiscrimination test do not apply to the Thrift Savings Plan because of legislation included in the FY1988 Continuing Resolution (P.L. 100-202). The §401(k) annual limit on elective contributions ($12,000 in 2003) does apply, however.

Table 6. Limits on Annual Contributions to Salary Deferral Plans by Plan Type, 2003

Plan type	Limit is lesser of: Annual dollar limit	Limit is lesser of: Percent of earnings	Is dollar limit inflation indexed?[a]	Does nondiscrimination test apply to elective salary deferrals?
IRA-employee	$3,000	100%	Yes	No
IRA-nonworking spouse	3,000[b]	[b]	Yes	No
401(k)	12,000	100%	Yes	Yes[c]
403(b)	12,000	100%	Yes	No[d]
457	12,000	100%	Yes	No
501(c)(18)	12,000	100%	Yes	Yes
SARSEP	12,000	25%	Yes	Yes
Federal thrift plan — FERS	12,000	13%	Yes	No
Federal thrift plan — CSRS	12,000	8%	Yes	No
SIMPLE retirement account	8,000	100%	Yes	No
SIMPLE 401(k)	8,000	100%	Yes	No

[a] Scheduled increases included in P.L. 107-16 will override inflation indexing for several years. See Table 7.

[b] Contributions of a worker and a nonworking spouse in combination cannot exceed 100% of the worker's earnings.

[c] Effective in 1999, a §401(k) plan is exempt from the nondiscrimination test if it meets a "safe harbor" plan design set forth in P.L. 104-188. (See preceding page for details.)

[d] The nondiscrimination test does apply to *employer* contributions to §403(b) plans, however.

Annual salary deferrals in a *SIMPLE* are limited in 2003 to $8,000. (The scheduled increases in this limit under P.L. 107-16 beginning in 2002 are shown in **Table 7**.) The nondiscrimination test is waived for deferrals to these plans. The $200,000 limit on the annual compensation that can be used as the basis for plan contributions does not apply in the case of employer matching contributions to a SIMPLE retirement account.

The nondiscrimination test can be waived for *§401(k) plans* that meet one of two employer contribution goals set forth in P.L. 104-188. These "safe harbor §401(k)s" must have (1) employer contributions to the accounts of all eligible nonhighly compensated employees of at least 3% of pay or (2) matching contributions at least as generous as the following: $1 for each $1 of salary deferral up to 3% of pay, plus $0.50 for each $1 of salary deferral over the next 2% of pay.

Table 7. Annual Dollar Limits on Elective Salary Deferrals, 1975-2008

[Note: Higher "catch-up" limits apply for participants age 50 and older beginning in 2002–see text for details]

	Annual elective deferral limit by plan type:				
Year(s)	§401(k)[a]	§403(b)[b]	§457 [b]	IRA	SIMPLE
1975-78	—-	[c]	—-	$1,500	—-
1979	—-	[c]	$7,500	1,500	—-
1980-81	[c]	[c]	7,500	1,500	—-
1982-86	[c]	[c]	7,500	2,000	—-
1987	$7,000	$9,500	7,500	2,000	—-
1988	7,313	9,500	7,500	2,000	—-
1989	7,627	9,500	7,500	2,000	—-
1990	7,979	9,500	7,500	2,000	—-
1991	8,475	9,500	7,500	2,000	—-
1992	8,728	9,500	7,500	2,000	—-
1993	8,994	9,500	7,500	2,000	—-
1994-95	9,240[d]	9,500	7,500	2,000	—-
1996	9,500	9,500[e]	7,500	2,000	—-
1997	9,500	9,500	7,500[e]	2,000	$6,000[e]
1998-99	10,000	10,000	8,000	2,000	6,000
2000	10,500	10,500	8,000	2,000	6,000
2001	10,500	10,500	8,500	2,000	6,500
2002	11,000[f]	11,000[f]	11,000[f]	3,000[f]	7,000[f]
2003	12,000[f]	12,000[f]	12,000[f]	3,000[f]	8,000[f]
2004	13,000[f]	13,000[f]	13,000[f]	3,000[f]	9,000[f]
2005	14,000[f]	14,000[f]	14,000[f]	4,000[f]	10,000[f]
2006	15,000[f]	15,000[f]	15,000[f]	4,000[f]	[g]
2007	[g]	[g]	[g]	4,000[f]	[g]
2008	[g]	[g]	[g]	5,000[f]	[g]

[a] These limits also apply to §501(c)(18) plans, SARSEPs, and the Federal Employees' Thrift Savings Plan.

[b] Limits may be higher in some cases. See text for explanation.
[c] P.L. 99-514 placed dollar limits on §401(k) and §403(b) salary deferrals. Before that, deferrals were subject only to the overall limit on combined employee/employer contributions to qualified plans.
[d] Inflation indexing was changed so that the limit can rise only in $500 intervals.
[e] Beginning of inflation adjustments on the same basis as for §401(k) plans.
[f] Limit set in P.L. 107-16.
[g] Limit to be adjusted annually for inflation in $500 increments.

Plans exempt from nondiscrimination testing have a $250,000 limit. The $200,000 limit also does not apply to *§401(k) or §403(b) plans sponsored by governmental employers*. These plans may operate under the compensation limit in effect on July 1, 1993. Because of inflation indexing, that limit is $300,000 in 2003. No compensation limit applies to *§457 plans*.

Limits on Investments

Persons acting in a fiduciary capacity are required to follow the "prudent person" rule when investing contributions from salary deferrals. That is, investments are to be made according to the judgments that a prudent investor would make acting individually in investing for retirement.

Unless a special exemption is granted, the law specifically prohibits certain transactions between a plan and "disqualified persons." The disqualified group includes owners, officers, employee organizations, fiduciaries, persons providing services to the plan, family members of disqualified persons, or major partners of any of these persons. An excise tax of 5% is imposed on the amount of any prohibited transaction. Federal law restricts defined benefit pension trusts from holding more than 10% of plan assets in property or stock of the plan sponsor. This restriction was extended to §401(k) plans in 1999 (discussed below under *Exceptions*).

Salary deferral plans often allow participants to decide how to invest their accounts, but U.S. Department of Labor (DoL) regulations provide guidance on the investment options these plans can offer. A plan that allows participant-directed investing has to offer at least three diversified options with different risk/return characteristics.

Exceptions. Specific investment restrictions apply to *IRAs*, which cannot be invested in collectibles such as art, antiques, and other tangible assets. Such investments are treated as taxable distributions from the IRA. However, IRAs are allowed to invest in certain precious metals.

P.L. 105-34 established a limit on the investment of *§401(k)* assets in securities or property of the employer. Effective in 1999, salary deferrals in excess of 1% of pay that are invested in the employer's securities or property cannot exceed 10% of total plan investments unless the participant elects a higher percentage.

Federal laws on investment policies do not apply to *§457 plans*, but most states apply their own "prudent person" standards to their plans.

The DoL regulations that require a range of investment options apply only to plans qualified under §401 of the tax code.

Withdrawal Options

Funds may be withdrawn in four ways — as a loan, a rollover, an annuity contract, or a cash withdrawal. Loans and rollovers that comply with tax laws and regulations are considered nontaxable distributions. Each withdrawal method is discussed below.

