29 Small Business Retirement

Tab 29 Contents

New for 2024

- **SIMPLE plans.** Increased elective deferrals and increased nonelective contribution limits may apply in limited situations. See *Increased elective deferral limit,* and *Increased nonelective contribution limits,* page 29-10.
- **Qualified retirement plans.** Several new provisions affecting qualified retirement plans take effect for tax years beginning after December 31, 2023. Look for the New for 2024 headers under *Qualified Plans,* beginning on page 29-10.

Common Elections

- Election by an employer to automatically enroll employees in a 401(k) plan, page 29-18.
- Election to defer income on certain stock options, page 29-23.
- Election of delay in payment or a change in the form of payment using IRC section 409A rules, page 29-24.

2024 Retirement Plan Limitations

401(k)/403(b) deferral limits	Under age 50	$23,000	**SEP/profit sharing limits**	25%/$69,000
	Age 50 and over	$30,500		
SIMPLE deferral limits	Under age 50	$16,000	**Compensation limit**	$345,000
	Age 50 and over	$19,500		

New for 2024: Increased amounts may apply in limited situations.

Where to Deduct Qualified Pension Plan and IRA Contributions

Entity	Type of Contribution	Where to Report [1]
Schedule C (Form 1040) Sole Proprietors	Employer contributions made on behalf of employees	Schedule C (Form 1040), line 19, Pension and profit-sharing plans
	Employee elective deferrals to 401(k), SIMPLE, and SARSEPs	Schedule C (Form 1040), line 19, Pension and profit-sharing plans [3]
	Employer contributions and elective deferrals made on behalf of the sole proprietor	Schedule 1 (Form 1040), line 16, Self-employed SEP, SIMPLE, and qualified plans
	Employer contributions to an IRA on behalf of employees	Schedule C (Form 1040), line 26, Wages [2]
	Employer contributions to an IRA on behalf of the sole proprietor	Schedule 1 (Form 1040), line 20, IRA deduction, and/or Form 8606, *Nondeductible IRAs*
Form 1065 Partnerships	Employer contributions made on behalf of employees	Form 1065, page 1, line 18, Retirement plans, etc.
	Employee elective deferrals to 401(k), SIMPLE, and SARSEPs	Form 1065, page 1, line 18, Retirement plans, etc. [3]
	Employer contributions and elective deferrals made on behalf of a partner	Form 1065, page 5, Schedule K, line 13e, Other deductions, and Schedule K-1, box 13, Code R. The partner then enters amount on Schedule 1 (Form 1040), line 16
	Employer contributions to an IRA on behalf of employees	Form 1065, page 1, line 9, Salaries and wages [2]
	Employer contributions to an IRA on behalf of a partner	Form 1065, page 5, Schedule K, line 13e, Other deductions, and Schedule K-1, box 13, Code R. The partner then enters amount on Sch. 1 (Form 1040), line 20 and/or Form 8606
Form 1120-S S Corporations	Employer contributions made on behalf of employees	Form 1120-S, page 1, line 17, Pension, profit-sharing, etc., plans
	Employee elective deferrals to 401(k), SIMPLE, and SARSEPs	Form 1120-S, page 1, line 17, Pension, profit-sharing, etc., plans [3]
	Employer contributions and elective deferrals made on behalf of an S corporation shareholder-employee	Form 1120-S, page 1, line 17, Pension, profit-sharing, etc., plans [3]
	Employer contributions to an IRA on behalf of employees	Form 1120-S, page 1, line 8, Salaries and wages [2]
	Employer contributions to an IRA on behalf of an S corporation shareholder-employee	Form 1120-S, page 1, line 8, Salaries and wages, or line 7, Compensation of officers [2]
Form 1120 C Corporations	Employer contributions made on behalf of employees	Form 1120, page 1, line 23, Pension, profit-sharing, etc., plans
	Employee elective deferrals to 401(k), SIMPLE, and SARSEPs	Form 1120, page 1, line 23, Pension, profit-sharing, etc., plans [3]
	Employer contributions and elective deferrals made on behalf of a corporation shareholder-employee	Form 1120, page 1, line 23, Pension, profit-sharing, etc., plans [3]
	Employer contributions to an IRA on behalf of employees	Form 1120, page 1, line 13, Salaries and wages [2]
	Employer contributions to an IRA on behalf of a corporation shareholder-employee	Form 1120, page 1, line 13, Salaries and wages, or line 12, Compensation of officers [2]

[1] Pension and IRA contributions may have to be allocated to cost of goods sold on the employer's tax return. See *Inventory,* page 8-13.
[2] Also included as taxable wages on the employee's Form W-2. Employee then deducts a portion or all on his or her Form 1040 as an IRA contribution.
[3] [Reserved.]

Pension Plan Limitations

Taxpayers may have more than one qualified plan, but the contributions to all the plans must not total more than the overall limits. Contributions are limited to the lesser of the following amounts, or 100% of a participant's compensation for the year.

		2024 (Notice 2023-75	2023 (Notice 2022-55)
Traditional IRA and Roth IRA [1]	Under age 50	$7,000	$6,500
	Age 50 or older	$8,000	$7,500
SEP IRA [2] *Employees*	25% of wages up to	$69,000	$66,000
SEP IRA *Self-Employed*	20% of net self-employment (SE) income after the deduction for one-half of SE tax, up to	$69,000	$66,000
SIMPLE IRA [3] *(Employees and Self-Employed)* IRC §408(p), IRC §414(v)	Under age 50 = Elective deferrals up to	$16,000 [4]	$15,500
	Age 50 or older = Elective deferrals up to	$19,500 [4]	$19,000
	Employer must match dollar-for-dollar up to 3%[5] of the participant's compensation (no limit) or elect to match 2% of compensation for all employees (including nonparticipants). If the 2% match is elected, the matching contribution cannot exceed the per employee amounts of	$6,900	$6,600
401(k) Plan and SARSEP [2, 7] IRC §401(k), IRC §402(g), IRC §404(a)(3), IRC §414(v), IRC §415(c)	Under age 50 = Elective deferrals up to	$23,000	$22,500
	Age 50 or older = Elective deferrals up to	$30,500	$30,000
	Employer's deduction is limited to 25% of combined compensation for all participants before reducing for elective deferrals (20% of net SE income,[6] after one-half SE tax deduction in the case of a self-employed individual). The total of employer and employee contributions cannot exceed the lesser of 100% of employee's compensation or	$69,000 See *Note,* below	$66,000 See *Note,* below
403(b) Plans [2] IRC §402(g), IRC §414(v), IRC §415(c)	Under age 50 = Elective deferrals up to	$23,000	$22,500
	Age 50 or older = Elective deferrals up to	$30,500	$30,000
	Employees with at least 15 years of service with certain exempt organizations may qualify for up to $3,000 of additional contributions under IRC section 402(g)(7). The total of employer and employee contributions cannot exceed the lesser of 100% of employee's compensation or	$69,000 See *Note,* below	$66,000 See *Note,* below
Defined Contribution Plan [2] IRC §401(a)(17), IRC §404(a)(3), IRC §415(c)	Employer's deduction is limited to 25% of combined wages for all participants (20% of net SE income[6] after one-half SE tax deduction in the case of a self-employed individual). The total of employer and employee contributions cannot exceed the lesser of 100% of employee's compensation or	$69,000 See *Note,* below	$66,000 See *Note,* below
	Compensation limit	$345,000	$330,000
Defined Benefit Plan [2] IRC §401(a), IRC §415(b)	Maximum deductible amount is not less than the excess (if any) of 150% of the plan's current liability, over the value of plan assets. (There are exceptions.) Maximum annual distributions from the plan cannot exceed 100% of the participant's average compensation for the highest three years, or	$275,000	$265,000
	Compensation limit	$345,000	$330,000

[1] Compensation for purposes of a traditional IRA or Roth IRA includes wages and salaries, commissions, self-employment income, taxable alimony and separate maintenance, nontaxable combat pay, and taxable nontuition fellowship and stipend payments.

[2] Compensation for other employer-provided plans is defined in the plan document.

[3] Compensation for purposes of a SIMPLE IRA includes wages, tips, and other pay from the employer that is subject to income tax withholding. If self-employed, compensation is net earnings before SIMPLE IRA contribution deductions.

[4] ***New for 2024:*** Increased amounts may apply in limited situations. See *Increased elective deferral limit,* page 29-10, and *Increased nonelective contribution limits,* page 29-10.

[5] Employer can elect a lower percentage, but not lower than 1%, for any two out of five years.

[6] Compensation for a self-employed individual means net earnings from self employment minus the deduction for the pension plan contribution [IRC §401(c)(2)(A)(v)]. ***Example:*** 20% of $10,000 = 25% of $8,000.

[7] SARSEPs cannot be established after 1996. Existing SARSEPs can continue to have contributions made each year.

Note: If permitted by the plan, participants age 50 or older can make catch-up contributions which raise the overall contribution limit. For 2023, the overall limit is $73,500 (including $7,500 catch-up contributions) for 401(k) [other than SIMPLE 401(k)], 403(b), and SARSEP plans.

Rollover Chart

To / *From*	Roth IRA [2]	Traditional IRA	SIMPLE IRA	SEP IRA	457(b) Governmental	Qualified Plan [3] (pre-tax)	403(b) Plan (pre-tax)	Designated Roth Account	409A Plan [4]
Roth IRA	Yes [1]	No	No	No	No	No	No	No	No
Traditional IRA	Yes [5]	Yes [1]	Yes [1, 10]	Yes [1]	Yes [6]	Yes	Yes	No	No
SIMPLE IRA	Yes [5, 10]	Yes [1, 10]	Yes [1]	Yes [1, 10]	Yes [6, 10]	Yes [10]	Yes [10]	No	No
SEP IRA	Yes [5]	Yes [1]	Yes [1, 10]	Yes [1]	Yes [6]	Yes	Yes	No	No
457(b) Governmental	Yes [5]	Yes	Yes [10]	Yes	Yes	Yes	Yes	Yes [5, 7, 8]	No
Qualified Plan [3] (pre-tax)	Yes [5]	Yes	Yes [10]	Yes	Yes [6]	Yes	Yes	Yes [5, 7, 8]	No
403(b) Plan (pre-tax)	Yes [5]	Yes	Yes [10]	Yes	Yes [6]	Yes	Yes	Yes [5, 7, 8]	No
Designated Roth Account	Yes	No	No	No	No	No	No	Yes, if a direct trustee-to-trustee transfer	No
409A Plan [4]	No	No	No	No	No	No	No	No	No [9]

[1] Only one rollover in any 12-month period.

[2] Any after-tax contributions rolled into a Roth IRA are not taxable upon conversion.

[3] Defined contribution plans (i.e., 401(k), profit sharing, money purchase) and defined benefit plans.

[4] Nonqualified deferred compensation plan other than a 457(b) plan.

[5] Must include in income.

[6] Must have separate accounts.

[7] Must be an in-plan rollover.

[8] Any amount in a non-Roth qualified plan account can be rolled over to a Roth account in the same plan without penalty, whether or not the amount is currently distributable.

[9] Not as a tax-free rollover of vested contributions and earnings. Any transfer of funds from one account to another would be a taxable event.

[10] If 2-year participation in the SIMPLE IRA is met.

Note: Exceptions to rollover rules apply. See *Rollovers and Transfers,* page 13-19.

Pension Plan Characteristics—2024

	Qualifications	Contributions[1]	Deductions[1]	Distributions[2]	Due Dates	Penalties
Traditional IRA See page 13-7	• Any employee or self-employed individual with compensation. See *Compensation for IRA Contribution Purposes,* page 13-7. • A participant can use the compensation of a spouse to qualify. See *Spousal IRA,* page 13-7.	• Individual may decide how much, if any, to contribute on a year-by-year basis. • Total contributions are combined with Roth IRAs to determine annual limits.	Contributions are deductible if not covered by an employer retirement plan. If covered by an employer plan, the deduction phases out when modified AGI is between certain amounts. For modified AGI phaseout ranges, see *Reduced IRA Deduction,* page 13-9.	Fully taxable if the taxpayer has no basis in the IRA. If there is a basis, a portion of each distribution is a tax-free return of basis. A taxpayer cannot fully recover basis until funds from all traditional IRAs have been distributed.	• New accounts can be set up any time by return due date, no extensions. • Contributions must be made by the return due date, no extensions.	• 10% penalty for early withdrawal unless exception applies.[3] • A 6% penalty applies to any excess contributions if excess plus earnings are not withdrawn by due date (including extensions) of return. (IRC §4973) • 25% penalty for excess accumulation if required minimum distribution (RMD) rules are not followed. (IRC §4974)[4]
Roth IRA See page 13-11	• Any employee or self-employed individual with compensation. See *Compensation for IRA Contribution Purposes,* page 13-7. • A participant can use the compensation of a spouse to qualify. See *Spousal IRA,* page 13-7.	• Total contributions are combined with traditional IRAs to determine annual limits. • The allowable contribution amount phases out when modified AGI is between certain amounts. See *Roth IRA Limits – 2024,* page 13-11.	Roth IRA contributions are never deductible. Contributions add to the participant's basis in the Roth IRA.	Distributions come out of a Roth IRA in the following order. 1) *Contributions:* Distributions are tax free and penalty free until total distributions exceed total contributions. 2) *Conversions and rollover contributions:* Distributions are tax free to the extent the amount was taxed upon conversion or rollover, plus any basis from nondeductible contributions. 3) *Earnings:* Distributions come from earnings only after all contributions and conversions are distributed. • Qualified distributions are tax free and nonqualified distributions are taxable.[2] See *Distributions,* page 13-12	• New accounts can be set up any time by return due date, no extensions. • Contributions must be made by the return due date, no extensions.	• The 10% early withdrawal penalty may apply to distributions of conversions or earnings unless exception applies.[3] Penalty never applies to distributions of contributions. • The same 6% penalty on excess contributions that applies to traditional IRAs also applies to Roth IRAs if excess plus earnings are not withdrawn by due date (including extensions) of return. (IRC §4973)
SEP IRA See page 29-8	• Must be self-employed or work as an employee for an employer that contributes to a SEP on behalf of all eligible employees. • An employer cannot discriminate against any employee at least age 21 who has worked three of the immediately preceding five years for the employer with at least $750 in compensation from the employer in 2024.	• An employer must contribute a uniform percentage of pay for each eligible employee including those who die or terminate employment before contributions are made. • An employer does not have to make contributions each year. • Contributions must be based on a written allocation formula and must not discriminate in favor of highly-compensated employees. • Contributions must be in the form of money.	Contributions are generally deductible. Participation in another employer's pension plan does not affect the deduction. ***Exception:*** If a self-employed taxpayer contributes to a defined contribution plan, annual additions to an account are limited to the lesser of $69,000 (2024) or 100% of the participant's compensation. When computing this limit, the self-employed taxpayer must add contributions to all defined contribution plans. Because a SEP is considered a defined contribution plan for this limit, contributions to a SEP must be added to the contributions to other defined contribution plans.	Distributions are subject to IRA rules. If the participant also has a nondeductible basis in a traditional IRA, distributions from a SEP IRA will be partially taxable and partially tax free as a return of basis.	• New SEP plans can be set up any time by return due date, including extensions. • Contributions must be made by the return due date, including extensions.	• 10% penalty for early withdrawal unless exception applies.[3] • 10% penalty on excess contributions. (IRC §4972 and IRC §4979) • 25% penalty for excess accumulation if required minimum distribution (RMD) rules are not followed. (IRC §4974)[4]

[1] For dollar limitations, see the *Pension Plan Limitations* chart, page 29-2.

[2] [Reserved.]

[3] For exceptions to the 10% early withdrawal penalty, see *Exceptions to the 10% Penalty on Early Distributions* chart, page 13-3.

[4] See *Required Minimum Distribution (RMD),* page 13-21.

