11 Retirement Planning

I. Individual Retirement Arrangements (IRAs) [I.R.C. §408]

A. Introduction

The discussion that follows concerns the traditional IRA and changes that are in effect for 1997.

The TRA of 1997 has overhauled and expanded IRAs to include Roth "back-loaded" IRAs and education IRAs. The TRA of 1997 chapter contains information about developments that take effect in 1998 or later years. See that chapter for pertinent information.

B. Contributions

1. Contribution Limits

Contributions to an IRA are limited to the **lesser of** the amount of taxable compensation or $2,000 annually. **Beginning in 1997,** a married couple can contribute up to $2,000 to each spouse's IRA, **even if one spouse has little or no compensation.**

a. Compensation

- Compensation **includes** wages, salaries, tips, commissions, fees, self-employment income, taxable alimony, and separate maintenance payments. **Unearned income** such as interest, dividends, pensions, and rents are **not** considered in determining the amount of qualified compensation.

Note: In response to questions about disability pay, accrued leave, termination pay, etc., the IRS issued a "safe harbor" rule. Generally, the amount properly shown as "Wages" in box 1 of Form W-2 can be used in calculating an individual's compensation [Revenue Procedure 91-18]. Amounts shown in box 11 as nonqualified deferred compensation must be subtracted from the box 1 amount.

- "Net earnings from self-employment" is defined by §1402(a) but only with respect to a trade or business in which the personal services of the taxpayer are a material income-producing factor. **It is reduced by the deduction for one-half of the self-employment tax taken on line 26 of Form 1040** [§401(c)(2)(A)].

Example 1. All self-employment activities for each person must be considered. Don has a Schedule C with a $12,000 net profit and a Schedule F with a $15,000 net loss. The contribution is based on the net $3,000 loss. No contribution is allowed in this example.

Note: This netting rule does not apply to wages. The self-employment loss will not affect the wage contributions base.

Example 2. Don in the example above has wage income of $7,000 in addition to the two businesses. His IRA contribution base is $7,000, even though he has a net loss from the two businesses of $3,000.

b. Single and Spousal IRAs

- Any individual under age 70½ **with compensation** may contribute to an IRA. If husband and wife both have compensation, they may each contribute to separate IRAs based on their separate compensation amounts. **Each may contribute up to the maximum $2,000.**
- **If only one spouse has compensation, a special spousal IRA may be set up.** Contributions are made to separate IRA accounts for each spouse. Starting in 1997, the maximum combined contribution is $4,000, which may be divided between husband and wife as they choose provided neither spouse's contribution exceeds $2,000.

Example 3. Leo Hernandez has wages of $32,000 in 1997. His wife, Laura, is a homemaker and has no earned income. The Hernandez family may contribute a total of $4,000 to IRA accounts, one for Leo and one for Laura.

- The spousal IRA rules can be elected even if both have compensation.

Note: If one spouse is over 70½ and still working, contributions up to $2,000 may be made for the other spouse who is under 70½. No amount may be allocated to the person who is over 70½.

Example 4. Don is 58, but his wife, Jane, is 71. Jane has compensation income of $80,000 and Don has compensation income of $750. Since Jane is over age 70½, no amount can be credited to her IRA account. Up to $2,000 can be contributed to Don's spousal IRA.

2. Deductible and Nondeductible IRA Contributions

IRA deductions can be limited if the owner or spouse is considered covered by an employer retirement plan. Coverage by an employer plan is indicated for employees by a mark in the "Pension Plan" box on Form W-2.

Self-employed persons participating in a Keogh, SIMPLE, or SEP plan are also covered by a retirement plan. For details on the determination of who is considered "covered" by an employer plan, see **IRS Publication 590 (IRAs).** The definition of *active participant* is also discussed in IRS Publication 1602 (reprint of IRS Notice 87-16).

- The mere receipt of pension benefits is not considered active participation in an employer plan. Coverage under social security or Railroad Retirement **is not** coverage under an employer plan.
- Those who are covered by a retirement plan **must consider filing status and adjusted gross income limits** to see if they will have deductible or nondeductible contributions. See Figure 1 [IRS Publication 590]. For those who are not covered by an employer plan, contributions are deductible at **any income level.**

Figure 1

If Your Modified AGI* is:		If You Are Covered by a Retirement Plan at Work and Your Filing Status is:			If You Are Not Covered by a Retirement Plan at Work and Your Filing Status is:			
		•Single •Head of Household	• Married Filing Jointly (even if your spouse is not covered by a plan at work) • Qualifying Widow(er)	Married Filing Separately**	Married Filing Jointly (and your spouse is covered by a plan at work)	• Single • Head of Household	• Married Filing Jointly or Separately (and your spouse is not covered by a plan at work) • Qualifying Widow(er)	Married Filing Separately (even if your spouse is covered by a plan at work)***
At Least	But Less Than	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take
$0.01	$10,000.00	Full deduction	Full deduction	Partial deduction	Full deduction	Full Deduction	Full Deduction	Full Deduction
$10,000.00	$25,000.01	Full deduction	Full deduction	No deduction	Full deduction			
$25,000.01	$35,000.00	Partial deduction	Full deduction	No deduction	Full deduction			
$35,000.00	$40,000.01	No deduction	Full deduction	No deduction	Full deduction			
$40,000.01	$50,000.00	No deduction	Partial deduction	No deduction	Partial deduction			
$50,000.00 or over		No deduction	No deduction	No deduction	No deduction			

*__Modified AGI__ (adjusted gross income) is: (1) for Form 1040A—the amount on line 14 increased by any excluded series EE bond interest shown on Form 8815, *Exclusion of Interest from Series EE U.S. Savings Bonds Issued after 1989,* or (2) for Form 1040—the amount on line 31, figured without taking into account any IRA deduction or any foreign earned income exclusion and foreign housing exclusion (deduction), or any series EE bond interest exclusion from Form 8815.

**If you did not live with your spouse at any time during the year, your filing status is considered, for this purpose, as Single (therefore your IRA deduction is determined under the "Single" column).

***You are entitled to the full deduction only if you did not live with your spouse at any time during the year. If you did live with your spouse during the year, you are, for this purpose, treated as though you are covered by a retirement plan at work (therefore, your IRA deduction is determined under the "Married Filing Separately" column in the "If You Are Covered by a Retirement Plan..." section of the chart).

If Your Modified AGI* is:		If You Are Covered by a Retirement Plan at Work and Your Filing Status is:			If You Are Not Covered by a Retirement Plan at Work and Your Filing Status is:			
		•Single •Head of Household	• Married Filing Jointly (even if your spouse is not covered by a plan at work) • Qualifying Widow(er)	Married Filing Separately**	Married Filing Jointly (and your spouse is covered by a plan at work)	• Single • Head of Household	• Married Filing Jointly or Separately (and your spouse is not covered by a plan at work) • Qualifying Widow(er)	Married Filing Separately (even if your spouse is covered by a plan at work)***
At Least	But Less Than	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take
$0.01	$10,000.00	Full deduction	Full deduction	Partial deduction	Full deduction	Full Deduction	Full Deduction	Full Deduction
$10,000.00	$25,000.01	Full deduction	Full deduction	No deduction	Full deduction			
$25,000.01	$35,000.00	Partial deduction	Full deduction	No deduction	Full deduction			
$35,000.00	$40,000.01	No deduction	Full deduction	No deduction	Full deduction			
$40,000.01	$50,000.00	No deduction	Partial deduction	No deduction	Partial deduction			
$50,000.00 or over		No deduction	No deduction	No deduction	No deduction			

*Modified AGI (adjusted gross income) is: (1) for Form 1040A—the amount on line 14 increased by any excluded series EE bond interest shown on Form 8815, *Exclusion of Interest from Series EE U.S. Savings Bonds Issued after 1989*, or (2) for Form 1040—the amount on line 31, figured without taking into account any IRA deduction or any foreign earned income exclusion and foreign housing exclusion (deduction), or any series EE bond interest exclusion from Form 8815.

**If you did not live with your spouse at any time during the year, your filing status is considered, for this purpose, as Single (therefore your IRA deduction is determined under the "Single" column).