Loans. Federal law permits, but does not require, qualified plans to allow loans. Borrowing is subject to a maximum of the lesser of: (1) $50,000; or (2) the greater of one-half of vested contributions or $10,000.

The term of a loan cannot exceed 5 years unless the loan is used to purchase a principal residence. Interest charged on a plan loan is not tax-deductible for the borrower, regardless of the loan's purpose. In determining the amount available for borrowing, the largest amount borrowed in the prior 12 months is deducted from the $50,000 maximum, and the reduced maximum is applied in considering a loan request. At the time that an employee ceases to be covered by a plan, any outstanding loan balance is treated as a taxable distribution from the plan.

Exceptions. Borrowing is not permitted from *IRAs*, *SEPs*, *SARSEPs*, or *SIMPLE retirement accounts*. State or local government *§457 plans* may allow loans, but §457 plans of nonprofit organizations cannot.

The *Federal Employees' Thrift Savings Plan* allows borrowing in amounts up to the employee's own contributions plus investment earnings. Though loans originally were limited to four purposes (medical expenses, education expenses, purchase of a primary residence, financial hardship), this restriction was removed by P.L. 104-208. A thrift plan loan for home purchase may be paid off over 15 years, but other loans cannot exceed 4 years.

Rollovers. A rollover is a tax-free transfer of funds from one tax-deferred retirement account to another. Such transfers must be completed within 60 days to avoid taxation.

Upon leaving employment, a plan participant may roll over vested funds from a salary reduction plan to a plan offered by the next employer (if that plan accepts rollovers) or to a traditional IRA (but not to a Roth IRA). A plan distribution can be rolled over regardless of the proportion it constitutes of an individual's total assets in the plan, so long as the distribution is not "one in a series of periodic payments."

Although a rollover is not subject to tax, mandatory income tax withholding at a rate of 20% applies to all lump-sum distributions received directly by a participant from an employer plan, even if the distribution eventually is rolled over and thus not currently taxable. Only rollovers executed by trustee-to-trustee transfers escape tax withholding.

Exceptions. Beginning in 2002, P.L. 107-16 removed most of the past barriers to rollovers. Rollovers are now generally permitted among §401(k) plans, §403(b) plans, §457 plans, the TSP, and traditional IRAs.

IRA-to-IRA rollovers are limited to one per year for each IRA. A *Roth IRA* can be rolled over only to another Roth IRA. A *SIMPLE retirement account* can be rolled over to an IRA only if plan participation exceeds 2 years.

A *traditional IRA* can be converted to a *Roth IRA* by payment of the income tax on any untaxed funds withdrawn from the traditional IRA for this purpose. Only tax filers with AGI of $100,000 or less may convert a traditional IRA to a Roth IRA, however. This $100,000 limit applies to both single and joint filers.

Annuities and Cash Withdrawals. An annuity is obtained through a contract with an insurance company in which the retirement plan asset is used to purchase a series of benefit payments for a guaranteed time period, the participant's lifetime, or the joint lifetimes of the participant and a surviving beneficiary. A cash withdrawal is the direct removal of funds from an account by the participant, either in a lump sum or in multiple payments. Federal law requires that a plan must begin benefit payments to a participant no later than 60 days after the close of the plan year in which the latest of three events occurs: (1) attainment of age 65 or, if earlier, the plan's normal retirement age; (2) completion of 10 years of service; or (3) separation from employment.

To be exempt from a 10% excise tax on early withdrawals, an annuity or a cash withdrawal must be received under at least one of the following conditions: (1) after attainment of age 59½; (2) upon the death of the accountholder; (3) because of a permanent disability; (4) upon separation from employment under an early retirement provision after attainment of age 55; (5) upon withdrawal at any age if in the form of a life annuity; or (6) because of medical expenses that are large enough to be treated as an itemized deduction from income subject to the federal income tax.

At the plan's option, a cash withdrawal can be obtained while employed if needed to meet financial hardship,[25] but only the individual's elective deferrals can be withdrawn for this purpose. Hardship withdrawals are subject to the 10% early withdrawal excise tax unless one of the abovementioned six conditions for exemption is met.

Cash withdrawals are subject to the 20% mandatory income tax withholding described above under *Rollovers* if the withdrawal constitutes a lump-sum distribution or multiple payments received over fewer than 10 years. Otherwise, income tax withholding is optional.

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[25] Hardship withdrawals are allowed if needed by a participant to meet immediate and heavy financial needs for which no other resources are available. The following needs meet the definition of hardship: medical expenses; purchase of a principal residence; tuition for postsecondary education; and rent or mortgage payments to prevent eviction from, or foreclosure on the mortgage on, a principal residence.

Exceptions. The abovementioned early retirement exception to the early withdrawal penalty (item 4) does not apply for *IRAs*. Also, in-service withdrawals for financial hardship are not applicable to *IRAs* since IRAs are not employer plans.

However, three exceptions do apply to *IRAs*. Withdrawals from IRAs, including Roth IRAs, are not subject to the 10% early withdrawal tax if the funds are used to: (1) pay higher education expenses, (2) purchase a primary residence; or (3) pay for health insurance premiums after receiving unemployment benefits for at least 12 weeks. The home purchase exception is restricted to accountholders who have not owned a residence in the prior 2 years. The amount that may be withdrawn penalty-free for a home purchase is subject to a lifetime limit of $10,000.

Withdrawals from a *§457 plan* are permitted upon separation from employment, attainment of age 70½, "unforeseeable emergencies," or death. The early-withdrawal excise tax does not apply to §457 plans.

Early withdrawals from a *SIMPLE retirement account* are subject to a 25% excise tax if made within the accountholder's first 2 years of plan participation.

Required Minimum Distributions. To avoid tax penalties for late withdrawal, withdrawals must begin after the later of (1) attainment of age 70½, or (2) retirement from covered employment.[26] The required beginning date, when age is the controlling factor, is on or before the 1st of April following the calendar year in which age 70½ is attained. The amount of the required annual distribution is determined based on life expectancy using actuarial tables published by the IRS. The required minimum distribution applies to each affected account. An individual with multiple IRAs must calculate the required distribution based on all IRAs held but may make the actual withdrawal from only one of the IRAs.

On April17, 2002, the IRS issued final and temporary rules that simplify the process of determining the required minimum distribution from qualified plans and IRAs beginning as early as 2001. Similar rules for §457 plans were proposed May 8, 2002. These rules provide that all taxpayers can use the same table to receive distributions based on their life expectancy and that of a beneficiary. The table is based on an age differential between accountholder and beneficiary of 10 years. An exception is made where the beneficiary is a spouse who is more than 10 years younger. In this case, the accountholder may use the longer distribution period of their joint or last-survivor life expectancy.

Exceptions. Age 70½ is still the sole criterion for required minimum distributions from *IRAs*. However, there is no required minimum distribution from a *Roth IRA*. Required minimum distributions from *§403(b) plans* can be delayed until age 75 for pre-1987 contributions and investment earnings.

[26] The retirement date option was instituted by P.L. 100-647 for participants in governmental §457 plans and church plans (§457 or §403(b) plans) and by P.L. 104-188 for participants in other types of employer-sponsored plans.