Pension Plan Characteristics — 2024 *continued*

	Qualifications	Contributions[1]	Deductions[1]	Distributions[2]	Due Dates	Penalties
SIMPLE IRA See page 29-9	Must be self-employed or work as an employee for a small employer that offers a SIMPLE plan. Employers cannot maintain any other pension plan and must have 100 or fewer employees who received at least $5,000 of compensation for the preceding year.	• Each participant can decide the amount to contribute as an elective deferral, either as a percentage of compensation or a specific dollar amount. • Employers must choose to either contribute matching amounts for participating employees, up to 3% of compensation (no limit), or choose nonelective contributions equal to 2% of compensation for all eligible employees (subject to annual compensation limit). ***New for 2024:*** Increased amounts may apply in limited situations.	• Employee elective deferrals are generally excluded from the employee's income. • Employer contributions (including self-employed deferrals and matching contributions) are generally deductible.	Distributions are subject to IRA rules. If the participant also has a nondeductible basis in a traditional IRA, distributions from a SIMPLE IRA will be partially taxable and partially tax free as a return of basis.	• New plan can be set up any time between January 1 and October 1 of year for which contributions will apply. Exception for new employers. • Elective deferrals must be deposited into the employee's account within 30 days of the last day of the month in which the employee had the contribution withheld from wages. • The employer must contribute the matching amounts by the return due date, including extensions. [IRC §408(p)(5)(A)]	• 10% penalty for early withdrawal unless exception applies.[3] • The early withdrawal penalty is increased to 25% if the withdrawal is within the first two years of establishing a SIMPLE plan. [IRC §72(t)(6)] • 10% penalty on excess contributions. (IRC §4972) • 25% penalty for excess accumulation if required minimum distribution (RMD) rules are not followed. (IRC §4974)[4]
Qualified Plans See page 29-11	• Self-employed individuals, partnerships, and corporations can set up qualified plans. • Qualified plans must allow employees age 21 or over with at least 1000 hours of service over a year to participate [IRC §410(a)]. ***Note:*** Certain long-term part-time employees may qualify to participate in 401(k) plans.	Frequency and amount depends upon plan. Employee elective deferrals to 401(k) and 403(b) plans are at the discretion of the employee on a year-by-year basis. Employers are not required to match elective deferral contributions to 401(k) and 403(b) plans, except in the case of SIMPLE 401(k) and safe harbor 401(k) plans.	• Employee elective deferrals are generally excluded from the employee's income. • Employer contributions (including self-employed deferrals and matching contributions) are generally deductible by the employer. • Employee elective deferral limits apply to all plans of the participant.	Distributions are fully taxable unless the employee or employer has contributed after-tax money to the plan. For rules, see *Cost basis in a retirement plan,* page 13-18.	• New plan must be set up by return due date, including extensions, of the year for which contributions will apply. • Elective deferrals must be deposited into the employee's account no later than the 15th business day of the month following the payday. • Employer contributions must be made by the return due date, including extensions. [IRC §404(a)(6)]	• 10% penalty for early withdrawal unless exception applies.[3] • 10% penalty on excess contributions of employee elective deferrals and nondeductible employer contributions (IRC § 4972 and IRC §4979). Exception applies if excess deferrals are distributed within 2½ months of end of plan year. • 25% penalty for excess accumulation if required minimum distribution (RMD) rules are not followed. (IRC §4974)[4]

[1] For dollar limitations, see the *Pension Plan Limitations* chart, page 29-2.

[2] [Reserved.]

[3] For exceptions to the 10% early withdrawal penalty, see *Exceptions to the 10% Penalty on Early Distributions* chart, page 13-3.

[4] See *Required Minimum Distribution (RMD),* page 13-21.

Pension Plan Advantages/Disadvantages — 2024

	Advantages:		*Disadvantages*
SEP IRA See page 29-8	• The participant is fully vested in the account at all times. • Same tax deduction and deferral of income advantage as a traditional IRA. • Employee can designate some or all elective deferrals as Roth (not excluded from income) that are generally subject to the same taxation under the Roth IRA rules.	• Deductible contributions are not subject to AGI phase-out rules for taxpayers who are active participants in another employer plan. • Maximum contribution allowed for higher-income taxpayers is generally greater than an IRA. • A SEP IRA can be set up and deductible contributions made as late as the return due date, including extensions. • No annual reporting requirements.	• The employer must fund 100% of a participant's contribution. ***Exception:*** SARSEPs established prior to 1997. • Low-income participants cannot contribute as much to a SEP IRA as they can to a traditional IRA or a SIMPLE IRA. • Reduces qualified business income (QBI).
SIMPLE IRA See page 29-9	• The participant is fully vested in the account at all times. • Same tax deduction and deferral of income advantage as a traditional IRA. • Employee can designate some or all elective deferrals as Roth (not excluded from income) that are generally subject to the same taxation under the Roth IRA rules. • Maximum contribution allowed is generally greater than an IRA. • Lower-income taxpayers can contribute a higher percentage of earnings than a SEP IRA.	• No annual reporting requirements. • Similar features of a 401(k) plan without the complexity and restrictions placed on highly-compensated employees. • Elective deferrals through payroll withholding make it easier for employees to save for retirement. • Unlike a SEP IRA, most of the funds are contributed by the employee through voluntary elective deferrals. The employer match is relatively small in comparison.	• Must be set up by October 1 of the year contributions are to apply. • Employer with over 100 employees cannot have a SIMPLE IRA. • Lower elective deferral limits than 401(k) plans.
401(k) Plan See page 29-14	• The participant is fully vested in elective deferrals at all times. • Same tax deduction and deferral of income advantage as a traditional IRA. • Employee can designate some or all elective deferrals as Roth (not excluded from income) that are generally subject to the same taxation under the Roth IRA rules. • Maximum contribution allowed is generally greater than an IRA.	• Elective deferral limits greater than SIMPLE IRAs. • Employers often match dollar-for-dollar employee elective deferrals up to certain percentages. • Plan participants may choose to receive employer matching and nonelective contributions as Roth contributions. • Elective deferrals through payroll withholding makes it easier for employees to save for retirement.	• Complexity and restrictions placed on highly-compensated employees make it difficult and sometimes expensive to administer. • Key employees do not always receive the full benefit of allowable elective deferrals.
403(b) Tax-Sheltered Annuity Plan See page 13-17	• The participant is fully vested in elective deferrals at all times. • Same tax deduction and deferral of income advantage as a traditional IRA. • Employee can designate some or all elective deferrals as Roth (not excluded from income) that are generally subject to the same taxation under the Roth IRA rules.	• Elective deferral limits greater than SIMPLE IRAs. • Employers often match dollar-for-dollar employee elective deferrals up to certain percentages. • Elective deferrals through payroll withholding make it easier for employees to save for retirement.	• Limited as to what types of employers are eligible to offer a 403(b) plan to employees. Generally available only for employees of certain tax-exempt organizations.
Defined Contribution Plan See page 29-11	• Same tax deduction and deferral of income advantage as a traditional IRA. • Maximum contribution allowed for higher-income taxpayers is generally greater than an IRA. • Deductible contributions are not subject to AGI phaseout rules for taxpayers who are covered by another employer retirement plan.		• Can be more expensive and difficult to administer than a SEP IRA or SIMPLE IRA plan. • Annual reports are generally required. • Future benefits are dependent on contributions and fund performance.
Defined Benefit Plan See page 29-12	• Designed to provide a guaranteed monthly benefit for the life of a participant. • Shareholder employees of closely held corporations can contribute and deduct more per year to a defined benefit plan than a defined contribution plan. Contributions for self-employed taxpayers are limited to 100% of compensation per year. [IRC §404(a)(8)]		• Fixed income could be inadequate in future years as inflation decreases the defined benefit.
Nonqualified Deferred Compensation Plan See page 29-20	• The plan can discriminate in favor of key employees and owners. • There are no contribution limits or funding requirements.		• In order for an employee to defer taxes on the benefit, the employee has to be at risk for forfeiting the funds in the account through various contingencies. There is no minimum funding or vesting rules to protect employees. • Employer receives no benefit from a tax deduction for contributions until the contributions are reportable in the employee's Form W-2 wages. • Plan earnings are generally not tax deferred.

Note: For advantages/disadvantages of traditional IRAs and Roth IRAs, see *Pension Plan Advantages/Disadvantages,* page 13-6.

Small Business Retirement Plans

Cross References

- IRS Pub. 560, *Retirement Plans for Small Business*
- IRS Pub. 3998, *Choosing a Retirement Solution for Your Small Business*
- IRC §219, *Retirement savings*
- www.irs.gov/Retirement-Plans, *Retirement Plans*

Related Topics

- Retirement, Social Security, and Medicare, Tab 13

- Credit for Small Employer Pension Plan Startup Costs, Auto-Enrollment, and Military Spouse Participation (Form 8881), page **31-10.**

Benefits for Offering a Retirement Plan

Setting up and maintaining a small business or self-employed retirement plan is relatively easy. Generally, under these plans, contributions that are set aside for retirement may be currently deductible by the employer and are not taxable to the employee until distributed from the plan. Starting and maintaining a small business retirement savings plan can be as straight forward as allowing employees to contribute to an IRA through payroll deductions.

Many financial institutions have the necessary documents and are willing to help set up and maintain these retirement plans, thus easing the administrative burden on individual employers.

Employer benefits:

- Employer contributions are tax deductible.
- Assets in the plan grow tax free.
- Flexible plan options are available.
- Businesses may receive tax credits and other incentives for starting a plan.
- A retirement plan may attract and retain higher quality employees, reducing new employee training costs.

Employee benefits:

- Tax on employee contributions may be deferred until distributed.
- Investment gains in the plan are not taxed until distributed. Investment gains in Roth accounts may be tax free.
- Retirement assets can be carried from one employer to another.
- Contributions can be made through payroll deductions.
- Retirement Savings Contributions Credit may be available. See *Retirement Savings Contributions Credit,* page 11-16.
- Assets grow with compounding interest.
- Better financial security upon retirement.

IRS Retirement Plans Navigator

The IRS has a website to assist taxpayers in finding the right retirement plans for their business. The website provides comparisons of different plans, tips on how to choose the right plan, information on maintaining a plan, and resources for correcting plan errors. Information can be found at www.irs.gov/Retirement-Plans.

Definitions

Common-law employee. A common-law employee is an individual who performs services for an employer who has the right to control and direct the results of the work and the way in which it is done. For example the employer:

- Provides the employee's tools, materials, and workplace, and
- Can fire the employee.

Common-law employees may set up a traditional IRA and/or a Roth IRA on their own with income from their work as an employee. They may not set up any other form of qualified retirement plan for income from that work, even if that income is treated as self-employment income for Social Security tax purposes. For example, common-law employees who are ministers, members of religious orders, full-time insurance salespeople, and U.S. citizens employed in the United States by foreign governments cannot set up retirement plans for their earnings from those employments (other than traditional or Roth IRAs), even though those earnings are treated as self-employment income. See *Individual Retirement Arrangement (IRA),* page 13-7.

An individual may be a common-law employee and a self-employed person as well.

Example: Jan is an attorney who works for a corporation as a common-law employee during regular working hours. She also practices law during the evening as a self-employed person. She may set up an IRA based on her common-law employment earnings and/or participate in an employer-sponsored qualified retirement plan, if available. She may also set-up a qualified plan based on her earnings from self-employment.

Example: Randy is the senior pastor at First Avenue Church. He is treated as a common-law employee even though his salary from the congregation is treated as self-employment income for Social Security purposes. However, fees he reports on Schedule C (Form 1040), for performing marriages, baptisms, and other personal services are self-employment earnings for qualified plan purposes. He may contribute to an IRA based on his salary from the church or participate in an employer-sponsored plan, if available. He may also set-up a qualified plan based on his self-employment earnings reported on Schedule C.

Compensation. Compensation for plan allocations is the pay a participant receives from the employer for personal services for a calendar year. Compensation generally includes:

- Wages and salaries,
- Fees for professional services,
- Other amounts received (cash or noncash) for personal services rendered by the employee, including commissions and tips, fringe benefits, and bonuses, and
- Difficulty-of-care payments to home healthcare workers (not subject to income tax, but considered compensation for the purpose of calculating contributions to nondeductible IRAs).

Earned income. Earned income is net earnings from self-employment in which the individual materially participated. Earned income can also come from property created by an individual's personal efforts, such as royalties from books or inventions. Earned income includes net earnings from selling or disposing of the property but does not include capital gains. If a taxpayer has more than one business, but only one has a retirement plan, only the earned income from that business is considered for that plan.

Employer. An employer is generally any person for whom an individual performs, or did perform, any service as an employee. A sole proprietor is treated as his or her own employer for retirement plan purposes. However, a partner is not an employer for retirement plan purposes. The partnership is treated as the employer of each partner.

Highly-compensated employee. A highly-compensated employee is one who:

- Owned more than 5% of the interest in the business at any time during the current or preceding year (regardless of compensation), or
- For the preceding year, received compensation from the employer of more than $150,000 (if the prior year is 2023), and, if the employer elects, was in the top 20% of employees when ranked by compensation.

Highly-Compensated Employee Compensation Threshold Chart

Preceding year	*2024*	*2023*	*2022*	*2021*
Received compensation	$155,000	$150,000	$135,000	$130,000

Leased employee. A leased employee who is not a common-law employee must generally be treated as an employee for retirement plan purposes if he or she does all the following.

- Provides services to the employer under an agreement between the employer and a leasing organization,
- Has performed services for the employer substantially full time for at least one year, and
- Performs services under the primary direction of the employer.

Exceptions for leased employees. A leased employee is not treated as an employee for purposes of retirement plans if all the following conditions are met.

- Leased employees are not more than 20% of the employer's nonhighly-compensated work force,
- The employee is covered under the leasing organization's qualified pension plan, and
- The leasing organization's plan is a money-purchase pension plan that has all the following provisions.
  - Immediate participation. This requirement does not apply to any individual whose compensation from the leasing organization in each plan year during the 4-year period ending with the plan year is less than $1,000.
  - Full and immediate vesting.
  - A nonintegrated employer contribution rate of at least 10% of compensation for each participant.

However, if the leased employee is a common-law employee, that employee will be an employee for all purposes, regardless of any pension plan of the leasing organization.

Net earnings from self-employment. For SEP IRAs and qualified plans, net earnings from self-employment is gross income from a trade or business (provided the self-employed individual's personal services are a material income-producing factor) minus allowable business deductions. Allowable deductions include contributions to SEP IRAs and qualified plans for common-law employees and one-half of the self-employment tax.

Partners and shareholders. Net earnings include a partner's distributive share of partnership income or loss (other than separately stated items such as capital gains and losses), and guaranteed payments to limited partners if paid for services to or for the partnership. Distributions of other income or loss to limited partners and income passed through to shareholders of S corporations are not considered net earnings from self-employment.

Participant. A participant is an eligible employee who is covered by the employer's retirement plan.

Partner. A partner is an individual who shares ownership of an unincorporated trade or business with one or more persons. For retirement plans, a partner is treated as an employee of the partnership.

Sole proprietor. A sole proprietor is an individual who owns an unincorporated business by himself or herself, including a single-member LLC that is treated as a disregarded entity for tax purposes. For retirement plans, a sole proprietor is treated as both employer and employee.

IRA Based Plans

Cross References

- IRS Pub. 560, *Retirement Plans for Small Business*
- IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*
- IRS Pub. 4333, *SEP Retirement Plans for Small Businesses*
- IRS Pub. 4334, *SIMPLE IRA Plans for Small Businesses*
- IRS Pub. 4587, *Payroll Deduction IRAs for Small Businesses*
- IRS Notice 2024-2

Related Topics

- Retirement Savings Contributions Credit, page 11-16
- Individual Retirement Arrangement (IRA), page 13-7
- Credit for Small Employer Pension Plan Startup Costs, Auto-Enrollment, and Military Spouse Participation (Form 8881), page 31-10

Individual Retirement Arrangement (IRA)

An IRA is a tax-favored personal savings arrangement which allows a taxpayer to set aside money for retirement. Similar to a qualified employer pension plan, it provides retirement income to participants, can result in the deferral of income until distribution, and must meet certain requirements under the Internal Revenue Code.