***You are entitled to the full deduction only if you did not live with your spouse at any time during the year. If you did live with your spouse during the year, you are, for this purpose, treated as though you are covered by a retirement plan at work (therefore, your IRA deduction is determined under the "Married Filing Separately" column in the "If You Are Covered by a Retirement Plan..." section of the chart).

New Law Alert: Tax law changes affect the AGI phaseout amounts for 1998 and future years. Spouses are also "unlinked" for active participant status starting in 1998. **See the TRA of 1997 chapter, page 422, for details.**

Form 8606 must be completed any year a nondeductible contribution is made. There is a $50 penalty if the form is not filed when required.

Example 5. Lydia, who is single, has a modified adjusted gross income of $29,433, which includes wages of $26,000. She is covered by her employer's retirement plan. She contributes $2,000 to her IRA and wants to know how much is deductible. The total value of her IRAs is $36,000. Her basis for 1996 and prior years is $5,000. Her worksheet from Publication 590 is Figure 2. Form 8606 is Figure 3.

Figure 2

Deductible (and nondeductible) IRA contributions for an IRA other than a spousal IRA. Complete lines 1 through 8 to figure your deductible and nondeductible IRA contributions for the year.		
Worksheet for Reduced IRA Deduction		
(Use only if you are covered, or considered covered, by an employee plan and your modified AGI is within the applicable phaseout range)		
If your ***filing status is:***	And your ***modified AGI*** is over:	***Enter*** on Line 1 below:
Single, or Head of household	$25,000	$35,000
Married-joint return, or Qualifying widow(er)	$40,000	$50,000
Married-separate return	$ -0-	$10,000

1. Enter applicable amount from above	35,000
2. Enter you ***modified AGI*** (combined, if married filing jointly)	29,433
Note: If line 2 is equal to or more than the amount on line 1, **stop here;** your IRA contributions are not deductible; see *Nondeductible Contributions*, later.	
3. Subtract line 2 from 1. (**If line 3 is $10,000 or more, stop here;** you can take a full IRA deduction for contributions of up to $2,000 or 100% of your compensation, whichever is less.)	5,567
4. Multiply line 3 by 20% (.20). If the result is not a multiple of $10, round it to the next highest multiple of $10. (For example, $611.40 is rounded to $620.) However, if the result is less than $200, enter $200	1,120
5. Enter your compensation. (**Do not** include your spouse's compensation, and, if you file Form 1040, do not reduce your compensation by any losses from self-employment.)	26,000
6. Enter contributions you made, or plan to make, to your IRA for 1997, but **do not** enter more than $2,000	2,000
7. IRA deduction. Compare lines 4,5, and 6. Enter the smallest amount (or a smaller amount if you choose) here and on the Form 1040 or 1040A line for your IRA, whichever applies. (If line 6 is more than line 7 and you want to make a nondeductible contribution, go to line 8.)	1,120
8. Nondeductible contribution. Subtract line 7 from line 5 or 6, whichever is smaller. Enter the result here and on line 1 of your Form 8606. (See *Nondeductible Contributions*, later.)	880

Figure 3

Form **8606**

Department of the Treasury
Internal Revenue Service

Nondeductible IRAs
(Contributions, Distributions, and Basis)

► Please see What Records Must I Keep? on page 2.
► Attach to Form 1040, Form 1040A, or Form 1040NR.

OMB No. 1545-1007

19~~96~~ 97

Attachment Sequence No. 47

Name. If married, file a separate Form 8606 for each spouse who is required to file Form 8606. See instructions.

LYDIA

Your social security number

Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return

Home address (number and street, or P.O. box if mail is not delivered to your home) | Apt. no.

City, town or post office, state, and ZIP code

Contributions, Nontaxable Distributions, and Basis

1	Enter your IRA contributions for 199~~6~~ 7 that you choose to be nondeductible. Include those made during 1/1/9~~7~~ 8–4/15/9~~7~~ 8 that were for 199~~6~~ 7. See instructions	1	880
2	Enter your total IRA basis for 199~~5~~ 6 and earlier years. See instructions	2	5,000
3	Add lines 1 and 2	3	5,880

Did you receive any IRA distributions (withdrawals) in 199~~6~~ 7?

- No ► Enter the amount from line 3 on line 12. Then, **stop** and read **When and Where To File** on page 2.
- Yes ► Go to line 4.

4	Enter only those contributions included on line 1 that were made during 1/1/9~~7~~ 8–4/15/9~~7~~ 8. This amount will be the same as line 1 if all of your nondeductible contributions for 199~~6~~ 7 were made in 199~~7~~ 8 by 4/15/9~~7~~ 8. See instructions			4	
5	Subtract line 4 from line 3			5	
6	Enter the total value of **ALL** your IRAs as of 12/31/96 plus any outstanding rollovers. See instructions	6			
7	Enter the total IRA distributions received during 199~~6~~ 7. Do not include amounts rolled over before 1/1/9~~7~~ 8. See instructions	7			
8	Add lines 6 and 7	8			
9	Divide line 5 by line 8 and enter the result as a decimal (to at least two places). Do not enter more than "1.00"	9	× .		
10	Multiply line 7 by line 9. This is the amount of your **nontaxable distributions for 199~~6~~ 7**			10	
11	Subtract line 10 from line 5. This is the **basis in your IRA(s) as of 12/31/9~~6~~ 7**			11	
12	Add lines 4 and 11. This is your **total IRA basis for 199~~6~~ 7 and earlier years**			12	5,880

Taxable Distributions for 199~~6~~ 7

13	Subtract line 10 from line 7. Enter the result here and on Form 1040, line 15b; Form 1040A, line 10b; or Form 1040NR, line 16b, whichever applies	13	

- If **both** husband and wife have nondeductible contributions, separate Forms 8606 must be completed for **each.** Copies of the form **should be retained** to establish the tax basis in the IRA for tax calculation when there are distributions.
- There is no requirement to keep deductible and nondeductible IRA contributions in separate accounts. When a distribution is made, the total value and basis of all IRAs enters into the tax computation. Distributions will be discussed later in this chapter.

3. Fees and Commissions

Trustee's fees paid to set up or manage an IRA are not considered IRA contributions if separately paid.

Broker's commissions paid when the investment is made are considered IRA contributions subject to the $2,000 limit.

4. Timing of Contributions

The deadline for establishing IRAs and making 1997 IRA contributions is April 15, 1998, even if an extension of time to file the tax return is granted.

C. Employment Taxes

When the employer helps set up IRAs for employees through payroll deduction, employment taxes are still due on the contributed amounts. The contribution is treated as compensation on the W-2. The individual takes the income tax deduction allowed when Form 1040 is filed. Such deductions are **not** salary deferrals to be reported in box 13 of Form W-2. They may be reported in box 14 as "other" information.

D. Distributions

1. Loan Possibility

Actual loans are prohibited transactions.

2. Permitted Distributions

Figure 4

The only distributions allowed **without penalty** are taken under the following conditions:

a. The participant has reached age 59½ (unless the owner is subject to the "5-year rule" in d).
b. The participant is deceased.
c. The owner is disabled (within the social security definition).
d. The owner starts a series of annuity payments over his or her life expectancy using an IRS-approved distribution method (see Required Distributions below). The payments under this exception must continue for a **minimum of five years, or** until the owner reaches 59½, whichever is the **longer** period.
e. **Beginning in 1997,** IRA distributions are allowed for medical expenses in excess of 7.5% of AGI.

Example 6. Bill is 57½ in 1997 and would like access to his IRA money. He may start taking distributions in 1997 over his life expectancy but must continue the periodic payments for at **least five years.** Even though he will be 59½ in 1999, he may not stop the periodic payments and take a larger amount until 2002. If he changes his payments, a 10% premature distribution penalty will apply to **all prior payments received.** The penalty is assessed in the year of change for all prior years. Interest also is charged.

Note: Letter ruling 9705033 clarifies that IRAs **do not have to be aggregated** for purposes of computing the annuity-type exception to the penalty (item d in Figure 4) **unless the IRA owner chooses to aggregate them.** This provides the IRA owner with even greater flexibility in determining the amount of annual distributions.