Tax Treatment of Withdrawals

Withdrawals of untaxed funds from tax-deferred accounts, unless in the form of a loan or rollover, are taxable when received. However, a number of special situations require further explanation.

General Rules. Amounts withdrawn from salary reduction plans that were contributed or acquired on a tax-deferred basis are subject to the federal income tax in the year the funds are received. Withdrawals are not subject to FICA or FUTA taxes, however. If a plan holds funds that were taxed when contributed (i.e., after-tax contributions), the percentage of the withdrawn amounts that is subject to tax is equal to the percentage that the tax-deferred funds comprise of the account's total assets. For example, if 10% of an individual's vested assets were from after-tax contributions, only 90% of each withdrawal would be subject to the income tax. When funds are withdrawn from a traditional IRA, the tax status is determined according to the tax status of all the individual's traditional IRAs, not just the status of the IRA from which the funds were actually taken.

The pro rata approach to taxation applies regardless of the status of the contributions actually being withdrawn. That is, withdrawals of funds that were identified originally as after-tax contributions are still treated for tax purposes as if they were withdrawn from the larger pool of after-tax and before-tax contributions. This procedure does not change the total amount of taxable income; it simply speeds up the time of taxation by denying the individual control over when taxable amounts are used as income.

Exceptions. Withdrawals from a *Roth IRA* are not subject to the general rule for taxation of retirement distributions. A Roth IRA withdrawal is assumed to come first from contributions until all contributions have been withdrawn. Since contributions to a Roth IRA have already been taxed, these initial withdrawals are tax free, even if the accountholder does not meet the criteria that determine when withdrawals from a Roth IRA generally are tax free. Those criteria do determine when withdrawals of *investment earnings* from a Roth IRA are tax free, however. To withdraw investment earnings from a Roth IRA tax free, the initial investment must have been made for a tax year at least 5 years earlier, and at least one of the following conditions must exist: (1) the accountholder has attained age 59½; (2) the accountholder is deceased or disabled; or (3) the funds will be used to purchase a primary residence by an accountholder who has not had ownership interest in a home for the prior 2 years.

Early Withdrawals. Taxable withdrawals before age 59½, unless covered by the exceptions listed earlier in the section on *Annuities and Cash Withdrawals*, are subject to an excise tax for early withdrawal. This tax, 10% of the amount of taxable funds withdrawn, is in addition to the regular income tax liability.

Exceptions. The 10% penalty tax does not apply to withdrawals from *§457 plans* unless the amount withdrawn had been rolled over from another type of retirement plan. The 10% penalty tax does apply to early withdrawals from *SIMPLE retirement accounts*, but the tax is higher (25%) on early withdrawals by SIMPLE accountholders who have been plan participants for less than 2 years.

Late Withdrawals. An excise tax is applied for late withdrawals. A late withdrawal is one that is deficient compared to the required minimum distribution. (See the preceding section on *Required Minimum Distributions.*) The excise tax for a late withdrawal is 50% of the amount of the deficiency.

Large Distributions. The excise tax for large distributions is no longer in force. It was waived for 3 years (1997-1999) by P.L. 104-188 and was repealed permanently by P.L. 105-34. Prior to 1997, a 15% excise tax had been levied for "excessive" distributions. This tax was applied to the excess distributions of an individual who received periodic payments from all plans (excluding §457 plans) that summed to more than $155,000 yearly in 1996 (indexed for inflation in $5,000 intervals). (The history of these limits is shown in **Table 8**.) A lump-sum distribution had been regarded as excessive if it were greater than $775,000 in 1996 (or five times the threshold for an excessive annual distribution).

Income Averaging. The 1986 Tax Reform Act phases out the practice of 10-year averaging of lump-sum distributions for tax purposes. Under 10-year averaging, the distribution is treated as if spread out over each of 10 years, beginning with the year of actual receipt. The 1986 Act allows persons already over age 50 on January 1, 1986, to elect 10-year averaging, but they must use the higher income tax rates that were in effect before the Tax Reform Act of 1986 took effect. The 1986 Act also ended the option to treat a distribution as a receipt of capital gains under the pre-1974 capital gains tax rules. Such treatment was phased out over the period 1987-1992.

For taxpayers denied 10-year averaging by the 1986 Act, the law had allowed 5-year averaging using post-1986 tax rates. However, 5-year averaging was ended in 2000 by P.L. 104-188.

Table 8. Thresholds Above Which Plan Distributions Were Subject to Excise Tax on Large Distributions, 1987-1997

Year	Annual threshold
1987	$112,500
1988	117,529
1989	122,580
1990	128,228
1991	136,204
1992	140,276
1993	144,551
1994	148,500
1995	150,000
1996	155,000
1997	160,000[a]

[a]The excise tax on large distributions was waived for 1997-1999 by P.L. 104-188 and repealed by P.L. 105-34 for all subsequent years.

Appendix A: Comparison of Federal Rules for Retirement Plans by Plan Type

This appendix provides a series of six tables comparing the federal rules for different types of retirement plans. This comparison covers the plan types analyzed in this report and three other types of employer plans: money purchase plans, in which the employer purchases securities on behalf of each covered employee on a periodic basis; profit-sharing plans, in which the employer allocates a percentage of annual profits to each employee; and defined benefit (DB) plans, which promise each covered employee that a benefit based on salary and/or tenure will be paid at retirement age from a pension fund.

The rules presented in these tables are federal *limits* on how plans can be designed. There is no mandate that employers offer plans, and plans often have flexibility within the federal rules to set specific limits with respect to such factors as retirement age, benefit level, and contribution rate.

Some complications in plan rules were omitted in order to keep this comparison in a compact format. For example, rules variations associated with a plan sponsor's being self-employed are not identified.

Table A-1. Eligibility Rules by Retirement Plan Type

Plan type	Employer eligibility	Extent of workforce coverage required	Employee eligibility
Traditional IRA	Not applicable	Not applicable	All employed individuals and their spouses
Roth IRA	Not applicable	Not applicable	All employed individuals and their spouses with AGI less than $110,000 (single filers) or $160,000 (joint filers)
SEP IRA	Any employer	100% of nonexcludible employees	Plan may exclude: (1) those under age 21; (2) those who worked for firm in less than 3 of last 5 years; (3) those earning less than $450 in last year; (4) members of bargaining unit; (5) nonresident aliens with no U.S. income
SARSEP IRA	Those with 25 or fewer eligible employees; a SARSEP cannot be started after December 31, 1996	At least 50% of eligible employees must defer salary	Plan may exclude: (1) those under age 21; (2) those who worked for firm in less than 3 of last 5 years; (3) those earning less than $450 in last year; (4) members of bargaining unit; (5) nonresident aliens with no U.S. income
SIMPLE IRA	Those with 100 or fewer employees earning at least $5,000; cannot offer another plan	100% of nonexcludible employees	Plan may exclude: (1) those earning less than $5,000 in each of 2 prior years and current year; (2) members of bargaining unit; (3) nonresident aliens with no U.S. income
§401(k)	Any nongovernmental employer; government plans limited to those adopted before May 6, 1986 and certain irrigation and drainage entities	Plan must benefit at least 70% of employees who are not highly compensated, or meet one of two other tests	Plan may exclude employees: (1) until later of attaining age 21 or completing 1 year of service; (2) who are members of bargaining unit; (3) who are nonresident aliens with no U.S. income Educational organizations may exclude employees until later of age 26 or 1 year of service if benefits fully vested after 1 year