Because an employer cannot contribute pre-tax money on behalf of the employee, IRAs are considered nonqualified plans. An employer plan that contributes to a traditional IRA on behalf of an employee must add the contributions to taxable wages on the employee's Form W-2. The employee, in turn, must meet certain requirements under the Internal Revenue Code in order to take a tax deduction on his or her Form 1040 and defer tax on the income.

For general rules that apply to traditional IRAs, see *Individual Retirement Arrangement (IRA),* page 13-7.

Deemed IRAs. An employer's qualified plan shall not fail to meet any requirements of the qualified plan rules solely by reason of establishing and maintaining a program that allows employees to make voluntary employee contributions to a traditional or Roth IRA. If the separate account for an employee otherwise meets the requirements of an IRA, it is subject only to the traditional IRA or Roth IRA rules that would apply if the employee set up the IRA on his or her own and not through the employer. [IRC §408(q)(2)]

Roth IRAs. For the general rules that apply to Roth IRAs, see *Roth IRA,* page 13-11.

Deductible and nondeductible contributions. For rules that apply to whether a traditional IRA contribution is deductible, partially deductible, or nondeductible, see *Reduced IRA Deduction,* page 13-9.

Payroll-Deduction IRA

An employer that may not want to adopt a formal retirement plan can allow its employees to contribute to an IRA through payroll deductions. The plan can be made available to any employee. The decision about whether to contribute, how much to contribute, and when to contribute is always made by the employee. The employer only arranges for the payroll deductions and transmits the employee's contributions to his or her IRA.

Simplified Employee Pension (SEP)

A SEP plan provides a simplified method to make contributions to a retirement plan for an employer and his or her employees. The employer adopts a written SEP agreement and makes contributions to a traditional individual retirement arrangement (SEP IRA) set up for each eligible employee. A SEP IRA is owned and controlled by the employee, and the employer makes contributions to the financial institution where the SEP IRA is maintained. SEPs have low start-up and operating costs. The employer can decide how much to contribute into a SEP each year, which gives the employer some flexibility when business conditions vary.

Eligible employee. An eligible employee is one who meets all the following requirements.

- Has reached age 21.
- Has been employed by the employer in at least three of the last five years.

continued on next page

- Has received at least $750 in compensation from the employer in 2024.

Less restrictive participation requirements are allowed, but not more restrictive ones. For example, an employer may consider employees who have reached age 19 to be eligible employees but may not require that they have reached age 25 before they are eligible.

Domestic employees. Effective for tax years beginning after December 29, 2022, any employer can set up a SEP for a domestic employee. For example, a household employer who sets up a SEP for a nanny.

Excludable employee. The following employees can be excluded from coverage under a SEP plan.

- Employees covered by a union agreement whose retirement benefits were bargained for in good faith by the employees' union and the employer.
- Nonresident alien employees who have received no U.S. source wages or other personal services compensation from the employer.

Setting up a SEP. A SEP plan may be set up anytime up to the due date of the employer's return (including extensions).

There are three basic steps in setting up a SEP.

1) The employer must execute a formal written agreement to provide benefits to all eligible employees. IRS Form 5305-SEP, *Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement,* may generally be used. Situations where Form 5305-SEP may not be used include:
   - The employer currently maintains any other qualified retirement plan other than another SEP.
   - The employer has any eligible employees for whom IRAs have not been set up.
   - The employer uses services of leased employees.
   - The employer is a member of any of the following, unless all eligible employees of all the members of these groups, trades, or businesses participate under the SEP.
     – An affiliated service group,
     – A controlled group of corporations, or
     – Trades or businesses under common control.
   - The employer does not pay the cost of the SEP contributions.
2) The employer must give each eligible employee a copy of Form 5305-SEP, its instructions, and other information as listed in the Form 5305-SEP instructions.
3) A SEP IRA must be set up by or for each eligible employee.

Employer contributions to a SEP IRA will not affect the amount an individual can contribute to a Roth or traditional IRA.

Credit for start-up costs. Two credits are available to help defray the start-up costs of a SEP and to encourage automatic enrollment in the plan. See *Credit for Small Employer Pension Plan Startup Costs, Auto-Enrollment, and Military Spouse Participation (Form 8881),* page 31-10.

Contributions. The SEP rules allow an employer to contribute a limited amount each year to each employee's SEP IRA. A self-employed individual may contribute to his or her own SEP IRA. Employers must contribute a uniform percentage of pay for each eligible employee, although contributions do not have to be made every year. Contributions must be based on a written allocation formula and must not discriminate in favor of highly-compensated employees. Contributions must be in the form of money. Property may not be contributed. Participants may be able to transfer or rollover certain property from one retirement plan to another. See *Rollovers and Transfers,* page 29-21.

Roth contributions. SEP plans can allow employees the ability to treat employee and employer SEP contributions as Roth contributions (in whole or in part). Grandfathered salary reduction SEPs cannot accept Roth contributions. Designated Roth contributions are not excludable from gross income.

Contribution limits. Contributions made for 2024 cannot exceed the lesser of 25% of the employee's compensation or $69,000. Compensation generally does not include the contributions to the SEP IRA.

Example: Trish earned $21,000 for 2024. The maximum contribution her employer can make to her SEP IRA is $5,250 (25% × $21,000).

Annual compensation limit. An employee's compensation in excess of $345,000 (2024) cannot be considered when computing the contribution limit for that employee.

Example: Victoria earned $300,000 for 2024. Because of the maximum contribution limit for 2024, her employer can only contribute $69,000 to her SEP IRA.

Example: Hugo earned $400,000 for 2024. His employer contributes 10% of each employee's wages into a SEP IRA. For 2024, the employer put $34,500 (10% of his wages, limited to $345,000) into Hugo's SEP IRA.

More than one plan. Annual contributions to defined contribution plans are limited to the lesser of $69,000 (2024) or 100% of the participant's compensation. Because a SEP is considered a defined contribution plan for purposes of this limit, contributions to a SEP IRA must be added to contributions to other defined contribution plans to compute the annual contribution limit.

Time limit for making contributions. Contributions must be made by the due date (including extensions) of the employer's tax return for the year.

Age limitation. There is no age limitation on contributions to a SEP IRA. However, required minimum distributions must be taken if the participant is age 73 or older. See *Required Minimum Distribution (RMD),* page 13-21.

Employer deduction. Generally, contributions made each year to each employee's SEP IRA are deductible. See *Where to Deduct Qualified Pension Plan and IRA Contributions* chart, page 29-1.

Self-employed individuals. Special rules apply when computing the maximum deductible contribution for a self-employed person. For calculating the percentage of compensation that applies to self-employed individuals, see *Self-employed deduc-tion limit,* page 29-15.

When to deduct contributions. When to deduct contributions made for a year depends on which tax year the SEP is maintained.

- If the SEP is maintained on a calendar year, the yearly contributions are deducted on the tax return for the year within which the calendar year ends.
- If the employer files its tax return and maintains the SEP using a fiscal year or short tax year, the contributions made for a fiscal (or short) year are deducted on the tax return for that fiscal (or short) year.

Example: The Coffee Cup, Inc. is a fiscal year taxpayer whose tax year ends June 30. The company maintains its SEP on a calendar year basis. The company deducts SEP contributions made for calendar year 2024 on its tax return for the tax year ending June 30, 2025.

Reporting on Form W-2. Non-Roth SEP contributions are not included on an employee's Form W-2 unless the contributions were made under a salary reduction agreement. Mark the retirement plan checkbox in box 13, Form W-2 for all eligible employees.

Roth SEP IRA W-2 reporting. The employer reports salary reduction contributions made to a Roth IRA for a SEP IRA on Form W-2, Box 12, using Code F. Include the same amount in boxes 1, 3, and 5.

The employer reports employer matching and nonelective contributions made to a Roth IRA on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts. etc.,* for the year in which the contributions are made to

the employee's Roth IRA, with the total reported in boxes 1 and 2a, using code 2 or 7 in box 7, and the IRA/SEP/SIMPLE checkbox in box 7 checked.

The salary reduction contributions to a Roth IRA under a SEP IRA arrangement are subject to income tax withholding as well as FICA and FUTA taxes.

The employer matching contributions are not subject to income tax withholding, FICA, or FUTA taxes.

See IRS Notice 2024-2.

Additional taxes. The tax advantages of a SEP IRA can be offset by additional taxes that may be imposed for any of the following actions.

- Making excess contributions.
- Making early withdrawals.
- Not making required withdrawals.
- Engaging in prohibited transactions.

Excess contributions. Excess contributions are included in the employee's income for the year and are treated as contributions by the employee to his or her SEP IRA.

Prohibited transactions. If an employee improperly uses his or her SEP IRA, such as borrowing money from it, the SEP IRA will no longer qualify as an IRA. The assets in the account will be treated as a distribution to the employee. See *Prohibited Transactions,* page 29-22.

SEP and IRA contributions on same income. A self-employed owner may make both a SEP contribution and an IRA contribution on the same earnings. The combined contribution cannot exceed earned income minus one-half self-employment (SE) tax. When earnings are less than the maximum IRA contribution for the year ($7,000 for a person under 50 in 2024), a special calculation must be made, as illustrated in the following example.

Example: Leon has net earnings from his Schedule C (Form 1040) business of $3,000. He has no other earned income. He chooses to contribute the maximum to his SEP and IRA. Leon must first reduce net earnings by one-half the SE tax or $212 ($3,000 × 0.9235 × 0.153 × 0.50). His maximum SEP contribution is $558. [($3,000 − $212) × 20%*]. His maximum IRA contribution is $2,230 ($3,000 − $212 − $558). The combined SEP and IRA contribution is $2,788 ($558 SEP + $2,230 IRA), which also equals his net profit from Schedule C ($3,000) minus one-half of SE tax ($212).

*See *Self-employed deduction limit,* page 29-15.

Distributions (withdrawals). Distributions are subject to IRA rules and are generally includable in income for the year received.

Tax-free rollovers. Tax-free rollovers can be made from one SEP IRA into another SEP IRA. See *IRA Distributions,* page 13-8.

SIMPLE IRA Plan

A SIMPLE (Savings Incentive Match Plan for Employees) IRA plan allows employees to contribute a percentage of their wages each paycheck and requires employer contributions. Each eligible employee must have his or her own SIMPLE IRA. The employer may choose which financial institution maintains the SIMPLE IRAs for the employees or may allow each employee to utilize the financial institution of his or her choice. Employees can decide how and where the money will be invested and are fully vested at all times.

Eligible employer. An employer who meets the following re-quirements can set up a SIMPLE IRA.

- The employer had 100 or fewer employees who received $5,000 or more in compensation from the employer for the preceding year.
- The employer does not maintain another qualified plan (except for certain union employees).

Once a SIMPLE IRA plan is in place, the employer must continue to meet the 100-employee limit. A 2-year grace period applies once this limit is exceeded.

Grace period. If an employer maintains a SIMPLE IRA plan for at least one year and ceases to meet the 100-employee limit in a later year, the employer will be treated as meeting the limit for the two calendar years immediately following the calendar year for which the limit was last met.

Eligible employee. Any employee who received at least $5,000 in compensation from the employer during any two years preceding the current year, and is reasonably expected to receive at least $5,000 during the current year, is eligible. The employer can use less restrictive eligibility requirements by eliminating or reducing the prior year compensation requirements, the current year compensation requirements, or both. The employer may not use more restrictive eligibility requirements. The term employee includes a self-employed individual who received earned income.

Excludable employee. The following employees do not need to be covered under a SIMPLE IRA plan.

- Employees covered by a union agreement whose retirement benefits were bargained for in good faith by the employees' union and the employer.
- Nonresident alien employees who have received no U.S. source wages, salaries, or other personal services compensation from the employer.

When to set up a SIMPLE IRA plan. A SIMPLE IRA can be set up effective on any date from January 1 through October 1 of a year for which contributions will be made, provided the employer has not previously maintained a SIMPLE IRA plan. This requirement does not apply to a new employer that comes into existence after October 1 and sets up the SIMPLE IRA plan as soon as administratively possible. A SIMPLE IRA plan cannot have an effective date prior to the date it is actually adopted. The plan is set up using Form 5304-SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—Not for Use With a Designated Financial Institution,* or Form 5305-SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—for Use With a Designated Financial Institution,* depending on whether the employer or the employees select the financial institution that will receive the contributions.

Setting up a SIMPLE IRA. SIMPLE IRAs are the individual retirement accounts into which the contributions are deposited. A SIMPLE IRA must be set up for each eligible employee. Forms 5305-S, *SIMPLE Individual Retirement Trust Account,* and 5305-SA, *SIMPLE Individual Retirement Custodial Account,* are model trust and custodial account documents that can be used for this purpose. Contributions to a SIMPLE IRA will not affect the amount an individual can contribute to a Roth or traditional IRA.

Credit for start-up costs. Two credits are available to help defray the start-up costs of a SIMPLE IRA and to encourage automatic enrollment in the plan. See *Credit for Small Employer Pension Plan Startup Costs, Auto-Enrollment, and Military Spouse Participation (Form 8881),* page 31-10.

Employee notification. An employer adopting a SIMPLE IRA plan must notify each employee of the following information before the beginning of the election period.

- The employee's opportunity to make or change an elective deferral choice under a SIMPLE IRA plan.
- The employer's decision to make either matching contributions or nonelective contributions.
- A summary description provided by the financial institution.
- Written notice that his or her balance can be transferred without cost or penalty if a designated financial institution is used.

Election period. The election period is generally the 60-day period immediately preceding January 1 of a calendar year. The dates of this period are modified if the SIMPLE IRA plan is set up in mid-year or if the 60-day period falls before the first day an employee becomes eligible.

Contributions. Contributions are made up of employee elective deferrals and employer contributions. The employer must make either matching contributions or nonelective contributions.

Roth contributions. SIMPLE IRAs can also accept Roth contributions.

Employee elective deferral limits. An employee may elect to defer up to $16,000 (2024) of his or her compensation to a SIMPLE IRA. The contributions must be expressed as either a percentage of the employee's compensation or a specific dollar amount.

New for 2024 ***Increased elective deferral limit.*** For tax years beginning after December 31, 2023, the elective deferral limit is increased to 110% of the otherwise applicable deferral limit if the employer has no more than 25 employees who have at least $5,000 (2024) in compensation for the year.

Employers with more than 25 employees may elect to have this 110% limit apply. If they make this election, the employer's 3% match is increased to 4%. See *Employer's matching contributions,* below.

Note: These increased limit rules do not apply if the employer had another qualified plan within three years immediately preceding the first year the employer maintains a SIMPLE plan.

Catch-up contributions. A SIMPLE IRA plan can permit participants who are age 50 or older at the end of the calendar year to make catch-up contributions. The catch up contribution limit for 2024 is $3,500.

Employees participating in multiple plans. The elective deferrals under a SIMPLE IRA count toward the overall annual limit ($23,000 in 2024 for employees under age 50) on employee elective deferrals if the employee participates in any other qualified plan during the year.

Employer matching contributions. An employer is generally required to match each employee's elective deferrals on a dollar-for-dollar basis up to 3% of the employee's compensation (not limited by the annual compensation limit). See *Increased elective deferral limit,* above. This requirement does not apply if nonelective contributions are made.

Example: In 2024, Jim's employee, Joel, earned $25,000 and chose to defer 5% of his salary. Jim had $40,000 of net earnings from self-employment and chose to contribute 10% of his earnings to his SIMPLE IRA. Jim makes 3% matching contributions.

The total contribution made for Joel is $2,000.

Employee elective deferral ($25,000 × 0.05)	$1,250
Employer matching contribution ($25,000 × 0.03)	750
Total contributions	$2,000

The total contribution Jim makes for himself is $5,200.

Employee elective deferral ($40,000 × 0.10)	$4,000
Employer matching contribution ($40,000 × 0.03)	1,200
Total contributions	$5,200

Reduced matching contribution. The matching contribution may be lower than 3% but may not be lower than 1%. The employees must be notified of the lower match within a reasonable time prior to the 60-day election period. An employer cannot choose a percentage less than 3% for more than two years during the 5-year period that ends with the year for which the choice is effective.