Example 7. Carrie, who is age 50, has medical expenses of $12,000 that are unreimbursed by insurance. She withdraws $12,000 from her IRA in 1997 to pay the medical expenses. Her 1997 AGI is $30,000. The "penalty-free" withdrawal amount is $9,750. She will be liable for the 10% premature distribution penalty of $225 (10% of $2,250, the amount of withdrawal not in excess of 7.5% of her AGI).

There is one additional exception to the 10% penalty for premature IRA distributions. The new exception, (like item e in Figure 4), is effective beginning in 1997. This new exception from the 10% penalty tax is created for withdrawals (distributions) to a class of unemployed individuals if the distribution doesn't exceed the premiums paid during the tax year of the distribution for **medical care insurance** for the taxpayer, his or her spouse, and dependents. To be eligible, the unemployed person:

(a) Must have been receiving unemployment compensation for 12 consecutive weeks (a self-employed individual is eligible is he or she would have been eligible for unemployment compensation but for the fact that he or she was self-employed)

(b) The distribution is in the taxable year (or succeeding year) of the payment of unemployment compensation

(c) The exception does not apply to the distributions made after the person is reemployed for at least 60 days

New Law Alert: For changes to distributions allowed without penalty in 1998 and later years, see page 423 of the **1997 Tax Legislation** chapter. Education expense and first-time home purchase withdrawals are allowed without penalty beginning in 1998.

3. Required Distributions

a. At 70½ distributions from an IRA must begin.

An individual who has reached 70½, during 1997 must receive a minimum distribution for 1997 by April 1, 1998. A minimum distribution for 1998 must be received by December 31, 1998. Distributions for later years must be made by December 31 of each year. (See Question and Answer 28C on page 248 of this book for those who are still employed.)

Note: Delaying the 1997 required distribution until the first three months of 1998 will result in **two** taxable distributions in 1998.

Figuring the minimum IRA distribution. Different rules apply for individual retirement accounts and annuities. For annuities, Proposed Regulations §§1.401(a)(9)-1, 1.401(a)(9)-2, and 1.408 apply. **For individual retirement accounts,** life expectancy tables found in Publication 590 are appropriate (see Figures 5, 6, and 7).

Figure 5

APPENDIX E. Life Expectancy Tables

TABLE I
(Single Life Expectancy)*

AGE	DIVISOR	AGE	DIVISOR
35	47.3	73	13.9
36	46.4	74	13.2
37	45.4	75	12.5
38	44.4	76	11.9
39	43.5	77	11.2
40	42.5	78	10.6
41	41.5	79	10.0
42	40.6	80	9.5
43	39.6	81	8.9
44	38.7	82	8.4
45	37.7	83	7.9
46	36.8	84	7.4
47	35.9	85	6.9
48	34.9	86	6.5
49	34.0	87	6.1
50	33.1	88	5.7
51	32.2	89	5.3
52	31.3	90	5.0
53	30.4	91	4.7
54	29.5	92	4.4
55	28.6	93	4.1
56	27.7	94	3.9
57	26.8	95	3.7
58	25.9	96	3.4
59	25.0	97	3.2
60	24.2	98	3.0
61	23.3	99	2.8
62	22.5	100	2.7
63	21.6	101	2.5
64	20.8	102	2.3
65	20.0	103	2.1
66	19.2	104	1.9
67	18.4	105	1.8
68	17.6	106	1.6
69	16.8	107	1.4
70	16.0	108	1.3
71	15.3	109	1.1
72	14.6	110	1.0

* Table I does not provide for IRA owners younger than 35 years of age. For additional life expectancy tables, see Publication 939.

APPENDIX E. Life Expectancy Tables

TABLE I
(Single Life Expectancy)*

AGE	DIVISOR	AGE	DIVISOR
35	47.3	73	13.9
36	46.4	74	13.2
37	45.4	75	12.5
38	44.4	76	11.9
39	43.5	77	11.2
40	42.5	78	10.6
41	41.5	79	10.0
42	40.6	80	9.5
43	39.6	81	8.9
44	38.7	82	8.4
45	37.7	83	7.9
46	36.8	84	7.4
47	35.9	85	6.9
48	34.9	86	6.5
49	34.0	87	6.1
50	33.1	88	5.7
51	32.2	89	5.3
52	31.3	90	5.0
53	30.4	91	4.7
54	29.5	92	4.4
55	28.6	93	4.1
56	27.7	94	3.9
57	26.8	95	3.7
58	25.9	96	3.4
59	25.0	97	3.2
60	24.2	98	3.0
61	23.3	99	2.8
62	22.5	100	2.7
63	21.6	101	2.5
64	20.8	102	2.3
65	20.0	103	2.1
66	19.2	104	1.9
67	18.4	105	1.8
68	17.6	106	1.6
69	16.8	107	1.4
70	16.0	108	1.3
71	15.3	109	1.1
72	14.6	110	1.0

* Table I does not provide for IRA owners younger than 35 years of age. For additional life expectancy tables, see Publication 939.

Figure 6

APPENDIX E. *(continued)*

TABLE II (continued)
(Joint Life and Last Survivor Expectancy)

AGES	45	46	47	48	49	50	51	52	53	54
45	44.1	43.6	43.2	42.7	42.3	42.0	41.6	41.3	41.0	40.7
46	43.6	43.1	42.6	42.2	41.8	41.4	41.0	40.6	40.3	40.0
47	43.2	42.6	42.1	41.7	41.2	40.8	40.4	40.0	39.7	39.3
48	42.7	42.2	41.7	41.2	40.7	40.2	39.8	39.4	39.0	38.7
49	42.3	41.8	41.2	40.7	40.2	39.7	39.3	38.8	38.4	38.1
50	42.0	41.4	40.8	40.2	39.7	39.2	38.7	38.3	37.9	37.5
51	41.6	41.0	40.4	39.8	39.3	38.7	38.2	37.8	37.3	36.9
52	41.3	40.6	40.0	39.4	38.8	38.3	37.8	37.3	36.8	36.4
53	41.0	40.3	39.7	39.0	38.4	37.9	37.3	36.8	36.3	35.8
54	40.7	40.0	39.3	38.7	38.1	37.5	36.9	36.4	35.8	35.3
55	40.4	39.7	39.0	38.4	37.7	37.1	36.5	35.9	35.4	34.9
56	40.2	39.5	38.7	38.1	37.4	36.8	36.1	35.6	35.0	34.4
57	40.0	39.2	38.5	37.8	37.1	36.4	35.8	35.2	34.6	34.0
58	39.7	39.0	38.2	37.5	36.8	36.1	35.5	34.8	34.2	33.6
59	39.6	38.8	38.0	37.3	36.6	35.9	35.2	34.5	33.9	33.3
60	39.4	38.6	37.8	37.1	36.3	35.6	34.9	34.2	33.6	32.9
61	39.2	38.4	37.6	36.9	36.1	35.4	34.6	33.9	33.3	32.6
62	39.1	38.3	37.5	36.7	35.9	35.1	34.4	33.7	33.0	32.3
63	38.9	38.1	37.3	36.5	35.7	34.9	34.2	33.5	32.7	32.0
64	38.8	38.0	37.2	36.3	35.5	34.8	34.0	33.2	32.5	31.8
65	38.7	37.9	37.0	36.2	35.4	34.6	33.8	33.0	32.3	31.6
66	38.6	37.8	36.9	36.1	35.2	34.4	33.6	32.9	32.1	31.4
67	38.5	37.7	36.8	36.0	35.1	34.3	33.5	32.7	31.9	31.2
68	38.4	37.6	36.7	35.8	35.0	34.2	33.4	32.5	31.8	31.0
69	38.4	37.5	36.6	35.7	34.9	34.1	33.2	32.4	31.6	30.8
70	38.3	37.4	36.5	35.7	34.8	34.0	33.1	32.3	31.5	30.7
71	38.2	37.3	36.5	35.6	34.7	33.9	33.0	32.2	31.4	30.5
72	38.2	37.3	36.4	35.5	34.6	33.8	32.9	32.1	31.2	30.4
73	38.1	37.2	36.3	35.4	34.6	33.7	32.8	32.0	31.1	30.3
74	38.1	37.2	36.3	35.4	34.5	33.6	32.8	31.9	31.1	30.2
75	38.1	37.1	36.2	35.3	34.5	33.6	32.7	31.8	31.0	30.1
76	38.0	37.1	36.2	35.3	34.4	33.5	32.6	31.8	30.9	30.1
77	38.0	37.1	36.2	35.3	34.4	33.5	32.6	31.7	30.8	30.0
78	38.0	37.0	36.1	35.2	34.3	33.4	32.5	31.7	30.8	29.9
79	37.9	37.0	36.1	35.2	34.3	33.4	32.5	31.6	30.7	29.9
80	37.9	37.0	36.1	35.2	34.2	33.4	32.5	31.6	30.7	29.8
81	37.9	37.0	36.0	35.1	34.2	33.3	32.4	31.5	30.7	29.8
82	37.9	36.9	36.0	35.1	34.2	33.3	32.4	31.5	30.6	29.7
83	37.9	36.9	36.0	35.1	34.2	33.3	32.4	31.5	30.6	29.7
84	37.8	36.9	36.0	35.1	34.2	33.2	32.3	31.4	30.6	29.7
85	37.8	36.9	36.0	35.1	34.1	33.2	32.3	31.4	30.5	29.6
86	37.8	36.9	36.0	35.0	34.1	33.2	32.3	31.4	30.5	29.6
87	37.8	36.9	35.9	35.0	34.1	33.2	32.3	31.4	30.5	29.6
88	37.8	36.9	35.9	35.0	34.1	33.2	32.3	31.4	30.5	29.6
89	37.8	36.9	35.9	35.0	34.1	33.2	32.3	31.4	30.5	29.6
90	37.8	36.9	35.9	35.0	34.1	33.2	32.3	31.3	30.5	29.6
91	37.8	36.8	35.9	35.0	34.1	33.2	32.2	31.3	30.4	29.5
92	37.8	36.8	35.9	35.0	34.1	33.2	32.2	31.3	30.4	29.5