Plan type	Employer eligibility	Extent of workforce coverage required	Employee eligibility
SIMPLE §401(k)	Nongovernmental employers with 100 or fewer employees earning at least $5,000; cannot offer another plan to employees covered by SIMPLE §401(k)	100% of nonexcludible employees	Plan may exclude: (1) those earning less than $5,000 in each of 2 prior years and current year; (2) members of bargaining unit; (3) nonresident aliens with no U.S. income Educational organizations may exclude employees until later of age 26 or 1 year of service if benefits fully vested after 1 year
Federal Thrift Savings	U.S. government	All employees in groups specified in law; federal agencies must contribute to accounts of all employees covered by FERS[a]	All civilian and military employees in groups specified in law; employees under CSRS[a] ineligible for employer contributions; only select military groups eligible for employer contributions
§403(b)	Religious, charitable, educational, research, and cultural organizations in the state and local government and nonprofit sectors	Plan must benefit at least 70% of employees who are not highly compensated, or meet one of two other tests	Plan may exclude employees: (1) who participate in §457 plan, §401(k) plan, or another §403(b) plan of employer; (2) who are in bargaining unit; (3) who are nonresident aliens with no U.S. income; (4) who are students in the sponsoring institution and work less than 20 hours a week Educational organizations may exclude employees until later of age 26 or 1 year of service if benefits fully vested after 1 year Eligibility in church plans determined by sponsor
§457	State and local government agencies, nonprofit organizations	No minimum federal requirement, but nonprofits can cover only selected groups	Eligibility determined by sponsor
Money purchase	Any employer	Plan must benefit at least 70% of employees who are not highly compensated, or meet one of two other tests	Plan may exclude employees: (1) until later of attaining age 21 or completing 1 year of service (2 years if benefits fully vested at that time); (2) who are members of bargaining unit; (3) who are nonresident aliens with no U.S. income Educational organizations may exclude employees until later of age 26 or 1 year of service if benefits fully vested after 1 year

Plan type	Employer eligibility	Extent of workforce coverage required	Employee eligibility
Profit-sharing	Any private-sector employer	Plan must benefit at least 70% of employees who are not highly compensated, or meet one of two other tests	Plan may exclude employees: (1) until later of attaining age 21 or completing 1 year of service (2 years if benefits fully vested at that time); (2) who are members of bargaining unit; (3) who are nonresident aliens with no U.S. income Educational organizations may exclude employees until later of age 26 or 1 year of service if benefits fully vested after 1 year
Private-sector defined benefit	Any private-sector employer[b]	Plan must benefit at least 70% of employees who are not highly compensated, or meet one of two other tests	Plan may exclude employees: (1) until later of attaining age 21 or completing 1 year of service (2 years if benefits fully vested at that time); (2) who are members of bargaining unit; (3) who are nonresident aliens with no U.S. income Educational organizations may exclude employees until later of age 26 or 1 year of service if benefits fully vested after 1 year

[a] CSRS, the Civil Service Retirement System, was replaced for employees hired after 1983 by FERS, the Federal Employees' Retirement System. The Thrift Savings Plan (TSP) was designed to be an integral part of the retirement benefit for post-1983 hires, along with the FERS DB plan and Social Security. Military personnel became eligible to participate in TSP in 2002.

[b] Governmental employers also sponsor defined benefit (DB) plans. However, most federal rules for DB plans do not apply to governmental plans.

Table A-2. Rules for Employee Contributions by Retirement Plan Type

Plan Type	Annual limit on employee tax-deferred contributions [a]	Annual limit on employee after-tax contributions	Nondiscrimination test for employee salary deferrals
Traditional IRA	$3,000 if employee (and spouse)[b] are not covered by an employer plan or if AGI does not exceed $40,000 (single filers) or $60,000 (joint filers); limit declines to $0 over next $10,000 of AGI;[c] limit is $0 for persons over age 70½; $500 "catch-up" contribution allowed if age 50 or older	$3,000 ($3,500 if "catch-up" contribution applies) minus allowable pre-tax contributions; same limit applies to employee's nonworking spouse	Not applicable
Roth IRA	Tax-deferred contributions not allowed	$3,000[b] if AGI does not exceed $95,000 (single filers) or $150,000 (joint filers); limit declines to $0 over next $15,000 of AGI for single filers (next $10,000 for joint filers); $500 "catch-up" contribution allowed if age 50 or older	Not applicable
SEP IRA	Employee contributions not allowed	Employee contributions not allowed	Not applicable
SARSEP IRA	$12,000 (indexed in $500 increments[d]); $2,000 "catch-up" contribution allowed if age 50 or older	After-tax employee contributions not allowed	Actual deferral percentage (ADP) of highly compensated employees cannot exceed ADP for other employees by more than lesser of: (1) 100% of the nonhighly compensated group's ADP; or (2) greater of (a) 2 percentage points, or (b) 25% of nonhighly compensated group's ADP; this test also applies to employer matching contributions
SIMPLE IRA	$8,000 (indexed in $500 increments[d]); $1,000 "catch-up" contribution allowed if age 50 or older	After-tax employee contributions not allowed	Exempt from test

Plan Type	Annual limit on employee tax-deferred contributions [a]	Annual limit on employee after-tax contributions	Nondiscrimination test for employee salary deferrals
§401(k)	$12,000 (indexed in $500 increments[d]); $2,000 "catch-up" contribution allowed if age 50 or older	After-tax employee contributions not allowed	Actual deferral percentage (ADP) of highly compensated employees cannot exceed ADP for other employees by more than lesser of: (1) 100% of the nonhighly compensated group's ADP; or (2) greater of (a) 2 percentage points, or (b) 25% of nonhighly compensated group's ADP; this test also applies to employer matching contributions[e]
SIMPLE §401(k)	$8,000 (indexed in $500 increments[d]); $1,000 "catch-up" contribution allowed if age 50 or older	After-tax employee contributions not allowed	Deemed to satisfy §401(k) test
Federal Thrift Savings	Lesser of $12,000 (indexed in $500 increments[d]) or 13% of pay (8% of pay under CSRS)[f]	After-tax employee contributions not allowed	None; §401(k) test waived by P.L. 100-202
§403(b)	$12,000 (indexed in $500 increments[d]); catch-up deferrals allowed up to $3,000 a year, $15,000 lifetime, for those with over 15 years of service and whose past deferrals do not exceed $5,000 times years of service; $2,000 "catch-up" contribution allowed if age 50 or older	After-tax employee contributions not allowed	No test for employee salary deferrals, but the §401(k) test does apply to employer matching contributions[e]
§457	$12,000 (indexed in $500 increments[d]); catch-up deferrals allowed up to twice the amount otherwise allowed in last 3 years before retirement; $2,000 "catch-up" contribution allowed if age 50 or older	After-tax employee contributions not allowed	Not applicable
Money purchase	Tax-deferred employee contributions not allowed	Not applicable	Not applicable
Profit-sharing	Tax-deferred employee contributions not allowed[g]	Not applicable[g]	Not applicable
Private-sector defined benefit	Tax-deferred employee contributions not allowed	After-tax employee contributions allowed; no limit specified in federal law	Not applicable

[a]Effective in 2002, P.L. 107-16 authorizes nonrefundable tax credits, in addition to tax deferrals, for contributions to IRAs and employer plans made by tax filers with AGI less than $25,000 (single), $37,500 (head of household), or $50,000 (joint).