New for 2024 See *Matching contributions for student loan repayments,* page 29-16.

Nonelective contributions. Instead of matching employee deferral contributions, an employer can choose to make nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 (2024) of compensation for the year. Nonelective contributions must be made whether or not the employee chooses to make employee elective deferrals. Nonelective contributions are limited by the annual compensation limit of $345,000 (2024).

New for 2024 ***Increased nonelective contribution limits.*** For tax years beginning after December 31, 2023, an employer can choose to make nonelective contributions of a uniform percentage at a rate of up to 10% of compensation for each employee who is eligible to participate and who has at least $5,000 (2024) of compensation for the year. These nonelective contributions cannot exceed $5,000 (2024) for the year.

For employers with more than 25 employees which elect to have the 110% elective deferral limit apply, the nonelective match is increased from 2% to 3% of employee's compensation. See *Increased elective deferral limit,* previous column.

Note: These increased limit rules do not apply if the employer had another qualified plan within three years immediately preceding the first year the employer maintains a SIMPLE plan.

Time limit for making contributions. Employee elective deferrals to SIMPLE IRAs must be made within 30 days after the end of the month in which the amounts would otherwise have been payable to the employee in cash. Employer matching contributions or nonelective contributions must be made by the due date (including extensions) for filing the employer's federal income tax return for the year.

When to deduct contributions. Non-Roth contributions to a SIMPLE IRA are deductible in the tax year that includes the last day of the calendar year for which they were made. Contributions are deductible if they are made by the due date (including extensions) of the federal income tax return for that tax year.

Example: Melissa is a sole proprietor whose tax year is a calendar year. Contributions under a SIMPLE IRA plan for the calendar year 2024 (including contributions made in 2025 by April 15, 2025 or October 15, 2025 if a valid extension was filed) are deductible in the 2024 tax year.

Where to deduct contributions. See *Where to Deduct Qualified Pension Plan and IRA Contributions* chart, page 29-1.

Payroll taxes. SIMPLE IRA plan contributions are not subject to federal income tax withholding. Employee elective deferrals are subject to Social Security, Medicare, and federal unemployment (FUTA) taxes. Matching and nonelective contributions are not subject to these taxes.

Reporting on Form W-2. Non-Roth SIMPLE IRA plan contributions are not included in wages, tips, other compensation (box 1) of Form W-2. Employee elective deferrals must be included in the boxes for Social Security and Medicare wages. Include the proper code (S) in box 12. Mark the retirement plan checkbox in box 13 for all eligible employees.

Roth SIMPLE IRA W-2 reporting. The employer reports salary reduction contributions made to a Roth IRA for a SIMPLE IRA on Form W-2, Box 12, using Code S. Include the same amount in boxes 1, 3, and 5.

The employer reports employer matching and nonelective contributions made to a Roth IRA on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts.* etc., for the year in which the contributions are made to the employee's Roth IRA, with the total reported in boxes 1 and 2a, using code 2 or 7 in box 7, and the IRA/SEP/SIMPLE checkbox in box 7 checked.

The salary reduction contributions to a Roth IRA under a SIMPLE IRA arrangement are subject to income tax withholding as well as FICA and FUTA taxes.

The employer matching contributions are not subject to income tax withholding, FICA, or FUTA taxes.

See IRS Notice 2024-2.

Distributions (withdrawals). Distributions from a non-Roth SIMPLE IRA are subject to traditional IRA rules and are generally includable in income for the year received.

Rollovers. Tax-free rollovers can be made from one SIMPLE IRA into another SIMPLE IRA. A rollover from a SIMPLE IRA to a non-SIMPLE IRA can be made tax free only after a 2-year participation in the SIMPLE IRA plan.

25% early withdrawal penalty. The 10% early withdrawal penalty that applies to other retirement plans and IRAs also applies to SIMPLE IRAs. However, the 10% penalty is increased to 25% if the early withdrawal occurs within two years of beginning participation.

Termination. SIMPLE IRA plans are maintained on a whole calendar year basis and must continue for the entire calendar year, funding all contributions promised in the employee notice.

Take the following steps to terminate a SIMPLE IRA plan.

- Notify employees within a reasonable time before November 2 that the SIMPLE IRA plan will be discontinued effective the following January 1.
- Notify the SIMPLE IRA plan's financial institution and payroll provider that there will be no SIMPLE IRA contributions for the next calendar year and that contributions will be terminated.
- Keep a record of these actions. Notice to the IRS is not required.

Example: Acme Company decided on November 18, 2024 to terminate its SIMPLE IRA plan as soon as possible. The earliest effective date for the termination is January 1, 2026. Acme must notify its employees before November 2, 2025, that it will not sponsor a SIMPLE IRA plan for 2026.

Exception: An employer may elect to terminate a qualified salary reduction agreement under a SIMPLE IRA plan in the middle of a year if the employer establishes and maintains a safe harbor section 401(k) plan to replace the terminated arrangement. [(IRC §408(p)(11)(A)]

Qualified Plans

Cross References

- IRS Pub. 560, *Retirement Plans for Small Business*
- IRS Pub. 3998, *Choosing a Retirement Solution for Your Small Business*
- IRS Pub. 4222, *401(k) Plans for Small Businesses*
- IRS Pub. 4530, *Designated Roth Accounts under 401(k), 403(b), or governmental 457(b) plan*
- IRS Pub. 4674, *Automatic Enrollment 401(k) Plans for Small Businesses*
- IRC §401, *Qualified pension, profit-sharing, and stock bonus plans*

Related Topics

- Retirement, Social Security, and Medicare, Tab 13
- Employee Stock Ownership Plans (ESOPs), page 37-14

Qualified Retirement Plans

The qualified plan rules are generally more complex than the SEP plan and SIMPLE plan rules. However, there are advantages to qualified plans, such as increased flexibility in designing plans and increased contribution and deduction limits in some cases.

A qualified retirement plan is a plan provided by an employer that:

- Provides retirement income to employees or results in the deferral of income by employees for periods extending generally to the end of employment or beyond, and
- Meets certain requirements under the Internal Revenue Code that give the plan its "qualified" status.

A retirement plan that fails to meet either of these two requirements is a nonqualified retirement plan.

Qualified plan characteristics. The following rules apply to qualified plans. This list is not all-inclusive.

- Plan must be for the exclusive benefit of employees or their beneficiaries. The term employee includes an individual who is self-employed. [IRC §401(c)(1)]
- The employer can deduct employer contributions and employee elective deferrals to the plan, subject to limitations. See *Pension Plan Limitations* chart, page 29-2. Earnings from contributions accumulate tax free until distributed.
- A qualified plan is either a defined contribution plan, a defined benefit plan, or a combination of both. Different rules apply to each. An employer can have more than one qualified plan, but contributions to all plans must not total more than the overall limits. See *Pension Plan Limitations* chart, page 29-2.
- Qualified plans are subject to nondiscrimination rules. See *Highly-compensated employee,* page 29-6.
- An employee must be vested in benefits under a minimum vesting schedule. See *Vesting Rules,* page 29-13.
- Certain types of distributions may qualify for tax-free rollover treatment into another qualified plan or IRA. See *Rollover Chart,* page 29-2.

Who can set up a qualified plan? A sole proprietor, a partnership, or a corporation can set up a qualified plan. A common-law employee or a partner of a partnership cannot set up a qualified plan.

For purposes of this rule, an individual retirement arrangement (IRA) is not considered a qualified plan since common-law employees and partners can set up their own IRAs. However, a SEP IRA is considered a qualified plan. A partner cannot set up and contribute to a SEP IRA even if he or she has self-employment earnings as a partner. However, the partnership can set up and contribute to a SEP IRA for all partners and employees of the partnership.

Top-heavy plan requirements. A top-heavy plan is one that mainly favors partners, sole proprietors, and other key employees. A plan is top-heavy for a plan year if, for the preceding plan year, the total value of accrued benefits or account balances of key employees is more than 60% of the total value of accrued benefits or account balances of all employees. Additional requirements apply to a top-heavy plan primarily to provide minimum benefits or contributions for non-key employees covered by the plan.

Most qualified plans must contain provisions that meet the top-heavy requirements and will take effect in plan years in which the plans are top-heavy. These qualification requirements for top-heavy plans are explained in IRC section 416 and its regulations.

New for 2024 ***Separate testing allowed.*** Effective for plan years beginning after December 31, 2023, employers are allowed to perform the top-heavy test separately on non-excludable and excludable employees. This is intended to remove the financial incentive to exclude employees from the 401(k) plan and increase retirement plan coverage to more workers.

SIMPLE and safe harbor 401(k) plan exception. The top-heavy plan requirements do not apply to:

- SIMPLE 401(k) plans (see *SIMPLE 401(k) Plan,* page 29-18),
- Safe harbor 401(k) plans that consist solely of safe harbor contributions (see *Safe Harbor 401(k) Plan,* page 29-19), or

- Qualified automatic contribution arrangements (see *Qualified automatic contribution arrangement (QACA),* page 29-18).

Defined Contribution Plans

A defined contribution plan provides an individual account for each participant in the plan. It provides benefits to a participant largely based on the amount contributed to that participant's account. Benefits are also affected by income, expenses, gains, losses, and forfeitures of other accounts that may be allocated to an account. A defined contribution plan can be either a profit-sharing plan or a money-purchase pension plan. Examples of defined contribution plans include:

- *Profit-sharing plan,* below.
- *Money-purchase pension plan,* below.
- *Stock bonus plan,* next column.
- *Employee stock ownership plan (ESOP),* next column.
- *Thrift savings plan,* next column.
- *401(k) Plans,* page 29-15.
- *Simplified Employee Pension (SEP),* page 29-7.
- *SIMPLE 401(k) Plan,* page 29-18.

New for 2024 **Pension-linked emergency savings accounts (PLESAs).** For plan years beginning after December 31, 2023, employers can offer PLESAs, which are individual accounts in defined contribution plans that are designed to permit and encourage employees to save for financial emergencies. Subject to certain restrictions, matching contributions are made with respect to PLESA contributions at the same rate as contributions to the linked defined contribution plan.

Employees who are eligible to participate in an employer's defined contribution plan and who qualify to contribute to a PLESA, if offered, may contribute to the PLESA even if they do not participate in the employer's defined contribution plan. Generally, the maximum balance in a participant's PLESA attributable to contributions is $2,500. Employers can choose to set a lower limit.

PLESAs are treated as designated Roth accounts. Therefore, contributions are not tax deductible, but withdrawals are generally tax free. Participants can withdraw funds held in the PLESA at least once a month, as necessary. (Notice 2024-22)

Profit-sharing plan. A business does not actually have to make a profit for the year in order for the employer to make a profit-sharing contribution, except for self-employed individuals. For example, a business that shows a net loss for the year can still make profit-sharing contributions on behalf of its employees. [IRC §401(a)(27)]

A profit-sharing plan can be set up to allow for discretionary employer contributions, meaning the amount contributed each year to the plan is not fixed. An employer may even make no contributions to the plan for a given year. This allows the profit-sharing plan to be more flexible than a money-purchase plan or a defined benefit plan. Contributions may not exceed the limitations. See *Pension Plan Limitations* chart, page 29-2.

The plan must provide a definite formula for allocating the contribution among the participants and for distributing the accumulated funds to the employees after a certain age is reached, after a fixed number of years, or upon certain other occurrences.

Money-purchase pension plan. Contributions to a money-purchase pension plan are fixed from year to year and are not based on business profits. Contributions are usually determined solely as a percentage of each participant's compensation. For example, the plan may require that contributions be 10% of each participant's compensation without regard to whether there is a profit (or the self-employed person has earned income). This applies even though the compensation of a self-employed individual as a participant is based on earned income derived from the business profits.

Stock bonus plan. A stock bonus plan is like a profit-sharing plan except that benefit payments must be made in shares of stock of the company. If a plan distributes cash to the participant, the participant must have the right to demand a distribution of company stock. If the stock is not readily tradable on an established market, participants must be given the right to require the company to repurchase the shares of stock it distributes to them under a fair valuation formula. [IRC §401(a)(23)]

See *Employee Stock Ownership Plans (ESOPs),* page 37-14.

Employee stock ownership plan (ESOP). An ESOP is a special type of profit-sharing or stock bonus plan designed to invest primarily in employer securities. See *Employee Stock Ownership Plans (ESOPs),* page 37-14.

Thrift savings plan. The thrift savings plan (TSP) is a retirement plan similar to 401(k) plans offered to private sector employees [IRC §7701(j)]. Eligible participants include the following.

- A federal employee covered by the Federal Employees Retirement System (FERS) or the Civil Service Retirement System (CSRS).
- A member of the uniformed services.
- A civilian in certain other categories of federal service, such as some justices, judges, and congressional positions.

Defined Benefit Plans

A defined benefit plan is any plan that is not a defined contribution plan. The employer makes contributions in an amount needed to provide definitely determinable future benefits to plan participants. Contributions are based on actuarial assumptions and computations. The employer generally can deduct the greater of:

- The amount necessary to satisfy the minimum funding requirement of the plan for the year,
- The amount necessary to provide all employees under the plan the remaining unfunded cost of their past and current service credits distributed as a level amount, or a level percentage of compensation, over the remaining future service of each such employee, or
- The amount of the plan's normal cost for the year plus the amount necessary to amortize certain unfunded liabilities over 10 years.

Rules required to maintain a defined benefit plan are complicated and may require continuing professional help.

Planning Tip: Although defined contribution plans are generally more popular than defined benefit plans, there are good reasons to consider a defined benefit plan. Small employers and sole proprietors may find their own current retirement savings inadequate with relatively few years left to save. Since defined benefit plans allow for deductible contributions at levels necessary to meet predetermined retirement benefits, business owners can generally defer greater amounts of income into their own retirement plans over a shorter period of time. Defined benefit plans are not subject to the 25% of combined wages deduction limit or the $69,000 (2024) per employee overall contribution limit that applies to defined contribution plans.

Target benefit plan. A target benefit plan is a combination of a defined benefit plan and a money-purchase plan. The plan is like a defined benefit plan in that the employer makes contributions in an amount needed to provide projected future benefits to plan participants (the target benefit). The plan is like a money-purchase plan in that contributions are subject to the defined contribution plan limitations. As a defined contribution plan, contributions are allocated to the separate accounts maintained for each participant. If earnings differ from those that were projected, benefits available to participants will increase or decrease accordingly. Target benefit plans are discussed in Regulation section 1.401(a)(4)-8.

IRC Section 414(x) Combined Plans

An eligible combined plan is one which allows an employer to maintain both a defined contribution plan and a defined benefit plan on a combined basis in order to reduce the administrative burdens and costs of maintaining separate plans. [IRC §414(x)]

Eligible combined plan. An eligible combined plan is a plan:

- That is maintained by an employer that is a small employer at the time the plan is established,
- That consists of a defined benefit plan and an applicable defined contribution plan,
- The assets of which are held in a single trust forming part of the plan and are clearly identified and allocated to the defined benefit plan and the applicable defined contribution plan to the extent necessary for the separate application of the IRC, and
- That meets the benefit, contribution, vesting, and nondiscrimination requirements under IRC section 414(x).

Small employer. A small employer is an employer that employed an average of at least two, but not more than 500 employees, on each business day during the preceding calendar year and who employs at least two employees on the first day of the plan year. In the case of an employer who was not in existence throughout the preceding calendar year, the determination is based on the average number of employees the employer is reasonably expected to employ on business days in the current calendar year.

How to Set Up a Qualified Plan

A qualified retirement plan is a written plan that has invested plan assets. The employer is responsible for setting up and maintaining the plan. A self-employed person is not required to have any other employees to have a qualified plan.

Set-up deadline. Qualified retirement plans adopted before the due date (including extensions) of the employer's tax return can be treated as adopted by the last day of the tax year. This applies to stock bonus, pension, profit sharing, and annuity plans [IRC §401(b)]. SIMPLE IRAs are subject to earlier deadlines. See *When to set up a SIMPLE IRA plan,* page 29-9.