APPENDIX E. Table for Determining Applicable Divisor for MDIB*
(Minimum Distribution Incidental Benefit)

Age	Applicable divisor	Age	Applicable divisor
70	26.2	93	8.8
71	25.3	94	8.3
72	24.4	95	7.8
73	23.5	96	7.3
74	22.7	97	6.9
75	21.8	98	6.5
76	20.9	99	6.1
77	20.1	100	5.7
78	19.2	101	5.3
79	18.4	102	5.0
80	17.6	103	4.7
81	16.8	104	4.4
82	16.0	105	4.1
83	15.3	106	3.8
84	14.5	107	3.6
85	13.8	108	3.3
86	13.1	109	3.1
87	12.4	110	2.8
88	11.8	111	2.6
89	11.1	112	2.4
90	10.5	113	2.2
91	9.9	114	2.0
92	9.4	115 and older	1.8

*Use this table if you have a beneficiary other than your spouse who is 10 or more years younger than you. For additional instructions, see *Minimum Distribution Incidental Benefit Requirement* in Chapter 6.

- Figure 5 shows that life expectancy at 70 is **16** years. If all the IRA account balances are $72,000 on December 31, 1996, the minimum 1997 distribution would be $4,500. This may be made in 1997 and taxed in 1997 or made by April 1, 1998, and added to the 1998 required distribution and taxed in 1998. **In 1998 a redetermination of life expectancy will give a factor of 15.3. Using the tables to refigure life expectancy will provide smaller payout amounts over a longer period. The alternative is to start with 16 and subtract 1 each year.** The method chosen must be used consistently.

If the life expectancy of a beneficiary is considered, the calculation becomes more involved. The age of a beneficiary spouse can be used, whatever the age of the spouse. If the beneficiary is someone other than the spouse and is more than 10 years younger than the IRA owner, a special Minimum Distribution Incidental Benefit table must be used (Figure 7).

Example 8. Jay turns 70½ in 1997 and is 71 as of December 31, 1997. His spouse, who is his beneficiary on all IRAs, is 48 on December 31, 1997. Using the Joint Life and Last Survivor tables (Figure 6), divide the value of all IRAs at December 31, 1997, by **35.6.**

Assume all the same facts except that his beneficiary, age 48, is his nephew. Using the nonspouse minimum distribution table (Figure 7), the divisor is **25.3.** The IRA account's value must be divided by 25.3 to get the minimum required distribution.

Where multiple IRA accounts are involved and each has a separate beneficiary, each account requires a separate minimum distribution computation. The total required distribution can be made from any, all, or only one of the accounts. For required distributions, **all IRAs including SEP-IRAs and SIMPLE-IRAs** are considered.

Practitioner Caution: Regarding IRA Basis Recovery on Form 8606. I.R.C. §408(d)(2) requires all IRA balances to be aggregated when applying §72 to determine the taxable portion of distributions. **This includes SEP IRAs and SIMPLE IRAs,** since there has been no amendment to §408 to exclude them.

However, Roth IRAs are not included in this computation, because they are specifically excluded by §408A(d)(4).

Basis in IRAs—Effect of Nondeductible Contribution. All IRAs (**including SEP-IRAs**) of one owner are considered when distributions are made. If both deductible and nondeductible contributions have been made, part of every withdrawal will be tax-free and part will be taxable. **Form 8606 is used to figure the taxable and nontaxable parts of the distribution.**

Example 9. Natasha has three IRA accounts. IRA-1 is a 1983 rollover account from a qualified company plan. IRA-2 is her SEP-IRA. IRA-3 contains **nondeductible** contributions made since 1987. In May 1997, at age 61, she takes a $10,000 distribution from IRA-3.

	FMV, 12-31-97	Basis
IRA-1	$50,000	0
IRA-2	$25,000	0
IRA-3	$15,000	$5,000*

*Includes $2,000 nondeductible contribution made in December 1997 for 1997.

Form 8606 is used to compute how much of the nondeductible contributions (IRA basis) should be allocated to the 1997 distribution (Figure 8). Since line 10 is 500, she will pay tax on $9,500. The amount of $10,000 will be entered on line 15a and $9,500 on line 15b if Form 1040 is filed.

Figure 8

Form **8606**

Department of the Treasury
Internal Revenue Service

Nondeductible IRAs
(Contributions, Distributions, and Basis)

▶ Please see What Records Must I Keep? on page 2.
▶ Attach to Form 1040, Form 1040A, or Form 1040NR.

OMB No. 1545-1007
199~~6~~7
Attachment Sequence No. 47

Name. If married, file a separate Form 8606 for each spouse who is required to file Form 8606. See instructions.
NATASHA

Your social security number

Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return

Home address (number and street, or P.O. box if mail is not delivered to your home) | Apt. no.

City, town or post office, state, and ZIP code

Contributions, Nontaxable Distributions, and Basis

1	Enter your IRA contributions for 199~~6~~7 that you choose to be nondeductible. Include those made during 1/1/9~~7~~8–4/15/9~~7~~8 that were for 199~~6~~7. See instructions	1	2,000
2	Enter your total IRA basis for 199~~5~~6 and earlier years. See instructions	2	3,000
3	Add lines 1 and 2	3	5,000
	Did you receive any IRA distributions (withdrawals) in 1996? — **No** ▶ Enter the amount from line 3 on line 12. Then, stop and read **When and Where To File** on page 2. — **Yes** ▶ Go to line 4.		
4	Enter only those contributions included on line 1 that were made during 1/1/9~~7~~8–4/15/9~~7~~8. This amount will be the same as line 1 if all of your nondeductible contributions for 199~~6~~7 were made in 199~~7~~8 by 4/15/9~~7~~8. See instructions	4	-0-
5	Subtract line 4 from line 3	5	5,000
6	Enter the total value of **ALL** your IRAs as of 12/31/9~~6~~7 plus any outstanding rollovers. See instructions — 6		
7	Enter the total IRA distributions received during 1996. Do not include amounts rolled over before 1/1/9~~7~~8. See instructions — 7		
8	Add lines 6 and 7 — 8		
9	Divide line 5 by line 8 and enter the result as a decimal (to at least two places). Do not enter more than "1.00" — 9 ×		
10	Multiply line 7 by line 9. This is the amount of your **nontaxable distributions for 199~~6~~7**	10	500
11	Subtract line 10 from line 5. This is the **basis in your IRA(s) as of 12/31/9~~6~~7**	11	4,500
12	Add lines 4 and 11. This is your **total IRA basis for 199~~6~~7 and earlier years**	12	4,500

Taxable Distributions for 199~~6~~7

13	Subtract line 10 from line 7. Enter the result here and on Form 1040, line 15b; Form 1040A, line 10b; or Form 1040NR, line 16b, whichever applies	13	9,500

b. Death of owner. When an owner dies, the rules for handling the account depend on who the beneficiary is. A surviving spouse has choices other beneficiaries do not have.