[b] A nonworking spouse can also contribute $3,000, but the couple's combined contributions cannot exceed their combined earnings. A spouse's participation in an employer plan does not disqualify an individual from making a deductible contribution, but the maximum deductible contribution is phased out as the couple's joint AGI rises from $150,000 to $160,000.

[c] The $10,000 phase-out range begins at $40,000 and $60,000 for 2003, at $45,000 and $65,000 for 2004, at $50,000 and $70,000 for 2005, at $50,000 and $75,000 for 2006, and at $50,000 and $80,000 for 2007 and thereafter. The phase-out interval remains at $10,000 until 2007, when it will increase to $20,000 for joint filers.

[d] When an amount is said to be "indexed in increments," the indexed amount remains unchanged until inflation adjustments exceed the specified increment, at which time the indexed figure rises by the amount of the increment. For example, the §401(k) salary deferral limit rose from $10,000 to $10,500 in 2000 because of 2 years of cumulative inflation adjustments to the $10,000 ceiling. P.L. 107-16 overrides inflation indexing for 2002 and several years thereafter because of statutory increases set forth in that law.

[e] A provision of P.L. 104-188, effective in 1999, deems the nondiscrimination test to be met for §401(k) plans and §403(b) plans that comply with a "safe harbor" design in regard to the level of employer contributions.

[f]The FERS and CSRS contribution limits rose to 11% and 6%, respectively, in July 2001 (from the original 10% and 5%), to 12% and 7% in January 2002, and rise by one percentage point annually thereafter until they reach 15% and 10%. In 2006, these percentage limits will be abolished.

[g] In a conventional profit-sharing plan, the employer makes all the contributions. Voluntary after-tax employee contributions are sometimes permitted by profit-sharing plans. In this case, the plan would be termed a profit-sharing *thrift* plan.

Table A-3. Employer Contribution Rules by Retirement Plan Type

Plan Type	Annual limit on employer contributions[a]	Is year-to-year flexibility allowed in employer contributions?	Vesting requirements for employer contributions	Employer plan funding requirements
Traditional IRA	No employer contribution	Not applicable	Not applicable	Not applicable
Roth IRA	No employer contribution	Not applicable	Not applicable	Not applicable
SEP IRA	Lesser of 25% of pay or $40,000 (indexed in $1,000 increments)	Yes	Immediate	Contributions and investment earnings held in IRAs
SARSEP IRA	Lesser of 25% of pay or $40,000 (indexed in $1,000 increments)	Yes	Immediate	Contributions and investment earnings held in IRAs
SIMPLE IRA	Employer must contribute according to one of two formulas: (1) 2% of pay; (2) 100% match of employee deferrals up to 3% of pay	Matching rate can apply to as little as 1% of pay, but must apply to 3% of pay at least 3 out of every 5 years	Immediate	Contributions and investment earnings held in IRAs
§401(k)	$40,000 (indexed in $1,000 increments), minus employee's deferral amount	Yes, if §401(k) is part of a profit-sharing or stock bonus plan	ERISA rules[b]	Contributions and investment earnings held in individual trust fund accounts
SIMPLE §401(k)	Employer must contribute according to one of two formulas: (1) 2% of pay; (2) 100% match of employee deferrals up to 3% of pay	Yes, if §401(k) is part of a profit-sharing or stock bonus plan	Immediate	Contributions and investment earnings held in individual trust fund accounts
Federal Thrift Savings	Employer must contribute 1% of pay to each FERS employee's account and match employee salary deferrals at rate of 100% for first 3% of pay plus 50% for next 2% of pay, yielding a maximum employer contribution of 5% of pay; employer cannot contribute to CSRS employees' accounts; selected military personnel are eligible for employer contributions	No	Immediate for federal matching; 3 years for automatic 1% federal contribution (2 years for some noncareer employees)	Contributions and investment earnings held in individual trust fund accounts

Plan Type	Annual limit on employer contributions[a]	Is year-to-year flexibility allowed in employer contributions?	Vesting requirements for employer contributions	Employer plan funding requirements
§403(b)	$40,000 (indexed in $1,000 increments), minus employee's deferral amount	No	Immediate except for failure to pay premiums	Contributions fund individual annuities or may be invested in custodial trust fund accounts
§457	$12,000 less employee's deferral amount	Yes	Immediate	In nonprofit plans, funds held by employer; in state/local plans, contributions and investment earnings held in individual trust fund accounts
Money purchase	$40,000 (indexed in $1,000 increments)	No	ERISA rules[b]	Minimum funding requirements apply; contributions are made according to a fixed formula
Profit-sharing	Aggregate amount cannot exceed 25%[c] of compensation of all employees; also limited to $40,000 (indexed in $1,000 increments)	Yes	ERISA rules[b]	Contributions set by plan sponsor, do not have to be from current profits; minimum funding requirements do not apply
Private-sector defined benefit	Employer must contribute enough to avoid negative balance in *funding standard account*; may not exceed *full funding limit*[d]	Yes, within a minimum/maximum range	ERISA rules[b]	Determined by ERISA and tax code;[e] must fund benefits earned each year and amortize any past unfunded liabilities over 30-40 years

[a] The annual employee pay upon which employer contributions can be based is limited to $200,000 in 2003 (indexed in $5,000 increments). Limits on employer contributions apply to employee salary deferrals as well, because these deferrals are considered in the tax code to be contributions made by employers at the behest of employee elections to defer current receipt of a part of pay. This column identifies the employer limit net of the employee's deferral amount.

[b] ERISA and the tax code require that employer contributions be fully vested after completion of 3 years of service, or after 6 years if vested in steps of 20% beginning after 2 years of service.

[c] This limit was changed to 25% from 15% effective in 2002 by P.L. 107-16.

[d] P.L. 107-16 repeals the full funding limit effective in 2004.

[e] ERISA and the tax code set rules for the funding of defined benefit (DB) pension liabilities. DB plans must establish a *funding standard account* to which charges and credits are made. Plans must fund pension benefits earned each year (*normal cost*) and amortize past service liabilities over 30 to 40 years. Actuarial gains and losses must be amortized over 5 years and changes in actuarial assumptions over 10 years. An additional funding requirement (*deficit reduction contribution*) applies to plans that are less than 90% funded. The funding standard account provides employers with some funding flexibility.