Sole proprietors. Effective for plan years beginning after December 29, 2022, a solo 401(k) plan may receive employee contributions up to the due date (without extension) of the individual's tax return for the initial year of set up.

Credit for start-up costs. Two credits are available to help defray the startup costs of small employer pension plans and to encourage automatic enrollment in the plans. See *Credit for Small Employer Pension Plan Startup Costs, Auto-Enrollment, and Military Spouse Participation (Form 8881),* page 31-10.

Written plan. To qualify, the plan must be in writing and must be communicated to employees. The plan's provisions must be stated in the plan. It is not sufficient to merely refer to a requirement of the Internal Revenue Code. The written plan can be an IRS-approved plan offered by a sponsoring organization, or it can be an individually designed plan. Organizations that can generally provide IRS pre-approved plans include banks, trade or professional organizations, insurance companies, mutual funds, law firms, and third-party administrators.

For more information on individually designed plans, see IRS Pub. 560, *Retirement Plans for Small Business.*

Employment Retirement Income Security Act (ERISA)

The Employee Retirement Income Security Act of 1974 (ERISA) is a federal law that sets minimum standards for retirement and health benefit plans in private industry. ERISA does not require any employer to establish a retirement plan. It only requires that those who establish plans must meet certain minimum standards.

ERISA covers retirement, health, and other welfare benefit plans. It provides that individuals and other fiduciaries who manage plans must meet certain standards of conduct. The law contains detailed provisions for reporting to the government and disclosure to participants. There are also provisions aimed at assuring that plan funds are protected and that participants who qualify receive their benefits.

Requirements. The Department of Labor's Employee Benefits Security Administration (EBSA) assists employers and employee benefit plan officials in understanding and complying with the requirements of ERISA as it applies to the administration of employee retirement, health, and other welfare benefit plans. For more information, see www.dol.gov/agencies/ebsa.

Disclosure regarding lifetime income. Benefit statements provided to defined contribution plan participants must include a lifetime income disclosure at least once during any 12-month period. The disclosure must illustrate the monthly payments the participant might be expected to receive if the total account balance were used to provide a lifetime income stream. The Department of Labor has a model disclosure rule.

Minimum Funding Requirement

Minimum funding requirements apply to money-purchase pension plans, defined benefit plans, multi-employer plans, and cooperative and small employer charity pension (CSEC) plans. [IRC §412(a)(2)]

An employer must actually pay enough into the plan to satisfy the minimum funding standard for each year. In the case of a money-purchase plan, the employer must make contributions for the plan year which are required under the terms of the plan. For example, if the plan says an amount equal to 10% of employee compensation will be contributed to the account of each employee for the year, the employer must actually pay that amount into each account. Determining the amount needed to satisfy the minimum funding standard for a defined benefit plan is complicated and may require professional help.

Vesting Rules

A qualified retirement plan must meet certain vesting rules. A vested benefit means an employee's right to the benefit is nonforfeitable. It cannot be lost upon the happening, or failure to happen, of any event.

Employee contributions. An employee must always be fully vested in his or her own contributions to the plan, such as employee elective deferrals to a 401(k) plan.

Employer contributions. The vesting schedule is the same for all employer contributions to defined contribution plans, whether it is employer matching contributions to a 401(k) plan or employer contributions to other types of profit-sharing or money-purchase plans. An employee must become vested in employer contributions under one of the following schedules. [IRC §411(a)(2)]

1) The employee becomes fully vested after completing at least three years of service (five years for defined benefit plans), or
2) The employee is partially to fully vested under the following schedule.

Years of Service	*Percent of Vested Benefits*	
	Defined Contribution Plans	*Defined Benefit Plans*
2	20%	
3	40%	20%
4	60%	40%
5	80%	60%
6	100%	80%
7 or more	100%	100%

Note: Employers can choose to allow employees to be vested sooner than the above schedules.

Author's Comment: A participant in an employer qualified plan is generally limited in his or her ability to cash in funds, even if he or she is fully vested. Employees generally cannot cash in or roll over vested benefits into an IRA until the employee separates from service. In contrast, a participant is always fully vested in an IRA, SIMPLE IRA, SEP IRA, and a Roth IRA and does not need to first retire or separate from service to have access to funds in these accounts. The employer cannot prevent the employee from cashing in one of these accounts.

Forfeitures. Special rules apply to forfeited benefit amounts.

Defined contribution plans. In defined contribution plans, forfeitures can be allocated to the accounts of remaining participants in a nondiscriminatory way or they can be used to reduce the employer's contributions.

Example: Jason set up a profit-sharing plan for his employees. He will contribute to each employee's account an amount equal to 5% of their compensation in each year in which his company shows a profit in excess of $50,000. Employees must complete at least three years of service (1,000 minimum hours per year) before they are vested in these contributions. Should an employee leave prior to becoming vested, the accumulated funds in his or her account are reallocated among the remaining participants.

Defined benefit plans. Forfeitures under a defined benefit plan cannot be used to increase the benefits any employee would otherwise receive under the plan. Forfeitures must be used instead to reduce employer contributions.

Contributions

Qualified plans are generally funded by employer contributions. However, under certain situations, employees participating in the plan may make either pre-tax elective deferrals into the plan, such as 401(k) or SIMPLE plan elective deferrals, or make after-tax contributions. Even though employee contributions may be after-tax contributions, the earnings on them are tax free until distributed in later years. Employee after-tax contributions must also satisfy the same nondiscrimination tests that apply to employer matching contributions. [IRC §401(m)]

Defined contribution plan limits. A defined contribution plan's annual contributions and other additions (excluding earnings) to the account of a participant cannot exceed the lesser of the following amounts.

- 100% of the participant's compensation, or
- $69,000 (2024).

The contribution limits, above, are a combination of employer contributions and elective employee deferrals. The basic limit on elective employee deferrals is $23,500 (2024).

Catch-up contributions. A 401(k) plan can permit participants who are age 50 or over at the end of the year to make additional contributions up to $7,500 (2024). Elective deferrals are not treated as catch-up contributions until they exceed the basic elective deferral limit. Catch-up contributions are not subject to the $69,000 (2024) total contribution limit.

Example: Korky is age 50 in 2024 and self-employed. She has $250,000 in net self-employment income after the one-half SE tax deduction. She has a solo 401(k) plan and contributes the maximum combination of elective deferrals and employer contributions allowed to a defined contribution plan. The combination of the maximum elective deferrals ($23,000) plus employer matching contributions ($250,000 × 20% = $50,000) cannot exceed $69,000 ($23,000 + $50,000 = $73,000, is limited to $69,000). The additional $7,500 (2024) catch-up contribution is not subject to the $69,000 limit. Thus, Korky can contribute a total of $76,500 to her solo 401(k) plan for 2024 ($69,000 + $7,500).

Defined benefit plan limits. The annual benefit for a participant under a defined benefit plan cannot exceed the lesser of the following amounts.

- 100% of the participant's average compensation for his or her highest three consecutive calendar years.
- $275,000 (2024).

Deadline for making contributions. Employers can make deductible contributions to a qualified plan for a tax year up to the due date of the employer's tax return for that year, including extensions. In contrast, IRA contributions must be made by April 15 of the year following the year for which the contribution applies, not including extensions.

Contributions are generally applied to the year in which they are made. They may be applied to the previous year if all the following requirements are met.

- Contributions are made by the due date of the employer's tax return for the previous year, plus extensions.
- The plan was established by the end of the previous year.
- The plan treats the contributions as though it had received them on the last day of the previous year.
- The employer does one of the following.
  - Specifies in writing to the plan administrator or trustee that the contributions apply to the previous year.
  - Deducts the contributions on the tax return for the previous year.

Note: A promissory note made out to the plan is not a payment and is considered a prohibited transaction subject to tax.

Partnership. A partnership shows contributions for partners on Form 1065 (Schedule K), and Schedule K-1, box 13, code R. The deduction then flows through to line 16 of the partner's Schedule 1 (Form 1040). See *Schedules K and K-1 (Form 1065),* page 20-27.

Self-employed individual. A self-employed individual can make contributions on his or her own behalf only if the self-employed individual has net earnings from self-employment in the trade or business for which the plan was set up. Net earnings must be from the personal services of the self-employed individual. Net earnings from investments do not qualify. If there is a net loss from self-employment, no contributions for the self-employed individual are allowed, even if contributions are made for common-law employees based on their compensation.

Employer Deduction

In general, an employer can deduct contributions made to a qualified plan, including those made on behalf of the owner of the business (i.e. sole proprietor, partner of a partnership, shareholder-employee of a corporation). The contributions, including earnings and gains, are generally tax free until distributed by the plan.

Deduction limits for defined contribution plans. The deduction limits are not the same as the contribution limits. An employer's deduction for contributions to a profit-sharing or money-purchase plan cannot be more than 25% of the combined compensation paid or accrued during the year to all eligible employees participating in the plan [IRC §404(a)(3)]. An exception applies for self-employed individuals. See *Self-employed deduction limit,* page 29-14.

The following rules apply when calculating the deduction limit.

- Elective deferrals are not subject to the limit.
  Example: An employer's only employee makes $40,000 gross wages and defers $10,000 into his 401(k). The employer makes a $5,000 matching contribution. The $5,000 does not exceed 25% of $40,000. The $10,000 elective deferral is not included in the 25% limit.
- Compensation includes elective deferrals.
  Example: An employer's only employee makes $40,000 gross wages and defers $10,000 into his 401(k) so that his taxable Form

W-2 wages equal $30,000. Compensation for purposes of this rule equals $40,000.

- The maximum compensation that can be taken into account for each employee is $345,000 for 2024.

Example: An employer's only employee makes $400,000 gross wages. The employer has a money-purchase plan in which an amount equal to 25% of an employee's compensation is contributed to his or her account. The employer's deduction limit in 2024 is $86,250 ($345,000 × 25%). However, since the employer is not allowed to contribute any more than $69,000 (2024) to the account of any employee under IRC section 415(c), the deduction is limited to $69,000, which is the actual amount contributed.

Self-employed deduction limit. Compensation equals net earnings from self-employment, minus the deduction for one-half of self-employment (SE) tax, minus the deduction for contributions on behalf of the self-employed individual to the plan.

Example #1: Larry is a self-employed carpet cleaner with one employee. He sets up a profit-sharing plan for himself and his employee in which he will contribute an amount equal to 15% of compensation to the account of each employee. Larry contributes 15% of his employee's Form W-2 wages on behalf of his employee.

Larry's Schedule C (Form 1040) net income equals $40,000 and his deduction for one-half SE tax equals $2,826 ($40,000 × 0.9235 × 0.153 × 0.50 = $2,826). Larry's contribution on behalf of himself can be calculated three different ways using the table, below.

1) $40,000 × 12.1220% = $4,849, or
2) $40,000 – $2,826 = $37,174 × 13.0435% = $4,849, or
3) $40,000 – $2,826 – $4,849 = $32,325 × 15% = $4,849.

The third calculation above cannot be made until the contribution amount is known. It is only listed in this example to demonstrate the rule. The first calculation above does not work if compensation exceeds the maximum earnings subject to Social Security tax. The following chart converts the percentage used for employees into the percentage that must be used for self-employed individuals.

Self-Employed Deduction Limit Percentage Table

Contribution rate for employees[1]	*Rate applied to net SE income minus one-half SE tax*	*Rate applied to net SE income before deducting one-half SE tax*[2]
1%	0.9901%	0.9202%
2%	1.9608%	1.8223%
3%	2.9126%	2.7068%
4%	3.8462%	3.5745%
5%	4.7619%	4.4255%
6%	5.6604%	5.2605%
7%	6.5421%	6.0799%
8%	7.4074%	6.8841%
9%	8.2569%	7.6736%
10%	9.0909%	8.4486%
11%	9.9099%	9.2098%
12%	10.7143%	9.9574%
13%	11.5044%	10.6916%
14%	12.2807%	11.4131%
15%	13.0435%	12.1220%
16%	13.7931%	12.8186%
17%	14.5299%	13.5034%
18%	15.2542%	14.1765%
19%	15.9664%	14.8384%
20%	16.6667%	15.4892%
21%	17.3554%	16.1293%
22%	18.0328%	16.7588%
23%	18.6992%	17.3781%
24%	19.3548%	17.9874%
25%	20.0000%	18.5870%

continued in next column

Self-Employed Deduction Limit Percentage Table

[1] If the plan's contribution rate is not a whole percentage (for example 8½%), see Example #2, below

[2] Assumes participant has not exceeded the maximum earnings subject to Social Security tax. If earnings exceed maximum Social Security earnings, subtract one-half of SE tax from self-employment earnings, then multiply by the percentage in the middle column method.

Example #2: Assume the same facts as Example #1, previous column, except that Larry will contribute 8 ½% of compensation to his profit-sharing plan. Larry's contribution on his own behalf would be calculated as follows.

Rate Worksheet for Self-Employed

1) Plan contribution rate as a decimal (8 ½ % = 0.085)	1)	0.085
2) Rate from line 1 plus 1 (0.085 + 1 = 1.085)	2)	1.085
3) Divide line 1 by line 2 and round to at least 3 decimal places (0.085 ÷ 1.085 = 0.078)	3)	0.078
4) Line 3 amount as percentage. **Apply this rate to net SE income minus ½ of SE tax (using table, previous column)**	4)	**7.8000%**
5) ½ SE tax ÷ net SE income (in this example $2,826 ÷ $40,000 = 0.070625)	5)	0.070625
6) Subtract the amount on line 5 from 1 (1 – 0.070625 = 0.929352)	6)	0.929352
7) Multiply the rate on line 4 by the amount in line 6	7)	0.072489
8) Line 8 amount as a percentage. **Apply this rate to net SE income before deducting ½ SE tax (using table, previous column)**	8)	**7.2489%**

Deduction limits for defined benefit plans. The deduction limit is based on actuarial assumptions and computations. An actuary must compute the deduction limit.

Where to deduct qualified pension plan and IRA contributions. See *Where to Deduct Qualified Pension Plan and IRA Contributions* chart, page 29-1.

Excess contributions. Contributions made in excess of the yearly limits are nondeductible. See *Defined contribution plan limits,* and *Defined benefit plan limits,* page 29-14.

Carryover. The excess may be carried over and deducted in later years, combined with contributions for those years. The combined deduction in a later year is limited to 25% of the participating employees' compensation. For purposes of this limit, a SEP is treated as a profit-sharing (defined contribution) plan. The 25% limit must be reduced for self-employed individuals. See *Self-employed deduction limit,* previous column.

Excess contribution penalty. Excess contributions to qualified pension and profit-sharing plans and SEPs are generally subject to a 10% excise tax, reported on Form 5330, *Return of Excise Taxes Related to Employee Benefit Plans.* The excise tax does not apply to any contributions made by a self-employed individual to meet the minimum funding requirements in a money-purchase pension plan or a defined benefit plan.

Employee Plans Compliance Resolution System (EPCRS). For information regarding correction programs for sponsors of plans, see *Employee Plans Compliance Resolution System,* page 29-22.

401(k) Plans

A qualified retirement plan can include a cash or deferred arrangement under which participants can choose to have part of their pre-tax compensation contributed to the plan rather than receive the compensation as taxable cash. These contributions are called "elective deferrals" because the participant chooses to defer receipt of the money. For rules on 401(k) plans that allow for after-tax Roth elective deferrals, see *Qualified Roth Contribution Program,* page 29-19.

Financial incentive. A de minimis financial incentive not paid for with plan assets (e.g., gift card), may be provided to employees who elect to participate in an employer's 401(k) plan. [IRC §401(k)(4)(A)]

Limit on elective deferrals. See *Pension Plan Limitations* chart, page 29-2.

Catch-up contributions. A 401(k) plan can permit participants who are age 50 or over at the end of the calendar year to also make catch-up contributions. For age 50 or older elective deferral contribution limits, see *Pension Plan Limitations* chart, page 29-2.

Elective deferrals are not treated as catch-up contributions until they exceed $23,000 (2024), the plan limit (if any), or the ADP test limit of IRC section 401(k)(3). See *Actual deferral percentage (ADP) test,* page 29-17.

