PacificCPE

COURSE
33451A

Retirement Plan Types and Core Tax Rules

Get a solid foundation in retirement planning by exploring the major types of retirement plans and the tax rules that govern them. This course covers key terminology, creditor and bankruptcy protections, and the critical tax code sections every practitioner should know. You'll also examine rollover rules, including permissible rollover charts and how original and new plans interact. Ideal for CPAs and tax professionals looking to build or refresh their foundational knowledge before diving into more advanced retirement planning topics.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

Start Course ↓ | Final Exam Copy ↓

LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the characteristics of various qualified retirement plans.
- Identify the types of distributions from qualified plans that are taxable.
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Chapter 1: TYPES OF RETIREMENT PLANS

Chapter Objective

After completing this chapter, you should be able to:

- Recall the characteristics of various qualified retirement plans.

How many people have warned you that you'll never see a penny of the hard-earned money you've poured into the Social Security system and that you'd better have your own retirement nest egg tucked away somewhere? Perhaps those doomsayers are overstating the case, but even if you eventually do collect Social Security, it's likely to provide only a fraction of the income you will need during retirement.

Congress responded to this problem several decades ago by creating a variety of tax-favored plans to help working people save for retirement. One such plan is set up by you, the individual taxpayer, and is appropriately called an individual retirement account or IRA. Another, which can be established by your employer or by you if you're self-employed, is referred to by the nondescript phrase "a qualified plan." A qualified plan is one that qualifies to receive certain tax benefits as described in Section 401 of the U.S. tax code.

There are other types of retirement plans, too, that enjoy some of the same tax benefits as qualified plans but aren't technically qualified because they are defined in a different section of the tax code. Many of these other plans closely follow the qualified plan rules, however. The most common of these almost-qualified plans are tax-deferred annuities (TDAs) and qualified annuity plans. (Don't be thrown by the name. Even though it may be called a qualified annuity plan, it's not defined in Section 401 and, therefore, isn't a qualified plan in the purest sense.) Both of these plans are defined in Section 403 of the tax code. Because many of the rules in Section 403 are similar to those in Section 401, TDAs and qualified annuity plans are often mentioned in the same breath with qualified plans.

All qualified plans, TDAs, and qualified annuity plans have been sweetened with breaks for taxpayers to encourage them to save for retirement. And working people have saved, often stretching as far as they can to put money into their retirement plans. But saving is only half the equation. The government also wants you to take money out of the plan and spend it chiefly on your retirement. For that reason, the government has enacted a series of rules on how and when you can —or, sometimes, must—take money out of your retirement plan. (Taking money out is called a distribution.)

What does this mean for you? If you (or your employer on your behalf) have ever put money into a retirement plan and received tax benefits as a result, then you cannot simply take the money out whenever you want. Nor can you leave it in the plan indefinitely, hoping, for example, to pass all of the funds on to your children.

Helpful Terms

Adjusted gross income (AGI). Total taxable income reduced by certain expenses, such as qualified plan contributions, IRA contributions, and deductible contributions to health savings accounts (HSAs).

Beneficiary. The person or entity entitled to receive the benefits from an insurance policy or from trust property, such as a retirement plan or an IRA.

Deductible contribution. A contribution to a retirement plan that an employer can claim as a business expense to offset income on the employer's tax return. You might know it as simply the employer's contribution. In the case of an IRA, a deductible contribution is one that an individual taxpayer can use to offset income on the individual's tax return.

Distribution. A payout of property (such as shares of stock) or cash from a retirement plan or an IRA to the participant or a beneficiary.

Earned income. Income received for providing goods or services. Earned income might be wages or salary or net profit from a business.

Eligible employees. Employees who qualify to participate in the employer's plan because they have met the eligibility requirements (such as having worked for the employer for a specified number of years).

Nondeductible contribution. A contribution to a retirement plan or an IRA that can't be claimed as a business expense or used as an adjustment to offset taxable income on an income tax return.

