Ameriprise Financial
Kuttin Wealth Management
Jonathan S. Kuttin, CRPC®, AAMS®, RFC®, CRPS®
Private Wealth Advisor
445 Broadhollow Road
Suite 120
Melville, NY 11747
631-770-0335
800-445-4595
jonathan.s.kuttin@ampf.com
http://www.kuttinwealthmanagement.com

Retirement Plans: The Employee Perspective

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Retirement Plans: The Employee Perspective

What is the employee perspective on employer-sponsored retirement plans?

Qualified employer-sponsored retirement plans can provide a number of tax and nontax benefits to employees. The employee perspective on these plans should certainly consider the obvious tax deferral and retirement savings benefits. Additionally, however, employees should consider various strategies to optimize their benefits. For example, employees will approach their retirement plans most effectively when they take full advantage of employer-matched savings and by remaining with a particular company at least until vesting has occurred. In some cases, moreover, the advantages and disadvantages of borrowing from employer-sponsored plans should be evaluated.

How are employer-sponsored retirement plans categorized?

Employer-sponsored retirement plans may be categorized in two ways: (1) they're classified as either qualified or nonqualified, and (2) qualified plans are further subdivided into defined benefit plans and defined contribution plans.

Qualified versus nonqualified plans

Qualified plans are those that offer significant tax advantages to employers and employees in return for adherence to strict Employee Retirement Income Security Act (ERISA) and Internal Revenue Code requirements involving participation in the plan, vesting, funding, disclosure, and fiduciary matters.

Nonqualified deferred compensation plans, by comparison, are subject to less extensive ERISA and Code regulation; and the design and operation of these plans is generally more flexible. However, nonqualified plans are usually not as beneficial to either the employer or the employee from a tax standpoint.

Defined benefit plans versus defined contribution plans

A defined benefit plan is a qualified employer pension plan that guarantees a specified benefit level at retirement; actuarial services are needed to determine the necessary annual contributions to the plan. These plans are typically funded by the employer.

A defined contribution plan, by comparison, is one in which each employee participant is assigned an individual account, and contributions are defined (in the plan document) on an annual basis, often in terms of a percentage of compensation. Unlike a defined benefit plan, a defined contribution plan doesn't promise to pay a specific dollar amount to participants at retirement. Rather, the benefit payable to a participant at termination or retirement is the value of his or her individual account.

Why should an employee participate in a qualified employer-sponsored retirement plan?

Participation in an employer-sponsored retirement plan is probably the most effective way to save for retirement. If you have an individual retirement account (IRA) rather than an employer-sponsored plan, you know that your annual contribution amount is relatively limited. Employer-sponsored plans allow much higher annual contributions. And, if your primary method of saving for retirement is to personally invest in securities, there is always a temptation to spend your savings prior to retirement. The temptation to withdraw your money prematurely from an employer-sponsored plan is severely curtailed. This is because many qualified plans don't permit in service withdrawals at all, or permit them only for limited reasons (for example, financial hardship). In addition, a 10 percent early distribution penalty generally applies to the taxable portion of any withdrawal you make before age 59½ (unless an exception applies).

In addition to the retirement savings aspect of employer-sponsored retirement plans, these plans can offer significant tax advantages. Certain defined contribution plans allow employees to defer part of their salaries into the plan. Deferring part of your compensation can lower your present taxes. Postponing receipt of this taxable income is also useful, because when you eventually realize the income at some future point, it's possible that you'll be retired and/or in a lower tax bracket. Keep in mind that the earnings on your plan contributions grow tax deferred until you take distributions. 401(k), 403(b), and 457(b) plans can also permit Roth contributions. Roth 401(k) contributions are made on an after-tax basis, just like Roth IRA contributions. This means there's no up-front tax benefit, but if certain conditions are met, your Roth 401(k) contributions and all accumulated earnings are free from federal income taxes when distributed from the plan.

How can an employee optimize his or her retirement benefits?

One way to optimize your retirement benefits is to ensure that you contribute to the plan as much as the law allows in a given year. Also, keep in mind that if your salary increases, so should your contribution level. For example, it's nice for you to contribute a flat $100 to your 401(k) plan each month, but if your salary increases by $1,000 each year, the amount of your contribution should increase also in order to maximize your retirement savings. Contributing to an employer-sponsored retirement plan, such as a 401(k) plan, can help you save for retirement, defer taxes on your current income, and defer (or eliminate) taxes on the earnings.

You can also optimize your retirement benefits by taking full advantage of employer matching contributions. Some employers, for example, might contribute 50 cents for every dollar you contribute to the plan. In a very real sense, this gives you an automatic 50 percent return on your investment.