The catch-up contribution a participant can make for a year cannot exceed the lesser of:
- The catch-up contribution limit, or
- The excess of the participant's compensation over the elective deferrals that are not catch-up contributions.

Example: Warren is age 57, with total compensation equal to $23,500 in 2024. The elective deferral limit for participants under age 50 equals $23,000 (2024). The catch-up contribution that he can make is limited to $500 ($23,500 – $23,000).

Example: Don is age 55, with total compensation equal to $200,000. Assume that under the ADP test for his company, page 29-17, his elective deferral limit is $9,000 in 2024. He can elect to defer an additional $7,500 (the maximum catch-up contribution limit) to his 401(k) plan for 2024.

Depositing elective deferrals. Employers that withhold elective deferrals from the wages of employees must deposit the deferrals into the employee's account as soon as reasonably possible, but not later than the 15th business day of the following month. If the employer does not make the deposits on time, the failure may constitute both an operational mistake, resulting in plan disqualification, and a prohibited transaction. See *Prohibited Transactions,* page 29-22.

Restriction on conditions of participation. A plan cannot require, as a condition of participation, that an employee complete more than one year (1,000 hours) of service.

Long-term part-time employees eligible. Except for collectively bargained plans (union), employers should have dual eligibility requirements for an employee to make elective deferral.
- One year of service (1000 hours), or
- Three years of consecutive service of at least 500 hours (beginning January 1, 2021), which makes 2024 the required participation beginning date for long-term part-time employees.

Note: Effective for plan years beginning after December 31, 2024, three consecutive 12-month periods are reduced to two consecutive 12-month periods.

Employers may exclude employees working less than 1000 hours per year from employer matching contributions and testing under nondiscrimiation, coverage, and top-heavy rules. (Notice 2020-68)

Employer matching contributions. A plan can permit the employer to make matching contributions for an employee who makes an elective deferral to a 401(k) plan. For example, the plan could say the employer will contribute 50¢ for every dollar a participating employee chooses to defer. Using a matching contribution formula means the employer only contributes to the accounts of employees who make elective deferrals into the 401(k) plan. Matching contributions are generally subject to the ACP test. See *Actual contributions percentage (ACP) test,* page 29-17.

New for 2024 ***Matching contributions for student loan repayments.*** The SECURE 2.0 Act of 2022 permits employers to make matching contributions into a participant's retirement account when the employee makes a qualified student loan payment.

A student loan payment is not a contribution to a retirement plan. However, it may be treated as a contribution for purposes of meeting the matching contribution rules. An employer may rely on the employee's certification that the employee made a qualified student loan payment when making a matching contribution into the employee's retirement plan.

Qualified student loan payment. A qualified student loan payment is a payment made by an employee in repayment of a qualified education loan incurred by the employee to pay qualified higher education expenses, but only:
- To the extent the payments in the aggregate for the year do not exceed an amount equal to:
  - The elective deferral limitation for the year, or if lesser, the employee's compensation for the year, reduced by
  - The elective deferrals made by the employee for the year, and
- If the employee certifies annually to the employer that such payment had been made on the student loan.

Matching contributions. The matching contribution on account of a qualified student loan payment will be treated as a matching contribution to a defined contribution plan if:
- The plan provides elective deferral matching contributions at the same rate as qualified student loan payment matching contributions,
- The plan provides matching qualified student loan payment contributions on behalf of employees otherwise eligible to receive elective deferral matching contributions,
- All employees eligible to receive elective deferral matching contributions are eligible to receive qualified student loan payment matching contributions, and
- The plan provides that qualified student loan payment matching contributions vest in the same manner as elective deferral matching contributions.

Types of elective deferrals. The following types of elective deferral plans can adopt a policy to match qualified student loan payments.
- 401(k) elective deferrals (see *401(k) Plans,* page 29-15),
- 403(b) tax-sheltered annuity (TSA) plan elective deferrals,
- Simple elective deferrals (see *SIMPLE IRA Plan,* page 29-9), and
- 457(b) deferred compensation plans.

Nonelective contributions. A qualified 401(k) plan can also make contributions (other than matching contributions) for participating employees without giving the employee the choice to take cash instead. The employer makes a contribution for each eligible participant, whether or not the participant decides to make an elective deferral into the 401(k) plan. Under a traditional 401(k) plan, the employer has the flexibility of changing the amount of nonelective contributions each year, according to business conditions.

Roth employer matching and nonelective contributions. If the plan allows, plan participants may choose to receive employer matching and nonelective contributions as Roth contributions. Any designated Roth contribution made by the employer must be nonforfeitable and is not excludable from the employee's gross income.

Reporting designated Roth contributions under an applicable retirement plan. Designated Roth nonelective contributions and designated Roth matching contributions are not subject to withholding for federal income tax. Additionally, these contributions are generally not subject to Social Security or Medicare tax withholding.

Form W-2. Include designated Roth contributions, made in lieu of elective deferrals, in boxes 1, 3, and 5 or Form W-2, *Wage and Tax Statement.* Report them in box 12 using code AA for a section 403(b) plan, or EE for a governmental 527(b) plan.

Form 1099-R. Designated Roth nonelective and matching contributions must be reported in boxes 1 and 2a of Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, for the year in which they are allocated to an individual's account. Use code G in box 7.

Vesting. A participant is always 100% vested in his or her own elective deferrals. Normal vesting rules apply to employer matching contributions. See *Vesting Rules,* page 29-13.

Elective deferral deductions. Non-Roth elective deferrals are excluded from an employee's taxable wage reported in box 1 of the employee's Form W-2. See *Where to Deduct Qualified Pension Plan and IRA Contributions,* page 29-1.

FICA and FUTA. Elective deferrals are included in wages for FICA and FUTA tax purposes.

Excess deferrals. If an employee's elective deferrals exceed the limits for the year, the employee can have the excess distributed. He or she must notify the plan by April 15 of the year following the excess deferrals or an earlier date if specified in the plan. Assuming the plan permits these distributions, the plan must then pay the employee that amount by April 15 of the year following the excess deferrals.

Excess withdrawn by April 15. If the employee withdraws the excess deferral by April 15 of the following year, it is not included in gross income in the year of distribution. In this case, it is taxable in the year it was deferred. However, any income earned on the excess deferral is taxable in the year it is withdrawn. The distribution is not subject to the additional 10% tax on early distributions. See *Exceptions to the 10% Penalty on Early Distributions* chart, page 13-3.

Excess not withdrawn by April 15. If the employee does not withdraw the excess deferral by April 15, the excess, though taxable in the prior year, is not included in the employee's cost basis in calculating the taxable amount of any eventual distributions under the plan. In effect, an excess deferral left in the plan is taxed twice, once when contributed and again when distributed. If the employee's excess deferral is allowed to stay in the plan, the plan can be disqualified.

Example: Martin mistakenly elected to defer $26,500 into his 401(k) plan in 2024, when he was only age 47. The $3,500 excess deferral was not distributed by April 15, 2025. Upon audit, it is discovered he was only allowed to defer $23,000. In addition to having to pay tax on the excess deferral, the $3,500 does not add to his cost basis in the plan. When the funds are eventually distributed, he must pay tax on the distribution.

Nondiscrimination tests. Plan sponsors must test deferred compensation plans each year to ensure that the contributions made by and for nonhighly-compensated employees are proportional to highly-compensated employees. These nondiscrimination tests are called the actual deferral percentage (ADP) test and the actual compensation percentage (ACP) test.

Actual deferral percentage (ADP) test. The ADP test prevents a highly-compensated employee from deferring a greater percentage of his or her compensation than a nonhighly-compensated employee. [Reg. §1.401(k)-2]

The ADP test is satisfied if either of the following apply.

- The ADP for the eligible highly-compensated employees for the plan year is not more than the ADP for the eligible nonhighly-compensated employees for the applicable year multiplied by 1.25, or
- The excess of the ADP for the eligible highly-compensated employees for the plan year over the ADP for the eligible nonhighly-compensated employees for the applicable year is not more than 2 percentage points, and the ADP for the eligible highly-compensated employees for the plan year is not more than the ADP for the eligible nonhighly-compensated employees for the applicable year multiplied by 2.

See *Highly-compensated employee,* page 29-6.

Note: The ADP test does not apply to SIMPLE and safe harbor 401(k) plans. See *SIMPLE 401(k) Plan,* page 29-18, and *Safe Harbor 401(k) Plan,* page 29-19.

Example #1: Gopher Company has a 401(k) for all eligible employees. In 2024, each eligible employee made the following elective deferrals.

Employee	*Compensation*	*Elective deferral*
Aaron	$300,000	$13,020
Bruce	66,000	3,146
Courtney	49,500	1,375

For each employee, the ratio of elective deferrals to the employee's compensation for 2024 is:

Employee	*Ratio*	*ADP*
Aaron	13,020 ÷ 300,000	4.34%
Bruce	3,146 ÷ 66,000	4.77%
Courtney	1,375 ÷ 49,500	2.78%

The ADP for the highly-compensated employee (Aaron) is 4.34%. The ADP for the nonhighly-compensated employees (Bruce and Courtney) is 3.78% [(4.77% + 2.78%) ÷ 2]. Because 4.34% is less than 4.73% (3.78% × 1.25), the plan satisfies the ADP test.

Example #2: Assume the same facts as Example #1, except that elective deferrals are as follows.

Employee	*Compensation*	*Elective deferral*	*AD Ratio*
Aaron	$300,000	$17,310	5.77%
Bruce	66,000	3,146	4.77%
Courtney	49,500	1,375	2.78%

The ADP for the highly-compensated employee (Aaron) is 5.77%. The ADP for the nonhighly-compensated employees (Bruce and Courtney) is the same as Example #1 (3.78%). Because 5.77% exceeds 4.73% (3.78% × 1.25), the plan does not satisfy the first part of the ADP test. However, because the ADP for the highly-compensated employee does not exceed the ADP for the nonhighly-compensated employees by more than 2 percentage points (5.77% – 3.78% = 1.99%), and the ADP for the highly-compensated employee does not exceed the ADP for the nonhighly-compensated employees multiplied by 2 (3.78% × 2 = 7.56%), the plan satisfies the second part of the ADP test.

Actual contribution percentage (ACP) test. The ACP test uses the same multiples and percentages found in the ADP test except that it includes employer matching contributions along with employee elective deferrals to arrive at the actual contribution percentage. [Reg. §1.401(m)-2]

See *Actual deferral percentage (ADP) test,* page 29-17.

Note: The ACP test does not apply to SIMPLE and safe harbor 401(k) plans. See *SIMPLE 401(k) Plan,* page 29-18, and *Safe Harbor 401(k) Plan,* page 29-19.

Example: Lake Corporation maintains a 401(k) plan under which it makes a 50¢ matching contribution for each dollar of employee elective deferrals. The actual contribution percentages for highly-compensated employees versus nonhighly-compensated employees are as follows.

	Employee Contributions %	*Matching Contributions %*	*Actual Contribution %*
Highly-compensated Employees	4.0%	2.0%	6.0%
Nonhighly-compensated Employees	3.0%	1.5%	4.5%

continued on next page

Because the ACP for the highly-compensated employees (6%) exceeds 5.63% (4.5% × 1.25), the plan does not satisfy the first part of the ACP test. However, because the ACP for the highly-compensated employees does not exceed the ACP for the nonhighly-compensated employees by more than 2 percentage points (6% − 4.5% = 1.5%), and the ACP for the highly-compensated employees does not exceed the ACP for the nonhighly-compensated employees multiplied by 2 (4.5% × 2 = 9%), the plan satisfies the second part of the ACP test.

Penalty for excess contributions of highly-compensated employees. If the ADP test and the ACP test show that contributions for highly-compensated employees are more than the test limits for these contributions, the employer may be subject to a 10% excise tax, reported on Form 5330, *Return of Excise Taxes Related to Employee Benefit Plans.* Excess contributions for purposes of this penalty include elective deferrals, employee contributions, or employer matching or nonelective contributions that exceed the amount permitted under the ADP or ACP tests.

Automatic enrollment election. To encourage employees to save for retirement, a 401(k) plan can have an automatic enrollment feature. Under this feature, an employee's pay is automatically reduced by a fixed percentage, limited to 15%, and contributed to the 401(k) plan on his or her behalf unless the employee affirmatively chooses not to have his or her pay reduced or chooses to have it reduced by a different percentage. The contributions are still considered elective deferrals.

Eligible automatic contribution arrangement (EACA). Under an EACA, a participant is treated as having elected to have the employer make contributions in an amount equal to a uniform percentage of compensation. This automatic election will remain in place until the participant specifically elects not to have such deferral percentage made or elects a different percentage. There is no required deferral percentage.

Qualified automatic contribution arrangement (QACA). A QACA is a safe harbor plan that contains an automatic enrollment feature and mandatory employer contributions. If a plan includes a QACA, it will not be subject to the ADP test or the top-heavy requirements. Additionally, the plan will not be subject to the ACP test if certain additional requirements are met.

The initial automatic employee contribution must be at least 3% of the employee's compensation. Contributions must automatically increase 1% per year so that, by the fourth year, the automatic employee contribution is 6% of compensation.

The automatic employee contributions cannot exceed 15% of compensation in any year. The employee is permitted to change the amount of his or her employee contributions or choose not to contribute, but must do so by making an affirmative election.

New for 2024: Starter 401(k) Plan

Effective for plan years beginning after December 31, 2023, a starter 401(k) deferral-only arrangement maintained by an eligible employer is treated as meeting the nondiscrimination tests under section 401(k). It will also not be treated as a top-heavy plan.

To qualify, a starter 401(k) plan must meet the following conditions.
- The automatic deferral,
- The contribution limitations, and
- The notice requirements under IRC section 401(k)(13)(E).

Automatic deferral. Each eligible employee is treated as having elected to have the employer make contributions at a uniform percentage of not less than 3% nor more than 15% of compensation. An employee can make an affirmative election to not participate, or to make elective deferrals at different specified level.

Contribution limitations. Under a starter 401(k) plan, the only contributions allowed are elective contributions of the employees. The maximum elective contribution with respect to each employee for the calendar year is limited to $6,000.

Catch-up contributions. For employees who have attained the age of 50 or more, the $6,000 limitation is increased by the IRA catch-up amount ($1,000 for tax year 2024).

The contribution limit and catch-up contribution limit will each be adjusted annually for inflation.

Notification. Each eligible employee must receive annual notice of his or her rights and obligations under the arrangement. [IRC §401(k)(13)(E)]

Eligible employer. An eligible employer is any employer that does not maintain any other qualified plan.

403(b) plans. The new law also creates a safe harbor deferral-only plan for employers with no retirement plan under the IRC section 403(b) annuity contract provisions. These rules generally mirror the same provisions that apply to starter 401(k) deferral-only arrangements.

SIMPLE 401(k) Plan

The SIMPLE 401(k) plan was created so small businesses could have an effective, cost-efficient way to offer retirement benefits to their employees. It is a qualified plan, however it is not subject to the annual nondiscrimination tests (ADP and ACP tests) that apply to traditional 401(k) plans. Similar to a safe harbor 401(k) plan, the employer is required to make employer contributions that are fully vested. See *Safe Harbor 401(k) Plan,* page 29-19.

Eligible employer. An employer who meets the following requirements can set up a SIMPLE 401(k).

- The employer had 100 or fewer employees who received $5,000 or more in compensation from the employer for the preceding year.
- The employer does not maintain another qualified plan (except for certain union employees).

Once a SIMPLE 401(k) is in place, the employer must continue to meet the 100-employee limit. A 2-year grace period applies once this limit is exceeded.

Employer contribution. Employers must make either:
- Matching contributions up to 3% of compensation for the year, or
- Nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 of compensation for the year.

No more than $345,000 (2024) of the employee's compensation can be taken into account when calculating matching and nonelective contributions.

New for 2024 The Secure 2.0 Act increased the employer nonelective contributions for both SIMPLE IRA plans and SIMPLE 401(k) plans. See *Increased nonelective contribution limits,* page 29-10.

