Retirement

QUALIFIED PLANS VS. NONQUALIFIED ARRANGEMENTS

Presented for

Valued Client

Presented by

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QUALIFIED PLANS VS. NONQUALIFIED ARRANGEMENTS

The Purpose…

- Investors can accumulate savings to create future retirement income in both qualified plans and nonqualified arrangements.

The Difference…

- Qualified accumulations enjoy special federal tax treatment for contributions and earnings in the account.
- By contrast, most nonqualified accumulations in savings or other investment vehicles receive no special tax treatment. The exceptions are life insurance and personally owned deferred annuities, which also enjoy tax deferral on earnings accumulations.

Qualified Accumulations Include…

- Employer-sponsored retirement plans established for the benefit of employees.
- Individual retirement accounts or annuities (IRAs) established by individuals on their own behalf.

Benefits of Qualification…

- Employers can deduct contributions made on behalf of employees.
- Employer contributions are not included in the employee's current gross income.
- Employees can generally withdraw contributions to a Roth account in an employer plan or to a personally owned Roth IRA tax free. Earnings may be withdrawn tax free if the account has been held for at least 5 years and the withdrawal is made after age 59½. If the withdrawal is made before the 5-year period or age 59½, income taxes and a 10% penalty tax may apply.
- In 401(k) and 403(b) plans, employees contribute a portion of their earnings on a pre-tax basis, and employers may match a designated percentage of the employee's income to increase total accumulations.
- Earnings on pre-tax contributions grow tax deferred. No taxes are due until funds are withdrawn. Earnings on contributions designated as Roth deferrals grow tax deferred and may be withdrawn tax free when certain requirements are met.

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- Personally owned, traditional individual retirement accounts and annuities (IRAs) permit deductible contributions for some taxpayers and tax-deferred accumulations until withdrawn.
- Taxpayers can contribute to a personal IRA for themselves and an unemployed spouse, within IRS limits relating to income and age. The allowable deduction is based on the contribution made for that year.
- Employees covered by an employer retirement plan can make deductible contributions to an IRA if income does not exceed certain thresholds. Individuals who earn above the threshold level may not take a deduction for their contributions, although they may contribute to an IRA with after-tax dollars. Accumulations are still tax deferred.
- Those age 50 and older may make additional "catch-up" contributions that exceed regular limits.

Nonqualified Arrangements…

- Contributions are typically made with after-tax dollars. Therefore, when funds are withdrawn, only the earnings on accumulations are taxed.
- Earnings left to accumulate may be taxed currently rather than tax deferred, depending on the type of savings or investment vehicle.
- Interest paid on a savings account or certificate of deposit is taxed as current income in the year it is credited.
- Interest earned on most investments is taxed as ordinary income; however, on certain investments—such as municipal bonds—interest may be tax exempt.
- Dividends received on stocks and mutual funds are generally taxed as ordinary income subject to a special 20% top rate on "qualified dividends," and may also be subject to the additional investment income tax of 3.8%.
- Interest earnings in a personally owned, nonqualified annuity generally escape current taxation if left to accumulate. Earnings are then taxed when income is distributed.
- Life insurance and annuity contracts are generally nonqualified (exceptions are annuities used to fund IRAs and employer retirement plans), but accumulations receive favorable tax treatment within these arrangements.
- Premiums paid for personally owned life insurance and annuity contracts are not deductible. Earnings are generally tax deferred until withdrawn, when only the earnings portion of the withdrawal is taxed.

The Bottom Line…

It’s important to consider the tax consequences of savings and investment options before deciding the best way to accumulate retirement assets. Will contributions be made with pre-tax or after-tax dollars? Will earnings be taxed currently or deferred? When accumulations are withdrawn, will they be taxed fully, partially or not at all? The answers can make a substantial difference in determining how much retirement income a selected strategy will create.

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SUMMARY

What Are Qualified Plans and Nonqualified Arrangements?

Qualified plans and nonqualified arrangements are both methods of saving and investing for retirement, with the primary objective to produce retirement income. A major difference is in how they are taxed.

Qualified plans must be set up in accordance with IRS requirements to receive special tax treatment on both contributions and earnings during the accumulation period.

Most nonqualified arrangements receive no special tax treatment. One exception is deferred annuities, which enjoy a tax-deferred accumulation of earnings until they are paid out as income.

What Are Some Types of Qualified Arrangements?

Typical qualified arrangements include certain employer-sponsored retirement plans established for the benefit of employees—401(k) and 403(b) plans, for example. Individual retirement accounts or annuities (IRAs) established by individuals also qualify for tax benefits.

What Are the Benefits of Qualified Contributions?

Employers may make contributions on behalf of their employees and, subject to certain limits, deduct the contributions from their taxes.

Employees enjoy even greater benefits. Contributions made with pre-tax dollars are not included in the employee's gross income and, consequently, are not currently taxed. In arrangements such as 401(k)s, SIMPLE IRAs and 403(b)s, where employees defer a portion of salary on a pre-tax basis, employers may make matching contributions up to some limit. Accumulations from both sources grow on a tax-deferred basis, so no taxes are imposed until they are withdrawn as income, typically at the employee's retirement.

Individually funded IRAs are subject to limits on deductibility and contribution maximums. With traditional IRAs, an individual's contributions may be tax deductible and grow tax deferred until they're withdrawn. With Roth IRAs, contributions are subject to current tax, while distributions can be received tax free when strict requirements are met.

What About Nonqualified Contributions?

Nonqualified contributions are made with after-tax dollars, meaning taxes are paid on funds before money can be set aside rather than when funds are withdrawn. Earnings may or may not be tax deferred, depending on the particular type of investment vehicle. If they are tax deferred, the earnings are taxed as income when they are paid out.

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Do Life Insurance and Annuities Meet Qualification Requirements?

Except for annuities used to fund IRAs and qualified employer retirement plans, the IRS does not consider accumulations in these contracts to be qualified. As a result, contributions are made with after-tax dollars. However, the earnings generated in both life insurance policies and annuities grow on a tax-deferred basis.

What's Important in Choosing a Retirement Income Investment?

Taxes are a major consideration in selecting individual savings and investment vehicles. Are contributions made with pre-tax or after-tax dollars? Are earnings taxed currently or are they tax deferred? When accumulations are withdrawn, are they taxed fully, partially or not at all? The answers can have a significant impact on the amounts intended to provide a future retirement income.


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