Surviving Spouse as Beneficiary

- The surviving spouse may:

  (1) Make the IRA his or her own (through a rollover or assumed rollover), with a caution that later distributions may be subject to the 10% premature distribution penalty if he or she is under 59½.

  (2) Begin receiving payouts of the decedent's IRA.

- Form 1099R will be issued in the beneficiary's name and TIN, not the decedent's.
- If the owner-spouse died **before** the required beginning date for distributions, payments from the IRA may be made over the surviving spouse's life expectancy, **or** the entire account balance may be withdrawn by the end of the fifth year following the year of death. The IRA plan document may specify one method.
- If the owner-spouse died **after** the required beginning date (age 70½ rule), distributions must be taken at least as rapidly as the decedent was receiving them.
- If a trust instrument is used, make sure the language in the trust allows a surviving spouse to roll over the proceeds if tax deferral is the intention.

Beneficiary Other Than Surviving Spouse

(1) May not treat the IRA account as his or her own.

(2) If the IRA owner died **before** the required beginning date, the beneficiary must receive distributions over the beneficiary's life expectancy or over the five-year period following the IRA owner's death. If the owner of the IRA died **after** the required beginning date, any undistributed amounts must be distributed at least as rapidly as the method being used at the owner's death.

(3) If a trust is the designated beneficiary of an IRA, beneficiaries of the trust are considered beneficiaries of the IRA **if** the following requirements are met.

- The trust is a valid trust under state law.
- The trust is irrevocable.
- Beneficiaries are identifiable from the trust instrument.
- A copy of the trust instrument is provided to the plan administrator.

[IRS Proposed Regulation §1.401(a)(9)-1 Q D-5]

Note: The IRA distribution is taxed to the beneficiary in the same manner as to the IRA owner. If the owner has a basis of nondeductible contributions, the beneficiary uses a basis recovery calculation.

c. Divorce. If an IRA is transferred from one spouse to another because of a divorce or separate maintenance decree, the transfer is tax-free. The recipient spouse has an IRA as of the date of the transfer. The spouse giving up the IRA has no distribution 10% penalty and no deduction. Future distributions are taxable to the recipient spouse.

All taxable alimony received under a decree of divorce or separate maintenance is treated as compensation for the IRA contribution and deduction limits.

4. Rollovers and Transfers

a. Transfer. A trustee-to-trustee transfer of funds is **not** a rollover. There is no distribution or availability of funds, so it is **tax-free**. Since it is **not** a rollover, it is **not** affected by the one-year waiting period that is required between rollovers.

b. Rollovers. **There are two kinds of rollover contributions to an IRA.** One IRA can be rolled over into another, and distributions from a qualified employer plan or 403(b) plan can be rolled into an IRA. Both must occur within 60 days.

A special rule extends the 60 days for deposits that are frozen because of bankruptcy or insolvency of a financial institution. When a lump-sum or terminating distribution is received in installments, the 60-day period starts on the date of the last installment. Payments may be rolled over individually as long as the final payment is rolled over on or before the sixtieth day on which it was received [Ltr. Rul. 7802035].

Practitioner Caution: A tax-free rollover from one IRA account to another may occur only **once** in a one-year period starting on the day a distribution is received [see Ltr. Rul. 9308050].

Example 10. Joe has one IRA account at a bank and one with a mutual fund. He may roll over, within the same one-year period, a distribution from the bank and also a distribution from the mutual fund to any third IRA. Within a 12-month period, he could not roll over funds from the bank IRA to the mutual fund IRA and then from the mutual fund IRA to any IRA.

Rollovers from Employer Plans to IRAs. Beginning in 1993, any distribution from an employer plan may be rolled over to an IRA if it is not:

(a) a mandatory distribution, or

(b) one of a series of substantially equal payments for a period of 10 years or more.

Note: Prior to 1993, only lump-sum distributions, complete distributions on terminations, or partial distributions of at least 50% of the plan balance could be rolled over.

- Qualified employer plan rollover distributions are subject to mandatory 20% withholding unless a direct rollover is made. The withholding **does not apply to IRA distributions.**
- Participants who receive only 80% of the taxable portion of a distribution because of the mandatory withholding are permitted to make up the difference from other funds to achieve a 100% rollover.
- The withholding shown on Form 1099R should be claimed as a payment on Form 1040 or Form 1040A. **A copy of Form 1099R should be attached to the return.**

5. Special Averaging

No

No special averaging (Form 4972) **is allowed** on distributions from an IRA, even if the money was rolled over from an employer plan.

6. Recognizing Losses

Losses on IRAs can be recognized only when all amounts in all IRA accounts have been distributed and the total distributions are less than unrecovered basis. **The loss is claimed as a miscellaneous itemized deduction on Schedule A, subject to the 2% floor.**

Example 11. Sue has made nondeductible contributions to two IRAs totaling $5,540 over four years. She has taken no distributions from the accounts, but the combined values have gone down to $3,000. She liquidates both accounts and claims $2,540 as a loss on Schedule A, subject to the 2% AGI floor.

E. Penalties

There are four categories of IRA penalties. They are computed on Form 5329.

1. Excess Contributions Tax

There is a 6% tax on excess contributions, whether or not a deduction was allowed. The penalty is assessed each year until the excess is eliminated.

2. Premature or Early Distributions Tax

A 10% tax applies to **taxable** IRA distributions received before age 59½ that are not due to death, disability, medical expenses in excess of 7.5% of AGI, or the periodic payment (annuity) provisions.

Prohibited transactions are treated as distributions. Borrowing from an IRA and pledging an IRA as security for a loan are considered distributions. Investment of IRA funds **in collectibles** is also considered a distribution subject to the 10% penalty. The TRA of 1997, effective for tax years beginning after 12/31/97, provides that the term "collectible" **does not include** platinum coins, or gold, silver, platinum, or palladium bullion if the bullion is in the physical possession of the IRA trustee.

Note: Completion of Form 5329 is not required if no exception to the early distribution penalty is satisfied. The 10% is entered directly on line 50 of the 1997 Form 1040.

3. Excess Accumulations Tax

This **50%** tax applies to IRA owners who are not taking the required minimum distribution from their accounts. **This penalty tax may be waived if the insufficient withdrawals are due to reasonable error**

and if steps are being taken to withdraw the correct amounts.

Examples of reasonable errors include (1) erroneous advice from the funding institution, (2) other pension advisors, or (3) individual miscalculation or misunderstanding of the minimum distribution computation. Form 5329 instructions tell the taxpayer to pay the tax and attach a letter of explanation. The penalty money will be refunded if a waiver is granted.

4. Excess Distributions

The TRA of 1997 repealed the 15% excise tax on excess distributions, effective for distributions received after 12/31/96.

- The following is an IRA Summary Record sheet that you and your clients may find useful.

APPENDIX A. Summary Record of IRA(s) for 199~~6~~7 (You May Keep This for Your Records.)

Name ____________________

I was ☐ covered ☐ not covered by my employer's retirement plan during the year.

I became age 59½ on ____________________.
(month) (day) (year)

I became age 70½ on ____________________.
(month) (day) (year)

Contributions

Name of IRA	Date	Amount contributed for 199~~6~~7	Check, if rollover contribution	Fair Market value of IRA as of December 31, 199~~6~~7, from Form 5498
1.				
2.				
3.				
4.				
5.				
Total				

Total contributions deducted on tax return $________

Total contributions treated as nondeductible on Form 8606 $________

Distributions

Name of IRA	Date	Amount of distribution	Reason (e.g., for retirement, rollover, withdrawal of excess contributions, etc.)	Income earned on IRA	Taxable amount reported on income tax return	Nontaxable amount from Form 8606, line 10
1.						
2.						
3.						
4.						
Total						

Basis of all IRAs as of 12/31/9~~6~~7 (from Form 8606, line 11) $________

Basis of all IRAs for 199~~6~~7 (from Form 8606, line 12) $________

Note: You should keep copies of your income tax return, and Forms W–2, 8606, and 5498.