Note: The less than 3% but not less than 1% for two out of five years option that is available for SIMPLE IRAs, is not available for SIMPLE 401(k) plans. See *Employer matching contributions,* page 29-10.

Elective deferral limits. Unlike other 401(k) plans, elective deferrals for SIMPLE 401(k) plans are subject to the same limitations as SIMPLE IRAs ($16,000 in 2024 if under age 50). See *Pension Plan Limitations* chart, page 29-2.

New for 2024 The Secure 2.0 Act increased the elective deferral limits for both SIMPLE IRA plans and SIMPLE 401(k) plans. See *Increased elective deferral limit,* page 29-10.

Catch-up contributions. A SIMPLE 401(k) plan can permit participants who are age 50 or older at the end of the calendar year to make catch-up contributions up to $3,500 (2024).

Safe Harbor 401(k) Plan

A safe harbor 401(k) plan is similar to a traditional 401(k) plan, but must provide for employer matching contributions that are fully vested. By meeting these requirements, the 401(k) avoids the complex ADP and ACP nondiscrimination testing rules. Safe harbor 401(k) plans are also well suited for self-employed individuals. A safe harbor 401(k), like a traditional 401(k), can be used by employers of any size and can be combined with other retirement plans. Unlike traditional 401(k) plans, the employee must always be 100% vested in all required employer contributions. The employer must make either matching contributions or nonelective contributions each year.

Matching contributions. Basic matching contributions must equal:

- 100% of each nonhighly-compensated employee's elective deferrals, up to 3% of compensation, and
- 50% of each nonhighly-compensated employee's elective deferrals in excess of 3% of compensation but not more than 5% of compensation.
- The rate of matching contributions for highly compensated employees, including a self-employed individual, must not exceed the rates for nonhighly compensated employees.

Enhanced matching formula. An employer may make enhanced matching contributions that meet the following requirements. [Reg. §1.401(k)-3(c)(3)]

- The aggregate amount of matching contributions is at least equal to the aggregate amount of matching contributions under the basic matching formula.
- The ratio of matching contributions does not increase as the amount of each employee's deferrals increase.

Nonelective contributions. Nonelective contributions must equal 3% of each nonhighly-compensated employee's compensation.

Solo 401(k) Plan

A 401(k) plan set up for a sole proprietor (including a business owned by spouses) with no other employees is sometimes called a solo 401(k) plan. With no other employees, the sole participant is deemed to have satisfied both the ADP test and the ACP test, thus allowing the sole proprietor to contribute the maximum possible amount allowed for any defined contribution plan.

Example: Tammy is under age 50 and self-employed. She sets up a single-participant 401(k) plan for herself. Her net profit after the one-half SE tax deduction for 2024 is $30,000. She contributes the maximum elective deferral of $23,000 to the plan.

The ADP and ACP tests have no effect on her elective deferrals as there are no other employees. The plan is also set up to contribute the maximum employer deduction, which is 20% for self-employed individuals. See *Pension Plan Limitations* chart, page 29-2.

Since elective deferrals do not reduce compensation for purposes of the employer deduction limit, her employer matching contribution is $6,000 ($30,000 × 20%). The total of employer contributions ($6,000) plus elective deferrals ($23,000) equals $29,000.

Qualified Roth Contribution Program

A qualified Roth contribution program is a plan that allows eligible employees to designate all or a portion of their 401(k) elective deferrals and employer contributions as after-tax Roth contributions. Elective deferrals and employer contributions designated as Roth contributions must be maintained in a separate Roth account.

401(k) characteristics. Qualified Roth contribution rules are the same as regular 401(k) rules in the following areas.

- Elective deferral limits are the same. See *Pension Plan Limitations* chart, page 29-2.
- Determining the maximum employee and employer annual contributions are the same. See *Pension Plan Limitations* chart, page 29-2.
- Nondiscrimination testing is the same.
- Required distribution rules are the same.
- Compensation includes elective deferrals for purposes of calculating the deduction limit.
- Elective deferrals and employer contributions are wages for purposes of Social Security and Medicare taxes.

Roth IRA characteristics. Qualified Roth contribution rules are the same as Roth IRA rules in the following areas.

- Elective deferrals are not excluded from gross income.
- Qualified distributions are excluded from gross income.
- The definition of a qualified distribution for purposes of the tax-free distribution rules is the same, except that the 5-year rule applies to designated Roth contributions.

Rollovers. A rollover from another account can be made to a designated Roth account. A distribution from a designated Roth account can only be rolled over to another designated Roth account or a Roth IRA. See *Rollover Chart,* page 29-2.

Distributions

Distributions from a qualified plan may be nonperiodic, such as a lump-sum distribution, or periodic, such as annuity payments.

Tax treatment. The tax treatment of a distribution depends upon the participant's basis in the plan. Basis represents the nondeductible after-tax contributions in a plan, such as a plan where the employee makes voluntary after-tax contributions in addition to pre-tax employer contributions. If all contributions to the plan are pre-tax contributions, such as employer contributions and employee elective deferrals, the plan will have zero basis and all distributions will be taxable.

Exceptions:

- Qualified distributions from a Qualified Roth Contribution Program may be tax-free. See *Qualified Roth Contribution Program,* previous column.
- Distributions that are properly rolled over are tax-free. See *Rollovers and Transfers,* page 29-21.
- A lump sum distribution to a participant born before January 2, 1936, may qualify for 10-year averaging at special tax rates. For details, see IRS Pub. 575, *Pension and Annuity Income.*

If a beneficiary has a cost basis in a qualified plan, a portion of each distribution may be nontaxable. To calculate the cost basis portion of a distribution, see *Distributions,* page 13-18.

10% penalty on early distribution. A distribution before age 59½ may also be subject to the 10% penalty on early distributions from qualified retirement plans unless one of the exceptions applies. See *Exceptions to the 10% Penalty on Early Distributions* chart, page 13-3.

Court Case: The taxpayer left his position as a partner in a law firm at age 56. He rolled money from his employer's qualified retirement plan into an IRA. The following year, he withdrew money from the IRA and paid tax on the distribution but not the 10% early withdrawal penalty. Under IRC section 72(t)(2)(A)(v), the 10% early withdrawal penalty does not apply if the distribution is from a qualified retirement plan and the participant has separated from service in or after the year he or she has reached the age of 55. However, this exception does not apply to distributions from IRAs. The IRS claimed the taxpayer was subject to the 10% early withdrawal penalty because the distribution came from an IRA, not a qualified retirement plan. The Tax Court and Court of Appeals agreed with the IRS. (*Kim,* 7th Cir., May 9, 2012)

Withholding requirement. If a distribution qualifies as an eligible rollover distribution (defined under *Rollovers and Transfers,* page 29-21), whether or not the distribution is actually rolled over, the distribution is subject to federal withholding at a rate of 20%. The 20% withholding rules do not apply to the following.

- Distribution is under $200.
- Distribution is a direct rollover (trustee-to-trustee transfer) to an IRA or another eligible retirement plan.
- Distribution is a long-term periodic distribution or a required minimum distribution (periodic or nonperiodic). However, if the participant does not make the choice to have zero withholding on the distribution:
  - Periodic distributions are subject to withholding based on their treatment as wages.
  - Nonperiodic distributions are subject to withholding at a rate of 10% of the taxable portion.

Required minimum distributions. A qualified plan must provide that each participant will either:

- Receive his or her entire benefits in the plan by the required beginning date, or
- Begin receiving regular periodic distributions by the required beginning date in annual amounts calculated to distribute the participant's entire account balance over his or her life expectancy or over the joint life expectancy of the participant and the designated beneficiary (or over a shorter period).

Required minimum distribution (RMD) rules apply individually to each qualified plan. A beneficiary cannot satisfy the requirement for taking minimum distributions from one plan by taking a distribution from another.

Note:

- A distribution from one IRA can satisfy the RMD requirements for all IRAs.
- A distribution from one tax-sheltered annuity account can satisfy the RMD requirements for all tax-sheltered annuities.

Required beginning date. A participant must begin to receive distributions from his or her qualified retirement plan by April 1 of the first year after the later of the following.

- The calendar year in which he or she reaches age 73, or
- The calendar year in which he or she retires from employment with the employer maintaining the plan.

The plan may require the participant to begin receiving distributions by April 1 of the year after the participant reaches age 73 even if the participant has not retired.

If the participant is a 5% owner of the employer maintaining the plan, the participant must begin receiving distributions by April 1 of the first year after the calendar year in which the participant reached age 73.

RMD calculation. The required minimum distribution for a plan that has an individual account balance is calculated by dividing the account balance by the applicable life expectancy (same calculation as for IRAs). For details and examples, see *Required Minimum Distribution (RMD),* page 13-21. The required minimum distribution for an annuity plan is calculated under special rules. The plan administrator of an an-nuity plan should be able to provide the beneficiary with infor-mation on required minimum distributions.

Loans treated as distributions. A loan from a retirement plan is treated as a distribution from the plan unless it qualifies under one of the following exceptions.

- The loan is used to buy a main home, or
- The loan must be repaid within five years.

If the loan meets one of these exceptions, it must be treated as a nonperiodic distribution to the extent the loan, when added to the outstanding balances of all loans from all plans of the employer, exceeds the lesser of:

- $50,000, or
- Half the present value (but not less than $10,000) of the nonforfeitable accrued benefit under the plan, determined without regard to any accumulated deductible employee contributions.

If the loan is not treated as a distribution, the interest on the loan is not deductible during any period that:

- The loan is secured by amounts from elective deferrals under a 401(k) or tax-sheltered annuity plan, or
- The beneficiary is a key employee. See *Nondiscrimination Rules Chart,* page 22-2.

Additional rules on loans apply with regard to substantially level payments, related employers, and related plans. For more information, see *Loans Treated as Distributions* in IRS Pub. 575, *Pension and Annuity Income.*

Distributions from 401(k) plans. A distribution from a 401(k) plan cannot be made until one of the following occurs.

- The employee retires, dies, becomes disabled, or otherwise separates from service (no longer an employee of the employer sponsoring the plan).
- The plan ends and no other defined contribution plan is established or continued.
- In the case of a 401(k) plan that is part of a profit-sharing plan, the employee reaches age 59½ or suffers financial hardship.
- The distribution is to an alternate payee under the terms of a qualified domestic relations order (QDRO).
- The employee becomes eligible for a qualified reservist distribution. A qualified reservist distribution is a distribution to a military reservist or member of the National Guard who has been called to active duty for at least 180 days or for an indefinite period. See *Qualified Reservist Distribution,* page 13-24.

Financial hardship distributions from 401(k) plans. An employee may qualify to take a distribution from his or her 401(k) plan prior to separation from service if the distribution is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. The plan must set forth nondiscriminatory and objective standards to determine the existence of an immediate and heavy financial need. [Reg. §1.401(k)-1(d)(3)]

Deemed immediate and heavy financial need. A distribution is deemed to be made on account of an immediate and heavy financial need of the employee if the distribution is for the expenses in the table page 29-21.

Primary beneficiary. Certain expenses incurred for a primary beneficiary under the 401(k) plan qualify for financial hardship distributions. A primary beneficiary under the plan is an individual who is named as a beneficiary under the plan and has an unconditional right, upon the death of the employee, to all or a portion of the employee's account balance under the plan.

Immediate and Heavy Financial Need	
Includes expenses for a primary beneficiary	***Only employee expenses qualify***
• Medical expenses that would be deductible on Schedule A (Form 1040) without regard to whether the expenses exceed the AGI threshold. • Tuition, related educational fees, and room and board for up to the next 12 months of post-secondary education for the employee, or for the employee's spouse, children, or other dependents. • Burial or funeral expenses for the employee's deceased parent, spouse, child, or other dependent.	• Costs related to purchasing a principal residence, excluding mortgage payments. • Payments necessary to prevent the eviction of the employee from his or her principal residence or foreclosure on the mortgage. • Expenses for the repair of the employee's principal residence that would have qualified as a casualty deduction on Schedule A (Form 1040) prior to 2018, without regard to whether the loss exceeds the AGI threshold. • Expenses and losses incurred by an employee on account of a federally declared disaster. See *Disaster Losses,* Tab 4.

A distribution cannot exceed the amount required to satisfy the financial need, including any amount necessary to pay federal, state, and local taxes on the distribution. The employee may not have any other alternative means reasonably available to satisfy the need. For more information, see Regulation section 1.401(k)-1(d)(3).

Note: Even if the distribution is allowed due to an immediate and heavy financial need, the distribution may be subject to income tax and the 10% early distribution penalty. The immediate and heavy financial need test only applies to the determination of whether or not the employee is allowed to take a distribution from his or her 401(k) prior to separation from service.

See *Exceptions to the 10% Penalty on Early Distributions*, page 13-3.

Tax on excess benefits. A 5% owner (or former 5% owner) of a business maintaining a qualified retirement plan is subject to a 10% tax on excess benefits includable in income. Excess benefits are amounts received at any age that are more than the benefits provided under the plan formula. The tax is reported on Schedule 2 (Form 1040), *Additional Taxes.*

Excise tax on reversion of plan assets. A 20% excise tax is generally imposed on the cash and fair market value of other property an employer receives directly or indirectly from a qualified plan upon termination of the plan (reversion of plan assets). The rate is increased to 50% if the employer does not establish or maintain a qualified replacement plan following the plan termination, or provide certain pro-rata benefit increases in connection with the plan termination. If a taxpayer owes this tax, report it on Form 5330 (Schedule I), *Return of Excise Taxes Related to Employee Benefit Plans.*

An example of a reversion of plan assets is when an employer terminates a defined benefit plan and transfers assets over to a defined contribution plan. The employer does not amend the plan in connection with the termination to provide for any increases in the accrued benefits of the participants as they are switched over to the new defined contribution plan. As a result, excess benefits revert back to the employer and are subject to the excise tax. However, if at least 25% of the amount available for reversion is transferred from the terminating defined benefit plan to the new defined contribution plan, the amount transferred to the new plan is not subject to the excise tax. (Rev. Rul. 2003-85)

Tax on failure to notify affected individuals of significant benefit accrual reduction. A $100 per participant tax ($500,000 per year maximum) may apply if a defined benefit plan or money-purchase plan is amended to provide for a significant reduction in the rate of future benefit accruals, and the plan administrator fails to notify the affected individuals of the reduction in writing. For details, see IRS Pub. 560, *Retirement Plans for Small Business.*

Rollovers and Transfers

The recipient of an eligible rollover distribution from a qualified plan can defer the tax on it by rolling it over into a traditional IRA or another eligible retirement plan.

Eligible rollover distribution. An eligible rollover distribution is a distribution of all or any part of an employee's balance in a qualified retirement plan that is not any of the following:

- A required minimum distribution.
- Any of a series of substantially equal payments made at least once a year over any of the following periods:
  - The employee's life or life expectancy, or
  - The joint lives or life expectancies of the employee and beneficiary, or
  - A period of 10 years or longer.
- A hardship distribution.
- A corrective distribution of excess contributions or deferrals under a 401(k) plan and any income allocable to the excess, or of excess annual additions and any allocable gains.
- Loans treated as distributions.
- Dividends on employer securities.
- The cost of life insurance coverage.

After-tax contributions. Taxpayers may be able to roll over the nontaxable part of a distribution made to another qualified retirement plan that is a qualified employee plan or a 403(b) plan, or to a traditional or Roth IRA. The transfer must be made either through a direct rollover to a qualified plan or 403(b) plan that separately accounts for the taxable and nontaxable parts of the rollover or through a rollover to a traditional or Roth IRA.

Any nontaxable amounts that a taxpayer rolls over into his or her traditional IRA become part of the basis in the taxpayer's IRAs. To recover basis when the taxpayer takes distributions from his or her IRA, Form 8606, *Nondeductible IRAs,* must be completed for the year of the distribution.

For more information, see *Rollovers and Transfers,* page 13-19.

Plan loan offset. A plan loan offset is the amount by which an employer plan account balance is reduced to repay a loan from the plan. Generally, a participant has 60 days from the date of the offset to complete an eligible rollover. However, if an offset occurs because of plan termination or a severance from employment, the deadline is extended to the due date of the participant's federal return (including extensions).

