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## **A Quick and Dirty Guide to Retirement Benefits**

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### INTRODUCTION

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Despite the title of the article, unfortunately there is no quick comprehension of retirement plans or the myriad of rules that govern them. There is also no way to avoid encountering these benefits in estate planning. A significant number of Americans, regardless of age, have some sort of retirement benefits, and estate planners must determine how to best handle these when developing an estate plan, both with respect to how they will affect a client during life and at death. The sections regarding retirement benefits are undisputedly some of the most complex sections of the Internal Revenue Code (and that is saying something), and this article does not intend to exhaustively explain any portion in detail. Thankfully, there are a number of other excellent attorneys and advisors who have taken on this daunting task. Rather, this article attempts to identify some of the most common retirement benefits and issues that should be considered in an estate planning practice.

### WHAT RETIREMENT PLANS ARE OUT THERE

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There are a multitude of different retirement plans, each governed by a different section of the Internal Revenue Code, and it is not uncommon for an individual to have more than one different type of plan, especially if he has changed employment multiple times during his life. However, a common thread among all retirement plans discussed in this article is that they are all structured to allow the money and property invested therein to grow tax-deferred (no taxes are charged to income or gains, such as interest, dividends, or capital gains) until such money or property is withdrawn.

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<sup>1</sup> Employee and participant are used interchangeably in this article in the context of qualified plans.

### I. Qualified Plans

A “qualified plan,” as used herein, is a defined benefits or a defined contribution plan established by an employer that satisfies the requirements of the Internal Revenue Code of 1986, as amended (the “Code”) and the Employee Retirement Income Security Act of 1974 (ERISA). Participation in a qualified plan is an appealing benefit for employers to offer employees because it provides certain tax advantages to both parties. An employer may deduct contributions made to an employee’s qualified plan on the company’s income tax return, and employees<sup>1</sup> recognize no current income on pre-tax contributions made to the plan. Moreover, once in the plan, earnings on contributions are tax exempt, meaning that such amounts are only subject to tax upon distribution. Roth qualified plans (discussed further later in this article) are the exception to this general rule as they allow participants to make contributions which are subject to income tax when made; however, qualified distributions from such plans are not subject to income tax again when distributed.

#### A. Categories of Qualified Plans

**1. Defined Contribution Plans.** A defined contribution plan is a type of qualified plan in which the participant’s benefits are determined by the contributions made to an individual account established for the participant, either by the participant himself or the participant’s employer, and the subsequent investment performance of such contributed assets. A participant usually has significant control over how the assets held in his defined contribution plans are invested and can decide which stocks, mutual funds, bonds, and other investment vehicles offered by the plan administrator to invest in. Defined contribution plans include

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profit-sharing plans, 401(k) plans, employee stock ownership plans, target benefit plans, stock bonus plans and money purchase pension plans, among others. Over the past several decades, the popularity of defined contribution plans has increased, and approximately half of American workers participate in some type of defined contribution plan today.<sup>2</sup> The participant in a defined contribution plan is typically responsible for deciding whether to make contributions, the size of such contributions, and the investments of his plan, but the participant also bears most of the responsibility and risk for the plan. This also means that a participant who is still in the workplace may be able to manage his contributions and investments in the plan in such a way to better coordinate his retirement with his overall estate plan.

**2. Defined Benefit Plans.** A defined benefit plan is a type of qualified plan established and funded by an employer that promises to pay each participant a specific benefit at retirement. The benefit is usually based on a formula that takes into account the participant's salary and the number of years that the participant has worked for the employer. The two types of defined benefit plans are pensions and cash-balance plans. Since these plans are significantly more expensive for the employer than defined contribution plans, they are less common today and more likely to be offered by large employers. Defined benefit plans are the most common type of plan for government employees.<sup>3</sup>

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<sup>2</sup> William Gale and Benjamin Harris, *Savings and Retirement: What are defined-contribution plans?*, ¶12 (2007), [http://www.taxpolicycenter.org/briefing-](http://www.taxpolicycenter.org/briefing-book/key-elements/savings-retirement/defined-contribution.cfm)

## B. Some Common Qualified Plans

### 1. 401(k)

Who Has It? Employees of for-profit and non-profit organizations and businesses.

What Is It? A 401(k) plan is a defined contribution plan and the most common type of qualified plan. A 401(k) allows a participant to invest a portion of his pre-tax salary in investments (stocks, bonds, mutual funds, etc.) offered by the plan administrator. The maximum amount that a participant can contribute to a 401(k) in 2014 is \$17,500, although individuals who are or who will turn 50 in 2014 may contribute an additional \$5,500 (referred to as a catch-up contribution). However, these limits are simply the maximum that a *participant* can contribute to his 401(k); employers may make additional contributions to employees' 401(k)s as well. In 2014, an employer may contribute up to \$34,500 to each employee's 401(k) so that the maximum total amount that can be contributed to a 401(k) in 2014 by both an employee and his employer is the lesser of: (i) \$52,000 (or \$57,500 for participants 50 and older) or (ii) 100% of the employee's salary. While an employee's contributions vest immediately, in most cases the employer's contributions do not vest until the employee has worked for the company for a certain amount of time.

A 401(k) can be structured as a traditional 401(k) or a Roth 401(k). A Roth 401(k) generally operates like a traditional 401(k) (and has the same contribution limits); however, after-tax dollars rather than pre-tax dollars are contributed to the account. Since the amounts contributed to a Roth 401(K) are subject to tax before contribution, they are not taxed again when withdrawn so long as the withdrawal meets

[book/key-elements/savings-retirement/defined-contribution.cfm](http://www.taxpolicycenter.org/briefing-book/key-elements/savings-retirement/defined-contribution.cfm)

<sup>3</sup> *Id.*

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