WORKSHEET
FOR
DETERMINING REQUIRED ANNUAL DISTRIBUTIONS FROM YOUR IRA(s)

1. Age	70½	71½	72½	73½	74½	75½
2. Year age was reached						
3. Value of IRA at the close of business on December 31 of the year immediately prior to the year on line 2[1]						
4. Divisor from Life Expectancy Table I or Table II[2]						
5. Required distribution (divide line 3 by line 4)[3]						

[1]If you have more than one IRA, you must figure the required distribution separately for each IRA.

[2]Use the appropriate divisor for each year and for each IRA. You can either (a) use the appropriate divisor from the table each year, or (b) use the appropriate divisor from the table for your 70½ year and reduce it by 1 (one) for each subsequent year. To find the appropriate divisor, use your age (and that of your beneficiary, if applicable) as of your birthday(s) in the year shown on line 2. If your beneficiary is someone other than your spouse, see *Minimum Distribution Incidental Benefit Requirement* in Chapter 6.

[3]If you have more than one IRA, you must withdraw an amount equal to the total of the required distributions figured for each IRA. You can, however, withdraw the total from one IRA or from more than one IRA.

Source: IRS Publication 590, IRAs (updated to 1997).

APPENDIX A. Summary Record of IRA(s) for 199~~6~~7 (You May Keep This for Your Records.)

Name ____________________

I was ☐ covered ☐ not covered by my employer's retirement plan during the year.

I became age 59½ on ____________________.
(month) (day) (year)

I became age 70½ on ____________________.
(month) (day) (year)

Contributions

Name of IRA	Date	Amount contributed for 199~~6~~7	Check, if rollover contribution	Fair Market value of IRA as of December 31, 199~~6~~7, from Form 5498
1.				
2.				
3.				
4.				
5.				
Total				

Total contributions deducted on tax return $__________

Total contributions treated as nondeductible on Form 8606 $__________

Distributions

Name of IRA	Date	Amount of distribution	Reason (e.g., for retirement, rollover, withdrawal of excess contributions, etc.)	Income earned on IRA	Taxable amount reported on income tax return	Nontaxable amount from Form 8606, line 10
1.						
2.						
3.						
4.						
Total						

Basis of all IRAs as of 12/31/9~~6~~7 (from Form 8606, line 11) $__________

Basis of all IRAs for 199~~6~~7 (from Form 8606, line 12) $__________

Note: You should keep copies of your income tax return, and Forms W-2, 8606, and 5498.

WORKSHEET
FOR
DETERMINING REQUIRED ANNUAL DISTRIBUTIONS FROM YOUR IRA(s)

1. Age	70½	71½	72½	73½	74½	75½
2. Year age was reached						
3. Value of IRA at the close of business on December 31 of the year immediately prior to the year on line 2[1]						
4. Divisor from Life Expectancy Table I or Table II[2]						
5. Required distribution (divide line 3 by line 4)[3]						

[1]If you have more than one IRA, you must figure the required distribution separately for each IRA.

[2]Use the appropriate divisor for each year and for each IRA. You can either (a) use the appropriate divisor from the table each year, or (b) use the appropriate divisor from the table for your 70½ year and reduce it by 1 (one) for each subsequent year. To find the appropriate divisor, use your age (and that of your beneficiary, if applicable) as of your birthday(s) in the year shown on line 2. If your beneficiary is someone other than your spouse, see *Minimum Distribution Incidental Benefit Requirement* in Chapter 6.

[3]If you have more than one IRA, you must withdraw an amount equal to the total of the required distributions figured for each IRA. You can, however, withdraw the total from one IRA or from more than one IRA.

Source: IRS Publication 590, IRAs (updated to 1997).

II. Keogh (H.R. 10) Plan

One major type of self-employed retirement plan is still called a Keogh plan. These plans are now subject to the same rules as corporate pension plans with a few exceptions.

A. Establishing the Plan

1. How to Set Up

Only a sole proprietor or a partnership can set up a Keogh plan. The term *employee* is defined to include a self-employed individual. For pension plan purposes **only** an individual who owns the entire interest in an unincorporated trade or business is treated as his or her own employer.

The written plan must be established on or before the end of the year in which the plan is to be effective. This is a disadvantage of Keogh plans as opposed to SEP plans.

There are two basic kinds of Keogh plans: defined contribution and defined benefit. Different rules apply to each. **This discussion will focus on defined contribution plans.**

- **Defined contribution plans can be either profit-sharing or money purchase plans.**
- If contributions are geared to profits, the plan is a profit-sharing plan.
- A plan that requires **fixed contributions** (regardless of profits) is a money purchase plan.
- To maximize deductible contributions, a separate money purchase plan **may supplement** a profit-sharing plan.

Any of the following acts between the plan and a disqualified person is prohibited:

1. Selling, exchanging, or leasing property
2. Lending money or extending credit
3. Furnishing goods, services, or facilities

Example 12. A farmer wishes to buy farmland with his Keogh trust money and cash-rent it to himself at market rates. Since he is the owner-employer and would be renting from the plan, this is a prohibited transaction. There is a 10% excise tax on the amount involved in prohibited transactions. A 100% penalty applies if the transaction is not corrected.

Note: The TRA of 1997 increased the excise tax to 15% for prohibited transactions that take place **after** August 5, 1997.

2. Who Must Be Covered

Self-employed persons **need not** have employees besides themselves to set up a Keogh plan. If there are other employees, however, they must be allowed to participate in the plan if they meet the **minimum participation requirements.**

An employee must be included in a plan if he or she

- Has reached age 21, and
- Has at least one year of service (two years if there is a two-year vesting provision in the plan). The general rule defines "year of service" as a 12-month period during which the employee has **not less than 1,000 hours of service** [I.R.C. §410(a)(3)(A)].
- The employer is **not** required to cover a seasonal or part-time employee who works **less** than 1,000 hours during a 12-month period.
- Any plan may have more lenient participation standards—age 18 and six months' service, for example. This is usually done when a parent employer wants to start coverage for a child employee.

Note: A plan cannot exclude an employee because he or she has reached a specified age older than age 21. For example, employees over age 70½ can still participate in a Keogh plan even though they cannot make IRA contributions.

- The aggregation rules require an owner-employee with multiple controlled businesses to cover all employees who have met the minimum participation standards. No plan may be established for the owner-employee unless a plan has been established for the employees of the controlled business.

New Law Alert: Changes affecting 1997 and later years are in the **1996 Tax Legislation** chapter. Special aggregation rules have been **repealed** for tax years that begin after December 31, 1996. (See pages 295, 297, and 304 for details.)

Practitioner Note:

An advantage of Keogh plans over SEP plans is the ability of the self-employed owner to use vesting schedules. Vesting schedules for employees can be more **restrictive** than the immediate vesting condition mandated by SEP plans.

B. Contributions—Compensation Limit Is Increased to $160,000 for 1997

1. Contributions Limits

a. Employee. Contributions for common-law employees are made at the rate specified in the plan, **based upon their compensation** (up to the Compensation Limit of $160,000 for 1997). **Annual contributions may not exceed the smaller of**

1. $30,000, **or**
2. 25% of compensation up to $160,000.

The deductions limit for contributions is further limited by the type of plan.

Important: Deductions for contributions to profit-sharing plans are limited to 15% of compensation. Money purchase plans have a compensation limit of 25%.