Nondiscrimination rules. The provisions in the U.S. tax code that prohibit certain retirement plans from providing greater benefits to highly compensated employees than to other employees.

Participant or active participant. An employee for whom the employer makes a contribution to the employer's retirement plan.

Tax-deductible expense. An item of expense that can be used to offset income on a tax return.

Tax deferral. The postponement of tax payments until a future year.

Vested benefit. The portion of a participant's retirement plan accumulation that a participant can keep after leaving the employer who sponsors the plan or the portion that goes to a participant's beneficiary if the participant dies.

Instead, you must follow a complex set of rules for withdrawing money from the plan during your lifetime, and your beneficiaries must follow separate rules after your death. These rules are called distribution rules, and if you or your beneficiaries don't follow them, the government will impose penalties, sometimes substantial ones.

This chapter identifies and briefly describes the types of retirement plans to which these distribution rules apply. If you have a retirement plan at work or if you have established one through your own business, you should find your plan listed below. Also, if you have an IRA, you will find your particular type among those described below.

There's also an entire category of plans known as nonqualified plans to which distribution rules don't apply. Such plans are used by employers primarily to provide incentives or rewards for particular— usually upper management—employees. These plans don't enjoy the tax benefits that IRAs and qualified plans (including TDAs and qualified annuities) do, and they consequently aren't subject to the same distribution restrictions. Although this chapter helps you identify nonqualified plans, such plans have their own distribution rules, which fall outside the scope of this course.

Identifying your particular retirement plan probably won't be as difficult as you think. This is because every plan fits into one of four broad categories:

- Qualified plan
- IRA
- Plan that is neither an IRA nor a qualified plan but has many of the characteristics of a qualified plan, or
- Plan that is neither an IRA nor a qualified plan and does not have the characteristics of a qualified plan.

QUALIFIED PLANS

A qualified plan is a type of retirement savings plan that an employer establishes for its employees and that conforms to the requirements of Section 401 of the U.S. tax code. Why is it called "qualified"? Because if the plan meets all of the requirements of Section 401, then it qualifies for special tax rules, the most significant of which is that contributions the employer makes to the plan on behalf of employees are tax-deductible. Probably the best-known qualified plan is the 401(k) plan, discussed below.

The advantages to you, the employee, working for an employer with a qualified plan, aren't only the opportunity to accumulate a retirement nest egg, but also the chance to postpone paying income taxes on money contributed to the plan. Neither the contributions you make nor any of the investment returns are taxable to you until you take money out of the plan. In tax jargon, the income tax is deferred until the money is distributed and available for spending (usually during retirement).

Congress also built in some safeguards to help ensure that your plan assets are around when you finally do retire. For example, the assets must be held in trust and are generally protected from the claims of creditors.

In return for these tax benefits, the plan must comply with a number of procedural rules. First, the plan must not discriminate in favor of the company's highly compensated employees. For example, the employer can't contribute disproportionately large amounts to the accounts of the company honchos. Also, the employer can't arbitrarily prevent employees from participating in the plan or from taking their retirement money with them when they leave the company. Finally, the plan must comply with an extremely complex set of distribution rules, which is the focus of this course.

Seven of the most common types of qualified plans are described below.

Those plans are:

- Profit-sharing plans, which include 401(k) plans and Roth 401(k) plans
- Stock bonus plans
- Money purchase pension plans
- Employee stock ownership plans
- Defined benefit plans
- Target benefit plans, and
- Plans for self-employed people, called Keogh plans.

Profit-Sharing Plans

A profit-sharing plan is a type of qualified plan that allows employees to share in the profits of the company and to use those profits to help fund their retirement. Despite the plan's title and description, an employer doesn't have to make a profit in order to contribute to a profit-sharing plan. Similarly, even if the employer makes a profit, it doesn't have to contribute to the plan. Each year, the employer has discretion over whether or not to make a contribution, regardless of profitability.