Table A-4. Nondiscrimination and Integration Rules by Retirement Plan Type

Plan Type	Nondiscrimination rules[a]	Social security integration[b]	Rules for top-heavy plans[c]
Traditional IRA	Not applicable	Not applicable	Not applicable
Roth IRA	Not applicable	Not applicable	Not applicable
SEP IRA	Not applicable	Difference in contribution rates above and below Social Security taxable wage base cannot exceed 5.7 percentage points	Applicable
SARSEP IRA	Applies to employer matching contributions	Not allowed	Applicable
SIMPLE IRA	Not applicable	Not allowed	Exempt
§401(k)	Cannot discriminate among employees in regard to benefit availability, rights, or features	Not allowed	Applicable
SIMPLE §401(k)	Cannot discriminate among employees in regard to benefit availability, rights, or features	Not allowed	Exempt
Federal Thrift Savings	Not applicable	Not allowed	Exempt
§403(b)	Cannot discriminate among employees in regard to benefit availability, rights, or features	Difference in contribution rates above and below Social Security taxable wage base cannot exceed 5.7 percentage points	Applicable
§457	Not applicable	Not applicable	Not applicable
Money purchase	Cannot discriminate among employees in regard to benefit availability, rights, or features	Difference in contribution rates above and below Social Security taxable wage base cannot exceed 5.7 percentage points	Applicable

Plan Type	Nondiscrimination rules[a]	Social security integration[b]	Rules for top-heavy plans[c]
Profit-sharing	Cannot discriminate among employees in regard to benefit availability, rights, or features; allocation of employer contributions cannot favor highly compensated employees	Difference in contribution rates above and below Social Security taxable wage base cannot exceed 5.7 percentage points	Applicable
Private-sector defined benefit	Cannot discriminate among employees in regard to benefit availability, rights, or features; plan must benefit at least the lesser of: (1) 50 employees, or (2) the greater of (a) 40% of all employees, or (b) 2 employees	*Offset plan* cannot reduce pension below half of accrued benefit; difference in accrual rates above and below Social Security wage base cannot exceed 0.75 percentage point in *excess plan*	Applicable

[a] This column presents the nondiscrimination rules that apply to employer-provided benefits. Nondiscrimination testing of salary deferrals is displayed in **Table A-2**.

[b] If an employer takes Social Security benefits explicitly into account in designing a retirement plan, the plan is said to be *integrated*. Since Social Security benefits favor lower-paid workers, the tax code permits employer-sponsored benefits to favor higher-paid workers, so long as the benefits in combination with Social Security are *nondiscriminatory*.

[c] A top-heavy defined contribution plan is one in which the accounts of key employees hold more than 60% of the plan's total assets. A top-heavy defined benefit plan is one in which the present value of accrued benefits for key employees exceeds 60% of the present value of all accrued benefits. Top-heavy plans are required to provide employer contributions for non-key employees at least as great as the lesser of: (1) 3% of pay; or (2) the rate provided for key employees. These rules apply only in years in which a plan meets the top-heavy criteria.

Table A-5. Plan Distribution Rules by Retirement Plan Type[a]

Plan Type	Excise tax on early withdrawals	Excise tax on late withdrawals	In-service withdrawals	Rollover options	Loan availability
Traditional IRA	10% of taxable amount withdrawn before age 59½ unless exception[b] applies	50% of amount by which withdrawal falls short of minimum required distribution[c] after age 70½	Allowed	Once a year to another traditional IRA; can be converted to Roth IRA by payment of tax on tax-deferred amounts by accountholders with AGI of less than $100,000; to employer plan that accepts rollovers	None
Roth IRA	10% of amounts taxed upon conversion or investment earnings withdrawn before age 59½ unless exception[b] applies	None	Allowed	Once a year to another Roth IRA	None
SEP IRA	10% of taxable amount withdrawn before age 59½ unless exception[b] applies	50% of amount by which withdrawal falls short of minimum required distribution[c] after age 70½	Allowed	To another SEP IRA or traditional IRA; can be converted to Roth IRA	None
SARSEP IRA	10% of taxable amount withdrawn before age 59½ unless exception[b] applies	50% of amount by which withdrawal falls short of minimum required distribution[c] after age 70½	Allowed	To another SARSEP IRA or traditional IRA; can be converted to Roth IRA	None
SIMPLE IRA	10% of taxable amount withdrawn before age 59½ unless exception[b] applies; penalty is 25% if withdrawal is within first 2 years of SIMPLE participation	50% of amount by which withdrawal falls short of minimum required distribution[c] after age 70½	Allowed	To another SIMPLE IRA or traditional IRA (if in SIMPLE at least 2 years); can be converted to Roth IRA	None

Plan Type	Excise tax on early withdrawals	Excise tax on late withdrawals	In-service withdrawals	Rollover options	Loan availability
§401(k)	10% of taxable amount withdrawn before age 59½ unless exception[d] applies	50% of amount by which withdrawal falls short of minimum required distribution[c] after later of age 70½ or retirement	Allowed after age 59½, earlier in case of financial hardship	To an employer plan that accepts rollovers or to traditional IRA	Limited to the lesser of (1) $50,000 or (2) the greater of (a) 50% of vested amount or (b) $10,000
SIMPLE §401(k)	10% of taxable amount withdrawn before age 59½ unless exception[d] applies	50% of amount by which withdrawal falls short of minimum required distribution[c] after later of age 70½ or retirement	Allowed after age 59½, earlier in case of financial hardship	To an employer plan that accepts rollovers or to traditional IRA	Limited to the lesser of (1) $50,000 or (2) the greater of (a) 50% of vested amount or (b) $10,000
Federal Thrift Savings	10% of taxable amount withdrawn before age 59½ unless exception[d] applies	50% of amount by which withdrawal falls short of minimum required distribution[c] after later of age 70½ or retirement	Allowed in case of financial hardship; one-time withdrawal allowed by employees after age 59½	To an employer plan that accepts rollovers or to traditional IRA	Limited to sum of employee's contributions plus related investment earnings; also limited to lesser of (1) $50,000 or (2) the greater of (a) 50% of vested amount or (b) $10,000
§403(b)	10% of taxable amount withdrawn before age 59½ unless exception[d] applies	50% of amount by which withdrawal falls short of minimum required distribution[c] after later of age 70½ or retirement; minimum required distribution of §403(b) assets acquired before 1987 can be delayed to age 75	Allowed after age 59½, earlier in case of financial hardship	To employer plan that accepts rollovers or to traditional IRA	Limited to the lesser of (1) $50,000 or (2) the greater of (a) 50% of vested amount or (b) $10,000
§457	No excise tax; withdrawals allowed only in event of job separation, attainment of age 70½, financial emergency, or death	50% of amount by which withdrawal falls short of minimum required distribution[c] after later of age 70½ or retirement	Allowed after age 70½, earlier for emergencies	To employer plan that accepts rollovers or to traditional IRA	Not allowed in nonprofit plans; in state/local plans, allowed up to lesser of (1) $50,000 or (2) greater of (a) 50% of vested amount or (b) $10,000

Plan Type	Excise tax on early withdrawals	Excise tax on late withdrawals	In-service withdrawals	Rollover options	Loan availability
Money purchase	10% of taxable amount withdrawn before age 59½ unless exception[d] applies	None; plan must start distributions after later of age 70½ or retirement	Allowed	To an employer plan that accepts rollovers or to traditional IRA	Limited to the lesser of (1) $50,000 or (2) the greater of (a) 50% of vested amount or (b) $10,000
Profit-sharing	10% of taxable amount withdrawn before age 59½ unless exception[d] applies	None; plan must start distributions after later of age 70½ or retirement	Allowed for assets held in plan at least 2 years	To an employer plan that accepts rollovers or to traditional IRA	Limited to the lesser of (1) $50,000 or (2) the greater of (a) 50% of vested amount or (b) $10,000
Private-sector defined benefit	10% of taxable amount withdrawn before age 59½ unless exception[d] applies	None; plan must start distributions after later of age 70½ or retirement	Not allowed	To an employer plan that accepts rollovers or to traditional IRA	Limited to the lesser of (1) $50,000 or (2) the greater of (a) 50% of vested amount or (b) $10,000

[a] Generally, retirement income is subject to the federal income tax upon receipt, but only to the extent that the funds have not been taxed previously. If income is received from an account or plan that includes both taxed and untaxed funds, the income tax applies to the same proportion of the income as untaxed funds make up of the total retirement asset.