A safe harbor definition of compensation is the wages reportable in box 1 of Form W-2. See Reg. §§1.415-2(d) and 1.414(s)-1(c)4 for other alternatives.

b. Self-employed. **Self-employed individuals can make contributions for themselves only if they have net earnings from self-employment.** Contributions for common-law employees based on their W-2 earnings will still be made, but a net loss for the self-employed person results in**no allowable contribution since he or she has no qualifying compensation.**

The annual contributions limits are the same for the owner-employee. However, because of the special definition of "compensation" for the self-employed, the overall effective rate is lower, limited by two factors. **The special limiting factors for the self-employed person involve defining compensation as net earnings from self-employment after taking into account:**

1. The deductions allowed for one-half of self-employment tax, and
2. The deductions for the self-employed person's contributions to the plan.

The deduction for the self-employed person's contribution to the plan is reflected in a lower actual rate than the stated rate in the plan: 25% becomes 20%, and 15% becomes 13.0435%. [IRS Publication 560 contains a table that is reproduced in **Figure 9.**]

The deduction for one-half of self-employment tax is taken as part of a seven-step process to arrive at maximum deductible contributions (**see Figure 10**).

Figure 9

Self-Employed Person's Rate Table	
Column A If the plan contribution rate is (shown as a %)	**Column B The self-employed person's rate is (% shown as a decimal)**
1	.009901
2	.019608
3	.029126
4	.038462
5	.047619
6	.056604
7	.065421
8	.074074
9	.082569
10	.090909
11	.099099
12	.107143
13	.115044
14	.122807
15*	.130435*
16	.137931
17	.145299
18	.152542
19	.159664
20	.166667
21	.173554
22	.180328
23	.186992
24	.193548
25	.200000

*The deduction for annual **employer** contribution to a SEP or profit-sharing plan cannot exceed 15% of the common-law employee participants' compensation (up to $160,000 of compensation), or 13.0435% of your net earnings (up to $160,000) (before computing the deduction for contribution on behalf of yourself) from the business that has the plan.

Example 13. If your plan contribution rate is 10% and your net earnings amount (reduced by your self-employment tax deduction) is $100,000, your deduction for employer contributions on behalf of yourself is $9,091 ($100,000 × 0.090909).

Self-Employed Person's Rate Worksheet. If your plan's contribution rate is not a whole number (for example, 10½%), you cannot use the previous table. However, you can use the *Self-Employed Person's Rate Worksheet*, discussed next.

Figure 10

Self-Employed Person's Rate Worksheet—1997	
1) Plan contribution rate as a decimal (for example, 10% would be 0.10%)	
2) Rate in line 1 plus 1, as a decimal (for example, 0.10 plus 1 would be 1.10)	
3) Divide line 1 by line 2. This is your self-employed rate as a decimal.	

Figuring your deduction. Now that you have your self-employed rate, you can figure your deduction for contributions on behalf of yourself by completing the following steps:

Step 1		
	Enter your rate from the *Self-Employed Person's Rate Table* or *Self-Employed Person's Rate Worksheet.*	
Step 2		
	Enter the amount of your net earnings from line 31, Schedule C (Form 1040) or line 36, Schedule F (Form 1040)	$
Step 3		
	Enter your deduction for self-employment tax from line 26, Form 1040.	
Step 4		
	Subtract Step 3 from Step 2 and enter the amount.	$
Step 5		
	Multiply Step 4 by Step 1 and enter the amount.	
Step 6		
	Multiply $160,000 by your plan contribution rate. Enter the result but not more than $24,000.	$
Step 7		
	Enter the smaller of Step 5 or Step 6. This is your deductible contribution. Enter this amount on line 28, Form 1040.	$

Example 14. Marla is a sole proprietor and has employees. The terms of her plan provide that she contribute 10½% (.105) of her net earnings amount and 10½% of her common-law employees' pay. Her 1997 net earnings amount from line 31, Schedule C (Form 1040) is $200,000. In figuring this amount, she deducted her common-law employees' pay of $60,000 and contributions for them of $6,300 (10½%× $60,000). This net earnings amount is now reduced to $193,267 by subtracting her self-employment **tax deduction** of $6,733. She figures her self-employed rate and deduction for employer contributions on behalf of herself as follows:

1) Plan contribution rate as a decimal (for example, 10% would be 0.10)	0.105
2) Rate in line 1 plus 1, as a decimal (for example, 0.10 plus 1 would be 1.10)	1.105
3) Divide line 1 by line 2. This is your self-employed rate as a decimal.	0.095023

Step 1		
	Enter your rate from the *Self-Employed Person's Rate Table* or *Self-Employed Person's Rate Worksheet.*	0.095023
Step 2		
	Enter the amount of your net earnings from line 31, Schedule C (Form 1040) or line 36, Schedule F (Form 1040)	$200,000
Step 3		
	Enter your deduction for self-employment tax from line 26, Form 1040.	6,733

Step 4		
	Subtract Step 3 from Step 2 and enter the amount.	$193,267
Step 5		
	Multiply Step 4 by Step 1 and enter the amount.	18,365
Step 6		
	Multiply $160,000 by your plan contribution rate. Enter the result but not more than $24,000.	$16,800
Step 7		
	Enter the smaller of Step 5 or Step 6. This is your deductible contribution. Enter this amount on line 28, Form 1040.	$16,800

c. Excess contributions. **Nondeductible contributions to a Keogh plan are subject to a 10% excise tax, which is reported on Form 5330.**

d. Salary reduction arrangements. A Keogh plan **can include** a cash or deferred arrangement [401(k)] plan. Eligible employees can elect to contribute part of their before-tax pay to the plan rather than receive the pay in cash. This amount, called an **elective deferral**, remains tax-free until it is distributed by the plan. **For 1997 the limit on elective deferrals is $9,500.** In general, a Keogh plan can include a 401(k) plan only if the Keogh is a **profit-sharing plan.**

2. Effect on Other Plan Contributions

In addition to the overall limits described earlier ($30,000, 25% of compensation up to $160,000 for 1997), there is a limit on elective deferrals to **more** than one plan [I.R.C. §402(g)]. Elective deferrals are amounts contributed under salary reduction agreements to

a. Cash or deferred arrangements [401(k) plans]
b. Simplified employee pensions [408(k)]
c. Tax-sheltered annuity plans [403(b)]

The general limit on tax-sheltered annuities is $9,500 for 1997. The limit on the 401(k) or 408(k) amount for 1997 is $9,500. Husband and wife **each** have a $9,500 limit.

Example 15. Steve is a policeman who earns $85,000 in 1997. He participates in a 403(b) elective deferral plan and contributes the maximum, or $9,500 to the plan. Mary, his wife, is a computer programmer and earns $65,000 in 1997. She contributes to her employer's 401(k) plan under an elective deferral arrangement **the** maximum of $9,500. Their total deferral for 1997 is $19,000.

Example 16: Contributions to HR-10 Plan. John, a self-employed individual, adopted a Keogh plan that provided for a combined profit-sharing and money purchase plan. The profit-sharing percentage is 10%, and the money purchase percentage is 15%. During 1997 he had a net profit from his only trade or business of $50,000. His deduction for one-half of self-employment tax is $3,532. He had one employee covered under the plan who was paid a wage of $20,000. Calculate his

required contributions and **maximum** contributions.

John's Keogh plan contribution for 1997	
1. Required: money purchase 15%	.130435
2. Optional: profit sharing 10%	.090909
Limited to 25% ÷ 1.25, or	20%

Step 1:Compute John's **overall** contribution limit:
$50,000 – $3532 = $46,468 × .20 = $9,294 overall limit

Step 2:Net earnings after plan deductions:
$46,468 – $9,294 = **$37,174**

Fund the money purchase plan first (mandatory):
$37,174 × 15% = $5,576

Step 3:Fund the profit-sharing plan
$9,294 overall limit – $5,576 from step 2 = **$3,718**

Any contribution in excess of $9,294 is an **excess** 1997 Keogh contribution for the owner, John.

Note: I.R.C. §415(f)(1)(B) states that "all defined contribution plans (whether or not terminated) of an employer **are to be treated as one** defined contribution plan."

Employee's Keogh plan contribution for 1997
$20,000 × .25 = $5,000

C. Distributions

1. Loans

The rules are different for common-law employees and key employees.

Keogh plan loans to **owner-employees** are subject to **prohibited transaction penalties.** Keogh plan loans may be made to **common-law employees.** The plan document must specify whether or not these loans will be a feature of the plan. This is discretionary.