Another consideration is vesting. If your employer matches your contributions (or funds the pension plan entirely), it may impose a vesting schedule on you. This means that you will not be able to take ownership in the employer-funded part of a pension plan until certain conditions have been met. Typically, the employer will require you to work for the company for a set number of years before you will become vested. If vesting occurs after 3 years of service and you're thinking of leaving the company after 2 and one-half years, it would be advisable for you to try to stick around for another six months.

Tip: *Employer contributions to SIMPLE IRA, SIMPLE 401(k), and SEP IRA plans are always 100 percent vested.*

Should you borrow money from your retirement plan?

Some retirement plans, such as the 401(k) plan, may allow you to borrow money from the plan under certain conditions. Typically, the interest charged on such a loan will be less than that of an unsecured bank loan. When you pay the money back, you're really paying the money to yourself. Therefore, borrowing money from your 401(k) plan may be the cheapest source of funds you can find for a loan.

When you take a loan from your 401(k) plan, the funds you borrow are removed from your plan account until you repay the loan. While removed from your account, the funds aren't continuing to grow tax deferred within the plan. So the economics of a plan loan depend in part on how much those borrowed funds would have earned if they were still inside the plan, compared to the amount of interest you're paying yourself. This is known as the opportunity cost of a plan loan, because you miss out on the opportunity for more tax-deferred investment earnings.

Also, while the interest you pay on a loan is usually deposited into your plan account, the benefits of this perk are somewhat illusory. To pay interest on a plan loan, you first need to earn money and pay income tax on those earnings. With what is left over after taxes, you pay the interest on your loan. When you later withdraw those dollars from the plan, they are taxed again because plan distributions are treated as taxable income. In effect, you are paying income tax twice on the funds you use to pay interest on the loan.

What are some of the more popular employer-sponsored retirement plans, and how do they work?

There are several plans; each has its own advantages and disadvantages. Along with the traditional pension plan (the defined benefit plan), there are 12 retirement plans that are most often offered by businesses:

- 401(k) plan
- Age-weighted profit-sharing plan
- Employee stock ownership plan (ESOP)
- Keogh plan
- Money purchase pension plan
- New comparability plan

- Profit-sharing plan
- SIMPLE 401(k)
- SIMPLE IRA
- Simplified employee pension plan (SEP)
- Target benefit plan
- Thrift savings plan

In addition, there are two nonqualified retirement plans that are especially popular with tax-exempt organizations:

- Section 403(b) plan
- Section 457(b) plan

401(k) plan

A 401(k) plan, sometimes called a cash or deferred arrangement, is a defined contribution retirement plan that allows employees to elect either to receive their compensation paid currently in cash or to defer receipt of the income until retirement. If deferred, the amount deferred is pretax dollars that go into the plan's trust fund; these dollars will be invested and then eventually be distributed (with investment earnings) to the employees. The employee is taxed when money is withdrawn or distributed to him or her from the plan. Often, employers make contributions matching some or all of employee deferrals in order to encourage employee participation. The business can deduct these employer contributions, subject to certain limitations. 401(k) plans can also permit Roth contributions. Roth 401(k) contributions are made on an after-tax basis, just like Roth IRA contributions. This means there's no up-front tax benefit, but if certain conditions are met, your Roth 401(k) contributions and all accumulated earnings are tax-free when distributed from the plan.

Age-weighted profit-sharing plan

An age-weighted profit-sharing plan is a defined contribution plan in which contributions are allocated based on the age of plan participants as well as on their compensation, allowing older participants with fewer years to retirement to receive much larger allocations (as a percentage of current compensation) to their accounts than younger participants.

Employee stock ownership plan (ESOP)

An employee stock ownership plan (ESOP), sometimes called a stock bonus plan, is a defined contribution plan in which participants' accounts are invested in stock of the employer corporation. The employer funds the plan. When a plan participant retires or leaves the company, he or she receives the vested interest in the ESOP in the form of cash or employer securities.

Keogh plan

A Keogh plan (sometimes called an HR-10 plan) is another name for any qualified retirement plan adopted by self-employed individuals. Only a sole proprietor or a partner may establish a Keogh plan; an employee cannot. Keogh plans may be set up either as defined benefit plans or as defined contribution plans. A Keogh plan allows you to contribute pretax dollars to the retirement plan (providing a tax deferral to you).

Money purchase pension plan

A money purchase pension plan is a defined contribution plan in which the employer makes an annual contribution to each employee's account in the plan. The amount of the contribution is determined by a set formula, regardless of whether the employer is showing a profit. Typically, the employer's contribution will be based on a certain percentage of each participating employee's compensation.

New comparability plan

A new comparability plan is a variant of the traditional profit-sharing plan. By dividing up plan participants into two or more classes, the new comparability plan allows businesses to maximize plan contributions to higher-paid workers and key employees and minimize allocations to other employees.