[b] The exceptions are: death, disability, withdrawal in the form of a life annuity, higher education expenses, up to $10,000 for a qualified home purchase, payment of medical expenses in excess of 7.5% of AGI, or payment of health insurance premiums after receiving unemployment benefits for at least 12 weeks. Withdrawals from a Roth IRA are presumed to come first from contributions, which are not taxed when withdrawn and thus are not subject to this 10% penalty.

[c] The minimum required annual distribution must be enough to use up the asset over the accountholder's lifetime (and that of a beneficiary deemed to be 10 years younger).

[d] The exceptions are: death, disability, retirement under an early retirement provision after attainment of age 55, withdrawal in the form of a life annuity, or payment of medical expenses in excess of 7.5% of AGI.

Table A-6. Rules[a] for Reporting, Disclosure, Fiduciary Responsibility and Allowable Investments by Retirement Plan Type

Plan Type	Required reporting by plan to federal agencies	Required disclosure by plan to participants	Requirements on plan fiduciaries	Prohibited investments
Traditional IRA	Distributions reported to IRS on Form 1099-R; contributions and account balances reported to IRS on Form 5498	Distributions reported to accountholder on Form 1099-R; contributions and account balances reported to accountholder on Form 5498	Exempt from ERISA rules[b]	Art, antiques, and other collectibles (except certain precious metals); penalty for prohibited transactions[c]
Roth IRA	Distributions reported to IRS on Form 1099-R; contributions and account balances reported to IRS on Form 5498	Distributions reported to accountholder on Form 1099-R; contributions and account balances reported to accountholder on Form 5498	Exempt from ERISA rules[b]	Art, antiques, and other collectibles (except certain precious metals); penalty for prohibited transactions[c]
SEP IRA	Distributions reported to IRS on Form 1099-R; contributions and account balances reported to IRS on Form 5498 Plan data reported to IRS on Form 5500 unless plan begun as *model plan*	Distributions reported to accountholder on Form 1099-R; contributions and account balances reported to accountholder on Form 5498 Simplified version of ERISA disclosure rules[d] also applies	ERISA rules apply[b]	Art, antiques, and other collectibles (except certain precious metals); penalty for prohibited transactions[c]
SARSEP IRA	Distributions reported to IRS on Form 1099-R; contributions and account balances reported to IRS on Form 5498 Plan data reported to IRS on Form 5500 unless plan begun as *model plan*	Distributions reported to accountholder on Form 1099-R; contributions and account balances reported to accountholder on Form 5498 Simplified version of ERISA disclosure rules[d] also applies	ERISA rules apply[b]	Art, antiques, and other collectibles (except certain precious metals); penalty for prohibited transactions[c]

Plan Type	Required reporting by plan to federal agencies	Required disclosure by plan to participants	Requirements on plan fiduciaries	Prohibited investments
SIMPLE IRA	Distributions reported to IRS on Form 1099-R; contributions and account balances reported to IRS on Form 5498	Distributions reported to accountholder on Form 1099-R; contributions and account balances reported to account-holder on Form 5498 Amended ERISA rules also apply: trustee must provide annual plan summary; employer must give plan description to eligibles and notify them of chance to elect participation	Employer relieved of fiduciary liability for losses related to participant control of assets, which occurs at earliest of: (1) choice among investment options; (2) rollover of funds to another account; (3) completion of 1 year in plan	Art, antiques, and other collectibles (except certain precious metals); penalty for prohibited transactions[c]
§401(k)	Distributions reported to IRS on Form 1099-R; contributions and account balances reported to IRS on Form 5498 Plan data reported to IRS on Form 5500; simplified reporting applies for plans with less than 100 participants	Distributions reported to participants on Form 1099-R ERISA rules also apply[d]	ERISA rules apply[b]	Investments in securities or real property of the employer of deferrals in excess of 1% of pay cannot exceed 10% of total deferral unless individual chooses; penalty for prohibited transactions[c]
SIMPLE §401(k)	Distributions reported to IRS on Form 1099-R; contributions and account balances reported to IRS on Form 5498 Plan data reported to IRS on Form 5500; simplified reporting applies for plans with less than 100 participants	Distributions reported to participants on Form 1099-R ERISA rules also apply[d]	ERISA rules apply[b]	Investments in securities or real property of the employer of deferrals in excess of 1% of pay cannot exceed 10% of total deferral unless individual chooses; penalty for prohibited transactions[c]
Federal Thrift Savings	Distributions reported to IRS on Form 1099-R	Transactions and account balances reported to participants semi-annually; plan summary provided by agencies to employees when plan changes	Rules set forth in USC Title 5, Section 8477	Investment limited to five funds established by law

Plan Type	Required reporting by plan to federal agencies	Required disclosure by plan to participants	Requirements on plan fiduciaries	Prohibited investments
§403(b)	Distributions reported to IRS on Form 1099-R; contributions and account balances reported to IRS on Form 5498 Plan data reported to IRS on Form 5500; simplified reporting applies for plans with less than 100 participants	Distributions reported to participants on Form 1099-R ERISA rules also apply[d]	ERISA rules apply[b]	Penalty for prohibited transactions[c]
§457	Distributions reported to IRS on Form 1099-R	Distributions reported to participants on Form 1099-R or W-2	None[e]	None[e]
Money purchase	Distributions reported to IRS on Form 1099-R Plan data reported to IRS on Form 5500; simplified reporting applies for plans with less than 100 participants	Distributions reported to participants on Form 1099-R ERISA rules also apply[d]	ERISA rules apply[b]	Penalty for prohibited transactions[c]
Profit-sharing	Distributions reported to IRS on Form 1099-R Plan data reported to IRS on Form 5500; simplified reporting applies for plans with less than 100 participants	Distributions reported to participants on Form 1099-R ERISA rules also apply[d]	ERISA rules apply[b]	Penalty for prohibited transactions[c]
Private-sector defined benefit	Distributions reported to IRS on Form 1099-R Plan data reported to IRS on Form 5500; simplified reporting applies for plans with less than 100 participants	Distributions reported to participants on Form 1099-R ERISA rules also apply[d]	ERISA rules apply[b]	Penalty for prohibited transactions;[c] investment in employer's securities or real property cannot exceed 10% of plan assets

[a] In addition to the requirements shown in this table, the financial institutions that invest plan assets also must file reports to comply with federal and state laws regulating banks, brokerage firms, and insurance companies.
[b] ERISA requires that plan fiduciaries act prudently and solely in the interests of plan participants and beneficiaries.
[c] Prohibited transactions involve the sale or transfer of assets between a participant, plan sponsor, or fiduciary and another interested party (e.g., family members, plan service providers). The penalty is an excise tax, raised to 15% from 10% by P.L. 105-34.
[d] Each participant must be furnished with a summary plan description and a summary annual financial report.
[e] Though federal laws on disclosure, fiduciary standards, and investment policy do not apply to §457 plans, state laws may apply.