When the employer contributes money to the plan on behalf of its employees, the contributions are generally computed as a percentage of all participants' compensation. The annual contribution to all accounts can be as little as zero or as much as 25% of the total combined compensation of all participants. For the purposes of making this calculation, the maximum compensation for any individual participant is capped at $360,000 for 2026. (The $360,000 increases from time to time for inflation.) No individual participant's (under age 50) account can receive more than $72,000 in a single year. (The $72,000 cap also increases from time to time for inflation.)

Example

Joe and Martha participate in their company's profit-sharing plan. Last year, the company contributed 25% of their respective salaries to the plan. Joe's salary was $120,000 and Martha's was $310,000. The company contributed $30,000 for Joe (25% × $120,000). The company's contribution for Martha was limited to the $72,000 ceiling, because 25% of Martha's salary was actually $77,500, which is above the limit.

This year, the company's profits tumbled, so the company decided not to make any contributions to the profit-sharing plan. Thus, the company will not contribute any money to the plan on Joe's or Martha's behalf.

There's an exception to the $72,000 limit for individuals who are older than 50 and who contribute to a 401(k) plan. For those individuals, the limit is increased by $8,000.

401(k) Plans

A special type of profit-sharing plan, called a 401(k) plan, is named after the subsection of the tax code that describes it. A traditional 401(k) plan allows you to direct (defer) some of your compensation into the plan. You don't have to pay income taxes on the portion of your salary you defer into the plan until you withdraw it.

The plan might or might not provide for employer contributions. Some employers make matching contributions, depositing a certain amount for each dollar a participant contributes.

Example

Fred participates in his company's 401(k) plan. His company has promised to contribute 25¢ for each dollar of Fred's salary that he defers into the plan. Fred's salary is $40,000. He directs 5% of his salary, which is $2,000, into the plan. The company matches with a $500 contribution (which is 25¢ × $2,000).

Other employers contribute a fixed percentage of compensation for each eligible employee, whether or not the employee chooses to contribute to the plan.

Example

Marilyn's salary for the current year is $60,000. Her company has a 401(k) plan that doesn't match employee contributions. Instead, the company contributes a flat 3% of each eligible employee's salary to the plan. Marilyn is saving to buy a house, so she isn't currently directing any of her salary into the 401(k) plan. Nonetheless, the company will contribute $1,800 (which is 3% × $60,000) to the plan for Marilyn.

The $72,000 limit applies to 401(k) plans, meaning the combined employer and employee contributions can't exceed $72,000 per year. (The salary deferral limit for employees is $24,500 per year in 2026, plus an additional $8,000 catch-up for employees over age 50.)

Tip

Individuals aged 60, 61, 62, or 63 are permitted even higher catch-up contributions for those specific years. They have a total catch-up contribution of $11,250 in 2026, which is $3,250 more than the regular contribution of $8,000 for 2026. Recall that catch-up contributions are in addition to the regular deferral amount. Once an individual reaches age 64, the regular catch-up contribution amounts will apply once again.

Caution!

Beginning in 2026, if your compensation for the preceding calendar year was greater than $150,000 (indexed for inflation), any catch-up contribution you make to your employer's 401(k) plan must be to a Roth 401(k). If your employer has not set up a Roth 401(k), you won't be able to make the catch-up contribution.

Roth 401(k) Plans

Although so-called Roth 401(k) plans are hot right now, the shocking truth is that there's no such thing as a Roth 401(k) plan. However, employers are permitted to add to a traditional 401(k) plan a special Roth feature, called a "qualified Roth contribution program." This feature allows employees to defer some of their salary into a "designated Roth account" instead of into the traditional 401(k) plan account.

The difference between the two types of accounts is in the tax treatment. Whereas contributions to traditional 401(k) plan accounts are tax-deductible, contributions to designated Roth accounts aren't. Instead, the tax benefits for designated Roth accounts come when you take distributions,