Inherited Retirement Plans

Rollover to beneficiary. Distributions of benefits from a deceased employee's eligible retirement plan may be rolled over directly to an IRA of a beneficiary who is not the surviving spouse of the employee [IRC §402(c)(11)]. The IRA is treated as an inherited IRA of the beneficiary. Distributions from the inherited IRA are subject to the distribution rules applicable to beneficiaries. The distribution rules apply also to amounts payable to a beneficiary under a qualified retirement plan, governmental section 457 plan, or a tax-sheltered annuity. To the extent provided by regulations, this rule applies to benefits payable to a trust maintained for a designated beneficiary to the same extent it applies to the beneficiary.

Note: A surviving spouse may treat an inherited IRA as his or her own IRA, or roll funds from a deceased spouse's employer-sponsored pension plan or IRA over to his or her own IRA or employer-sponsored pension plan [IRC §402(c)(9)].

See *Inherited IRA,* page 13-22.

Prohibited Transactions

Prohibited transactions are transactions between the plan and a disqualified person that are prohibited by law. The following are examples of prohibited transactions.

- A transfer of plan income or assets to, or use of them by or for the benefit of, a disqualified person (other than receiving benefits as a participant or beneficiary of the plan under the terms of the plan).
- Any act of a fiduciary by which he or she deals with plan income or assets in his or her own interest.
- The receipt of consideration by a fiduciary for his or her own account from any party dealing with the plan in a transaction that involves plan income or assets.
- Any of the following acts between the plan and a disqualified person:
  - Selling, exchanging, or leasing property.
  - Lending money or extending credit.
  - Furnishing goods, services, or facilities.

Disqualified person. The following are examples of disqualified persons.

- A fiduciary of the plan.
- A person providing services to the plan.
- An employer, any of whose employees are covered by the plan.
- An employee organization, any of whose members are covered by the plan.
- Any direct or indirect owner of 50% or more of a corporation, partnership, trust, or unincorporated enterprise that is an employer or employee organization described above.
- Any family member of any individual described above.
- Any corporation, partnership, trust, or estate of which any direct or indirect owner described above holds 50% or more ownership interest in the stock, capital or profits interest, or beneficial interest.
- Any officer, director, 10% shareholder, 10% partner, or highly-compensated employee of a person described above.

Tax on prohibited transactions. The initial tax on a prohibited transaction is 15% of the amount involved each year. If the transaction is not corrected, an additional tax of 100% of the amount involved is imposed. For details, see the instructions for Form 5330, *Return of Excise Taxes Related to Employee Benefit Plans.*

Plan Errors and Corrections

Retirement plans need to be reviewed regularly to ensure that they remain in compliance with current tax law.

Employee Plans Compliance Resolution System. The IRS has set up the Employee Plans Compliance Resolution System (EPCRS) which offers a comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the qualified plan requirements but have not met these requirements for a period of time. This system allows plan sponsors to correct these failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis. The three components of the EPCRS are the Self-Correction Program, the Voluntary Correction Program, and the Audit Closing Agreement Program. See www.irs.gov/Retirement-Plans/EPCRS-Overview.

Revenue Procedure 2021-30. There is current guidance governing the EPCRS program. (Rev. Proc. 2021-30)

Self-Correction Program. In many cases, a plan sponsor may correct insignificant operational failures without paying any fee or notifying the IRS.

Voluntary Correction Program. A plan sponsor may (any time before an audit) pay a fee, based on the size of the plan, and receive IRS approval for correction of a qualified plan. Form 8950, *Application for Voluntary Correction Program (VCP),* is filed electronically. Go to www.irs.gov/form8950 for additional filing information.

Audit Closing Agreement Program. If a failure is identified on audit, the plan sponsor may correct the failure and pay a sanction. The sanction imposed will bear a reasonable relationship to the nature, extent, and severity of the failure, taking into account any correction which occurred before audit.

Common errors. Examples of common errors found in EPCRS:

- Late or missed filing for Form 5500, see *Reporting Requirements,* below.
- Late or missed deposits of employee salary reduction contributions.
- Participant loan failures (for example, loans that exceed the maximum permitted dollar amount).
- Failure to timely amend plan for changes in tax law.
- Plan operational errors arising from failure to follow plan terms (for example, an employee who meets the plan's eligibility requirements but is not allowed to participate).
- Specified plan prohibited transactions (for example, sales or loans between the plan and a party in interest).

Reporting Requirements

The administrator or sponsor of a qualified plan is required to file either Form 5500, *Annual Return/Report of Employee Benefit Plan,* Form 5500-SF, *Short Form Annual Return/Report of Small Employee Benefit Plan,* or Form 5500-EZ, *Annual Return of One-Participant (Owners Partners and Their Spouses) Retirement Plan or a Foreign Plan,* on an annual basis. For more information see www.efast.dol.gov.

Nonqualified Deferred Compensation Plans

Cross References

- IRS Pub. 5528, *Nonqualified Deferred Compensation Audit Technique Guide*
- IRS Pub. 5992, *Equity (Stock)-Based Compensation Audit Technique Guide*
- IRC §409A, *Inclusion in gross income of deferred compensation under nonqualified deferred compensation plans*
- IRC §457, *Deferred compensation plans of State and local governments and tax-exempt organizations*
- IRC §457A, *Nonqualified deferred compensation from certain tax indifferent parties*

Related Topics

- Nonqualified Plans, page 13-19

Nonqualified Deferred Compensation Plans

A nonqualified deferred compensation (NQDC) plan is any plan or arrangement between an employer and an employee to pay the employee compensation at some future time. NQDC plans do not afford employers and employees the tax benefits associated with qualified plans because NQDC plans do not satisfy all the requirements of IRC section 401(a). A NQDC plan may be used to reward highly-compensated employees and key executives without having to meet nondiscrimination rules that apply to qualified plans.

Funding. NQDC plans are either funded or unfunded, though most are intended to be unfunded because of the tax advantages unfunded plans afford participants.

Funded NQDC. The plan is funded if the assets are set aside from the claims of the employer's creditors. If the employee has any beneficial interest in the funds, the benefit is likely taxable. The economic benefit doctrine requires an employee to include

in current gross income the value of assets unconditionally and irrevocably transferred as compensation into a fund for the employee's sole benefit if the employee has a nonforfeitable interest in the fund. See *IRC Section 409A Rules,* page 29-24.

Unfunded NQDC. An unfunded arrangement is one where the employee has only the employer's promise to pay the deferred compensation benefits in the future, and the promise is not secured in any way. The employer may keep track of the benefit in a bookkeeping account, or it may voluntarily choose to invest in annuities, securities, or insurance arrangements to help fulfill its promise to pay the employee. The employer may transfer amounts to a trust that remains part of the employer's general assets, subject to the claims of the employer's creditors if the employer becomes insolvent, in order to help keep its promise to pay the employee. To obtain the benefit of income tax deferral, it is important that the amounts are not set aside from the employer's creditors for the exclusive benefit of the employee.

The employer generally cannot deduct contributions to a NQDC plan until they are included in the employee's taxable compensation. [IRC §404(a)(5)]

Constructive receipt. Income is constructively received by a participant in the taxable year during which it is credited to their account, set apart for them, or otherwise made available so that they may draw upon it at any time. Allowing employees the use of credit cards, debit cards, and check books to access the deferred amounts is constructive receipt. Permitting employees to borrow against their deferred amounts achieves the same result. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. [Reg. §1.451-2(a)]

NQDC examples. Examples of nonqualified deferred compensation plans include:
- Section 457 and section 457A deferred compensation plans.
- Phantom stock and stock appreciation rights.
- Rabbi trusts.
- Taxable trusts.

Section 457A deferred compensation plan. Compensation deferred under a nonqualified compensation plan of a nonqualified entity is includible in gross income when there is no substantial risk of forfeiture of the right to the compensation. The term nonqualified entity means:
- Any foreign corporation unless substantially all of its income is:
  - Effectively connected with the conduct of a trade or business in the United States, or
  - Subject to a comprehensive foreign income tax, and
- Any partnership unless substantially all its income is allocated to persons other than:
  - Foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and
  - Tax-exempt organizations.

Certain exceptions apply to these rules. For more information, see Notice 2009-8.

Phantom stock and stock appreciation rights. Phantom stock and stock appreciation rights are nonqualified deferred compensation arrangements that allow employers to reward employees with stock-based compensation. Phantom stock arrangements involve crediting a specific number of shares to an employee's account without ever issuing the actual shares. At the end of a specified period, the employee receives compensation equal to either the FMV of the shares that were credited or the appreciation in the value of the shares since the date the shares were credited. Stock appreciation rights provide an employee with the right to receive compensation equal to the increase in the value of a specified number of shares over a specified period of time.

For both phantom stock and stock appreciation rights, employees generally recognize taxable compensation when the right to the benefit is exercised. Stock appreciation rights granted after 2004 have the following additional restrictions to avoid taxation at the grant date.
- The exercise price may never be less than the FMV of the stock on the grant date,
- The stock is traded on an established securities market, and
- There is no deferral of compensation (other than the deferral of income until exercised).

For additional information, see Notice 2005-1.

Rabbi trust. A rabbi trust is an irrevocable grantor trust set up for the purpose of holding contributions of deferred compensation. The employee is provided with some security that the agreed to compensation will be paid at the appropriate time and provides assurance that the employer cannot divert the funds for other purposes. However, the terms of the trust must contain a provision that subjects the trust assets to claim by creditors in order to avoid constructive receipt of income by the employee.

Taxable trust. A taxable trust is an irrevocable trust set up to receive contributions. The trust assets are protected against claims by creditors. The amounts are considered constructively received, and the employee pays tax on the income at the time the contributions are made. This type of arrangement provides a greater degree of security for the employee but does not defer recognition of taxable income on the deferred compensation.

Exception: Amounts deferred into a taxable trust after December 31, 2004, may qualify for tax deferral if the rules under IRC section 409A are met.

Election to defer income on stock options. Qualified employees who are awarded certain private company stock options may elect to defer income for up to five years. See *Election to defer income on stock options,* page 6-20.

Section 457 Deferred Compensation Plans

Section 457 deferred compensation plans are generally only available to employees of state or local governments and tax-exempt organizations. They can be either eligible plans or ineligible plans. Participants in eligible plans are not taxed currently on pay that is deferred under the plan or on any earnings from the plan's investment of the deferred pay. State or local government plan participants are generally taxed on amounts deferred in an eligible plan only when they are distributed from the plan. Tax-exempt organization plan participants are taxed on amounts deferred in an eligible plan when they are distributed or otherwise made available to the participant. Ineligible plans may trigger different tax treatment under IRC section 457(f).

New for 2024 For plan years beginning after December 31, 2023, employers are allowed to make matching contributions to Section 457 deferred compensation plans for qualified student loan repayments. See *Matching contributions for student loan repayments,* page 29-16.

Coordination with 403(b) plan. The IRS issued a private letter ruling in which it approved separate limitations for salary reduction contributions to a section 403(b) tax-sheltered annuity and a section 457(b) plan for the same year. IRC section 402(g) limits the amount of elective deferrals contributed tax free to certain plans, including 401(k) and 403(b) plans. This limitation does not apply to a 457(b) plan. Therefore, the 403(b) contributions did not have to be aggregated with the 457(b) contributions. (Ltr. Rul. 200934012)

Designated Roth account. A section 457(b) plan may allow designated Roth contributions and in-plan rollovers to designated Roth accounts.

IRC Section 409A Rules

IRC section 409A provides that compensation deferred under a NQDC plan must be included in gross income at the time of deferral to the extent that it is not subject to substantial risk of forfeiture, unless certain requirements are met.

For purposes of the rules under IRC section 409A, a nonqualified deferred compensation plan is any plan that provides for the deferral of compensation that a worker earns in one year but that is not paid until a future year, other than:

- A qualified employer plan such as a 401(k) or 403(b) plan,
- A section 457(b) plan,
- Any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

NQDC included in income when distributed. Deferred compensation can be included in income at the time it is distributed (instead of when deferred) if all the following requirements are met.

- Distributions may not occur until after one of the following.
  - Separation from service (six months after separation from service for key employees).
  - Disability.
  - Death.
  - Specified time (or pursuant to a fixed schedule) under the plan at the date of deferral.
  - A change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation.
  - The occurrence of an unforeseeable emergency.
- The plan may not permit the acceleration of the time or schedule of any payment under the plan (regulations may provide for exceptions).
- The participant elects to defer such compensation and the election is made:
  - Not later than the close of the preceding taxable year (or at such other time provided in regulations).
  - For the first year of eligibility, within 30 days after the date the participant becomes eligible to participate in the plan.
  - For any compensation based on services performed over a period of at least 12 months, the election must be made no later than six months before the end of the period.

Election of delay in payment or change in form of payment. In the case of a plan which permits under a subsequent election a delay in a payment or a change in the form of payment, all the following requirements must be met.

- The plan must require that the election may not take effect until at least 12 months after the date on which the election is made.
- For an election related to a payment due to separation from service, a specified time, or a change in ownership of the corporation, the plan requires that the payment with respect to which the election is made be deferred for a period of not less than five years from the date such payment would otherwise have been made, and
- For any election related to a specified time, the election may not be made less than 12 months prior to the date of the first scheduled payment.

Funding rules. An NQDC plan is subject to IRC section 409A even if funds used to pay deferred compensation are out of the reach of creditors, such as property held in a foreign trust. For more detailed rules on funding nonqualified deferred compensation plans, see IRC section 409A(b).

Substantial risk of forfeiture. IRC section 409A does not apply if the participant has a substantial risk of forfeiture under the terms of the deferred compensation plan. The rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to the compensation are conditioned upon the future performance of substantial services by any individual.

Example: Kevin's employer agrees to pay him a bonus of 10% of his annual salary if he stays on the job for at least one more year. Since Kevin's right to the bonus is conditioned upon him completing one more year of service, there is substantial risk of forfeiture, and the plan is not subject to the rules under IRC section 409A.

Failure to comply/improper deferrals. Generally, each year is considered separately. An improper deferral is taxable and all prior amounts deferred under the plan would become taxable. Amounts deferred in subsequent years in which the plan complies with IRC section 409A would not be affected even though improperly deferred amounts are still in the plan. (Reg. §1.409A-1 through 1.409A-6.)

Penalties. Compensation required to be included in gross income under IRC section 409A is subject to income tax plus two additional taxes. [IRC §409A(a)(1)(B)]

- 20% of the compensation which is required to be included in gross income.
- Premium interest tax equal to the underpayment rate plus one percent.

See Notice 2008-115.

Teacher salaries. Many teachers are offered an election to take their salary over a 12-month period even though they are paid for a school year of less than 12 months. In effect, by spreading salary over 12 months, a portion of the pay earned during the months of August, September, October, November, and December of one year is deferred until January through July of the following year.

Notice 2008-62. The IRS has issued guidance that may be relied upon until regulations are issued. An arrangement that pays recurring part-year compensation to an employee or independent contractor will not be considered deferred compensation if:

- The arrangement does not defer payment of any of the recurring part-year compensation beyond the last day of the 13th month following the beginning of the service period, and
- The arrangement does not defer from one taxable year to the next taxable year the payment of more than the applicable dollar amount under IRC section 402(g)(1)(B) in effect for the calendar year in which the service period begins ($23,000 for 2024).

Example: Karla works for the Minneapolis School District as a teacher during the school year beginning August 1, 2024 and ending May 31, 2025 (a 10-month school year). She is paid over the 12-month period that begins August 1, 2024 and ends July 31, 2025. Her annual salary is $60,000. Spread over 10 months, she earns $6,000 per month. Spread over 12 months, she is paid $5,000 per month. Under this arrangement, $1,000 per month multiplied by 5 months equals $5,000, which is the amount of income she earns in 2024 that is not paid to her until 2025. Since $5,000 is less than $22,500, this arrangement is not considered a deferred compensation plan subject to the rules of IRC section 409A.

~ End ~