Profit-sharing plan

A profit-sharing plan is a defined contribution plan that allows for employer discretion in determining the level of annual contributions to the retirement plan; in fact, the employer can contribute nothing at all in a given year if it so chooses. As the name suggests, a profit-sharing plan is usually a sharing of profits that may fluctuate from year to year. Generally, an employer will contribute to a profit-sharing plan in one of two ways: either according to a set formula or in a purely discretionary manner.

SIMPLE 401(k)

A savings incentive match plan for employees 401(k), or SIMPLE 401(k), is a retirement plan for small businesses (those with 100 or fewer employees) and for self-employed persons, sole proprietorships, and partnerships. The plan is structured as a 401(k) cash or deferred arrangement and was devised in an effort to offer self-employed persons and small businesses a tax-deferred retirement plan without the complexity and expense of the traditional 401(k) plan. The SIMPLE 401(k) is funded with voluntary employee pre-tax or Roth contributions, and mandatory, fully vested, employer contributions. The annual allowable contribution amount is lower than the annual contribution amount for regular 401(k) plans.

SIMPLE IRA

A savings incentive match plan for employees IRA (SIMPLE IRA) is a retirement plan for small businesses (those with 100 or fewer employees) and self-employed persons that is established in the form of employee-owned individual retirement accounts. The SIMPLE IRA is funded with voluntary employee pre-tax contributions and mandatory, fully vested, employer contributions. The annual allowable contribution amount is significantly higher than the annual contribution amount for regular IRAs.

Simplified employee pension plan (SEP)

Self-employed persons, including sole proprietors and partners, can sometimes set up simplified employee pension plans (SEPs) for themselves and their employees. A SEP is a tax-deferred qualified retirement savings plan that allows contributions to be made to special IRAs, called SEP-IRAs, according to a specific formula. Except for the ability to accept SEP contributions (i.e., allowing more money to be contributed and deducted) and certain related rules, SEP-IRAs are virtually identical to regular IRAs. Employer contributions are fully vested.

Target benefit plan

A target benefit plan is a hybrid of a defined benefit plan and a money purchase pension plan. It resembles a defined benefit plan in that the annual contribution is determined by the amount needed each year to accumulate a fund sufficient to pay a specific targeted benefit amount. It is like a money purchase plan in that the actual benefit received by the participant at retirement is based on his or her individual balance.

Thrift savings plan

A thrift savings plan is a defined contribution plan that is similar to a profit-sharing plan but has features that provide for (and encourage) after-tax employee contributions to the plan. This means that the employee must pay tax on his or her money before contributing to the plan. Typically, a thrift savings plan would provide after-tax employee contributions with matching employer contributions. Most thrift plans have been converted to 401(k) plans.

Section 403(b) plan

A 403(b) plan, also known as a tax-sheltered annuity or a tax-deferred annuity, is a special type of retirement plan under which certain government and tax-exempt organizations (including religious organizations) can purchase annuity contracts or can contribute to custodial accounts for eligible employees. Employees are not taxed on contributions made to the plan on their behalf until they receive their benefits. Section 403(b) plans generally fall into one of two types of plans: a salary reduction plan or an employer-funded plan. A 403(b) plan is not a qualified plan, but it is subject to many of the same rules, and salary reduction 403(b) plans are similar to 401(k) plans in many respects. Like 401(k) plans, 403(b) plans can also permit Roth contributions. Roth 403(b) contributions are made on an after-tax basis, just like Roth IRA contributions. This means there's no up-front tax benefit, but if certain conditions are met, your Roth 403(b) contributions and all accumulated earnings are tax-free when distributed from the plan.

Section 457(b) plan

A Section 457(b) plan is a nonqualified deferred compensation plan for governmental units, governmental agencies, and nonchurch-controlled tax-exempt organizations; it somewhat resembles a 401(k) plan. Unlike a 401(k) plan, a Section 457(b) plan for a tax-exempt organization must be structured so that it's not subject to the strict requirements of ERISA. Like 401(k) plans, 457(b) plans can also permit Roth contributions. Roth 457(b) contributions are made on an after-tax basis, just like Roth IRA contributions. This means there's no up-front tax benefit, but if certain conditions are met, your Roth 457(b) contributions and all accumulated earnings are tax-free when distributed from the plan.

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Ameriprise Financial
Kuttin Wealth Management
Jonathan S. Kuttin, CRPC®, AAMS®, RFC®, CRPS®
Private Wealth Advisor
445 Broadhollow Road
Suite 120
Melville, NY 11747
631-770-0335
800-445-4595
jonathan.s.kuttin@ampf.com
http://www.kuttinwealthmanagement.com

Ameriprise Financial