Appendix B: Abbreviations Used in This Report

ADP. Actual deferral percentage, a measure used in the nondiscrimination test for §401(k) and §403(b) plans.

AGI. Adjusted gross income.

CRS. Congressional Research Service.

CSRS. Civil Service Retirement System.

DB. A defined benefit pension plan, which promises participants future benefits based on tenure and salary and holds invested assets in a central fund to cover the promised benefits.

DC. A defined contribution plan, which accrues contributed funds and investment earnings in individual accounts for each participant. The assets in an individual's account become the vested property of the participant for use in retirement.

DoL. U.S. Department of Labor.

ERISA. Employee Retirement Income Security Act of 1974 (P.L. 93-406).

FERS. Federal Employees' Retirement System.

FICA. Federal Insurance Contributions Act, which authorizes collection of the federal payroll tax that funds Social Security and Medicare.

FUTA. Federal Unemployment Tax Act, which authorizes collection of the federal payroll tax that funds certain activities under the federal-state Unemployment Compensation system.

GAO. U.S. General Accounting Office.

GPO. U.S. Government Printing Office.

IRA. Individual retirement account.

IRS. U.S. Internal Revenue Service.

PWBA. Pension and Welfare Benefits Administration, former name of the division of the U.S. Department of Labor that has enforcement responsibilities under ERISA.

SARSEP. A simplified employee pension plan that includes a salary reduction agreement as authorized by §408(k) of the tax code.

§**401(k) Plan.** A qualified employer retirement plan that includes a salary reduction agreement authorized by §401(k) of the tax code.

§**403(b) Plan.** A tax-deferred annuity plan authorized by §403(b) of the tax code for sponsorship by certain educational, cultural, and research organizations.

§**457 Plan.** A nonqualified deferred compensation plan authorized by §457 of the tax code for sponsorship by government and nonprofit employers.

§**501(c)(18) Plan.** A union-sponsored thrift plan granted tax-deferred status by §501(c)(18) of the tax code.

SEP. A simplified employee pension plan as authorized by §408(k) of the tax code.

SIMPLE. A savings incentive match plan for employees of small employers as authorized by §408(p) of the tax code.

TSP. The Thrift Savings Plan, a §401(k)-type plan for federal employees.

USC. United States Code.

Appendix C: Location of Statutory Provisions For Retirement Plans

Law/section number	Provisions of section
Internal Revenue Code of 1986:	
25B	Nonrefundable credit equal to portion of retirement plan contributions for taxpayers with AGI below specified levels
72(a)	Treatment of annuities as income
72(b)	Exclusion of contributions to retirement plans from income
72(c)	Definitions of certain terms used in other sections
72(h)	Lump-sum payment option
72(m)	Special rules for annuities and distributions
72(o)	Rules for deductible employee contributions
72(p)	Rules for plan loans
72(q)	Penalty for early withdrawal
72(s)	Distribution requirements upon death of accountholder
72(t)	10% early withdrawal excise tax
219	Adjustment to AGI for IRA contributions
401(a)	Rules for qualified employer retirement plans
401(b)	Retroactive plan amendments
401(c)	Rules for self-employed individuals
401(d)	Rules for owner-employee plans
401(f)	Rules for custodial accounts
401(g)	Definition of annuity
401(i)	Definition of union-negotiated qualified plan
401(k)	Rules for cash or deferred arrangements (§401(k) plans)
401(m)	Nondiscrimination test for employee salary deferral contributions and matching employer contributions
401(n)	Coordination of qualified plan rules with qualified domestic relations orders

Law/section number	Provisions of section
402(a)	Rules for rollovers
402(b)	Tax treatment of contributions to nonexempt trust
402(c)	Tax treatment of foreign pension trusts
402(e)	Tax treatment of lump-sum distributions
402(f)	Requirement for written explanation of rollovers
402(g)	Limits on §401(k) and §403(b) elective deferrals
402(h)	Limits on contributions to SEPs
402(i)	Treatment of self-employed as employees for certain purposes
403(a)	Taxation of qualified employee annuities
403(b)	Rules for tax-sheltered annuities for §501(c)(3) organizations and public schools (§403(b) plans)
403(c)	Taxation of nonqualified annuities
404	Tax treatment of employer contributions
406	Treatment of employees of foreign affiliates
407	Treatment of employees of domestic firm with foreign operations
408(a)-408(i) and 408(m)-408(o)	Rules for IRAs
408(j)-408(l)	Rules for SEPs
408(p)	Rules for SIMPLEs
408A	Rules for Roth IRAs
410	Minimum standards for plan participation
411	Minimum standards for vesting of benefits
412	Minimum funding standards
413	Rules for collectively bargained plans, multiemployer plans
414(a)	Service for predecessor employer
414(b)	Employees of controlled group of corporations
414(c)	Employees of commonly controlled partnerships and proprietorships

Law/section number	Provisions of section
414(d)	Definition of governmental plan
414(e)	Definition and treatment of church plans
414(f)	Definition of multiemployer plan
414(g)	Definition of plan administrator
414(h)	Tax treatment of contributions
414(i)	Definition of defined contribution (DC) plan
414(l)	Plan mergers and consolidations, transfers of plan assets
414(m)	Employees of affiliated service group
414(n)	Employee leasing
414(p)	Definition of qualified domestic relations order
414(q)	Definition of highly compensated employee
414(r)	Rules for separate lines of business (SLOB rules)
414(s)	Definition of compensation
415	Limits on benefits and contributions
416	Rules for top-heavy plans
417	Minimum standards for survivor annuity provisions
457	Rules for deferred compensation plans of state and local governments and tax-exempt organizations (§457 plans)
501(c)(18)	Tax exemption for certain employee pension trusts
3121	Treatment of retirement contributions by FICA tax
3306	Treatment of retirement contributions by FUTA tax
4972	Excise tax on employer for nondeductible plan contributions
4973	Excise tax on excess contributions to IRAs and §403(b) plans
4974	Excise tax on failure to make minimum required distribution
4975	Excise tax on prohibited fund transactions
4979	Excise tax on employer for excess plan contributions

Law/section number	Provisions of section
4980A (repealed)	Excise tax on excess plan distributions
Employee Retirement Income Security Act of 1974:	
3	Definition of terms
4	Types of benefit plans covered
101-111	Reporting and disclosure rules
202	Rules for employee coverage
203	Vesting standards
204	Benefit accrual rules
205	Rules for joint and survivor annuity option
206	Rules for benefit commencement
401-405, 409-413	Rules for fiduciary conduct
406, 408	Prohibited transactions
501-513	Administration and enforcement
514	Preemption of state laws
Title 5, United States Code:	
Ch. 83, Subch. III	Provisions establishing the Civil Service Retirement System
Ch. 84, Subch. I, II, IV, V, and VI	Provisions establishing the Federal Employees' Retirement System
Ch. 84, Subch. III and VII	Provisions establishing the Federal Employees' Thrift Savings Plan