2. Permitted Distributions [§72]

Distributions allowed **without penalty** are those made under the following circumstances:

a. Attainment of age 59½.
b. Death.
c. Disability (within the social security definition).

d. Made to an alternate payee under a qualified domestic relations order (QDRO); a QDRO is defined in I.R.C. §414(p).
e. Made to pay medical expenses that exceed 7.5% of adjusted gross income (whether or not the participant actually itemizes deductions).
f. Timely made to reduce excess contributions or deferrals.
g. Part of a series of substantially equal payments beginning **after separation from service.** (The payments must continue for five years or until the employee reaches 59½, whichever is the longer period. A 10% penalty recapture applies if the longer period is not observed.)

Note: See Question and Answer 36 on pages 251–52 for more details.

h. Separation from service if the participant is age 55 or older in the year of separation.

3. Required Distributions

a. Age 70½. **Generally,** each participant must begin to receive plan benefits **no later** than April 1 of the year **following** the calendar year in which the participant reaches age 70½. But see exceptions to this rule on the next page.

A special pre-1984 election made by an individual excepts him or her from the 70½ rule and current beneficiary rules.

Practitioner Note.

Payments required under the current distribution rules are the same for all qualified plans. The year a plan participant reaches age 70½, he or she may defer the first payment until April 1 of the following year, but each distribution after that must be taken by December 31. The deferral would create a **bunching of two distributions in one year.**

For tax years beginning after 1996, plan participants (employees) who are still employed can **delay** receiving required distributions from qualified plans (including Keogh plans) until April 1 following the **later** of:

1. The calendar year the employee attains age 70½, or
2. The calendar year the employee retires.

This new rule does not apply to a 5% or more owner, including a self-employed individual. Those individuals must begin to receive their required distributions no later than April following the calendar year they reach age 70½.

See pages 247, 248, 299, and 300 for more details on this topic.

- The distribution amounts are based on life expectancy tables available in IRS Publication 939.
- The minimum distribution rules apply individually to each Keogh plan. The distribution requirement

- The minimum distribution rules apply individually to each Keogh plan. The distribution requirement for one plan cannot be satisfied by taking a distribution from another. (This is not the case with IRAs.)

b. Death of owner. The distribution rules for beneficiaries depend on whether the employee or self-employed participant has started taking required distributions.

If the employee dies after the required beginning date (April 1 of the year after the "70½ year"), the beneficiaries must take distributions at least as rapidly as the decedent had scheduled.

Example 17. Antoinette elected to receive benefits in equal installments over her 20-year life expectancy but died after 8 years. Her beneficiary would have to receive annual payments over the remaining 12 years but could elect to accelerate payments over a shorter period.

If the employee dies before the required beginning date, the entire account must be distributed either

1. By December 31 of the fifth year following the year of the employee's death, or
2. In annual amounts over the life or life expectancy of the designated beneficiary.

The terms of the plan or the policy of the plan administrator may permit the employee or the beneficiary to choose which of the rules applies. The choice must generally be made by December 31 of the year following the year of the employee's death. If no choice is made, the 5-year rule will apply.

1996 Tax Law Change Reminder: The **$5,000 death benefit exclusion** for employer-provided death benefits [I.R.C. §105(b)] paid to the beneficiary or estate is **repealed** for decedents whose date of death is **after August 20, 1996.** (See page 273 for details.)

See "Special Averaging" below for conditions under which a beneficiary may elect 5- or 10-year averaging for a lump-sum distribution.

c. Divorce. To cover child support, alimony, or property settlements, a state domestic relations court can require that all or part of a plan participant's retirement benefits be paid to a spouse, former spouse, child, or dependent. Employee plan administrators are required to honor a qualified domestic relations order (QDRO) that meets specific tax law tests [§414(p)].

The spouse or former spouse who receives a distribution pursuant to a QDRO must generally pay tax on it. A tax-free rollover to an IRA or special averaging are possibilities for the recipient. The participant giving up the retirement plan distribution is generally not taxed.

1996 tax legislation required the IRS to develop sample language for qualified domestic relations orders. Notice 97-11, I.R.B. 1997-2, 49, was issued to assist domestic relations attorneys, plan participants, and plan administrators in drafting and reviewing a qualified domestic relations order.

A payment that is **not** a QDRO payment will be taxed to the plan participant.

4. Plan Termination

The owner-employee and the common-law employee may roll over the distributions received to an IRA. If there is no rollover, special averaging is a possibility if other conditions are met.

Note: A final form in the 5500 series must be filed. All one-participant plans must file a Form 5500-EZ for their final plan year, even if total plan assets have always been less than $100,000.

5. Rollovers

Beginning January 1, 1993, any previously untaxed distribution from a qualified employer plan may be rolled over tax-free to an IRA **or** another qualified employer plan, provided:

a. It is not a mandatory distribution, or
b. It is not part of a series of substantially equal periodic payments for a period of 10 years or more.

Prior to 1993 more restrictive requirements applied to rollovers.

Note: There has been no change to the rule that **only previously untaxed distributions** may be rolled over. No amount on which tax has been paid may be rolled over.

III. Special Averaging [§402(a)(5)]

If a distribution from a qualified plan is a lump-sum distribution and is not rolled over, it may be eligible for taxation under a special averaging method.

Although called averaging methods, the 5- and 10-year methods are special formulas for figuring the tax on the lump-sum distribution only for the year of the receipt. The tax is paid **only once,** not over the next 5 or 10 years.

Figure 11

Tax on Lump-Sum Distribution Made in 1996					
(100% treated as ordinary income with no death benefit exclusion)					
Amount of Distribution			**5-year Averaging**		**10-year Averaging**
$50,000	Tax		$6,900		$5,874
Tax as %*			13.80%		11.75%
$100,000	Tax		$15,000		$14,471

Tax as %*			15.00%		14.47%
$250,000	Tax		$53,978		$50,770
Tax as %*			21.59%		20.31%
$500,000	Tax		$130,015		$143,682
Tax as %*			26.00%		28.74%
$1,000,000	Tax		$303,853		$382,210
Tax as %*			30.39%		38.22%

*Percentage of distribution that is paid as income tax.

Note: Except for extremely large lump-sum distributions (those exceeding $348,756), 10-year averaging will provide the least tax.

Form 4972 and instructions contain the basic qualifying information for special averaging.

Special 5- or 10-Year Averaging Method. If the employee who received a **qualifying lump-sum distribution reached age 50 before 1986** (was born before 1936), he can figure his tax on the distribution by using **either** 5-year averaging or 10-year averaging on Form 4972. This tax is in addition to the regular tax figured on his other income. It is reported on line 39 of the 1997 Form 1040.

If he chooses the 5-year averaging method for 1997, the tax is computed on Form 4972 using the Single Tax Rate Schedule for 1997. If he chooses the 10-year averaging method, the tax is computed on Form 4972 using the **special** 1986 tax rates. See page 4 of the Instructions for Form 4972 for tax rate schedules used to compute the tax for **both** the 5-year and 10-year averaging methods.

Note: **Beginning in 1995,** you may be able to figure the tax on a lump-sum distribution under the 5-year tax option **even if** the plan participant **was born after 1935.** You can do this only if the distribution is made **after** the participant has reached age 59½ and the distribution otherwise qualifies. This applies to distributions made after June 30, 1995 [I.R.C. §402(d)(4)B as amended by P.L. 102-318]. Refer to IRS Pub. 575 (*Pension and Annuity Income*) for details.

1996 Tax Law Change Reminder: Five-year averaging has been repealed for tax years beginning after 1999. It is still permitted for 1997, 1998, and 1999 tax returns. See pages 298–99 for more details.

A distribution is a qualifying lump-sum distribution for special averaging only if all six of the following conditions are met:

a. The distribution came from a qualified pension, profit-sharing, or stock bonus plan.
b. The distribution came from all the employer's qualified plans of one kind (pension, profit-sharing, or stock bonus) in which the participant had funds.
c. The distribution was for the **full** amount credited to the participant. For this purpose, the full amount credited to the participant does not include any accumulated deductible employee contributions under the plan.

d. The distribution was paid within a single tax year.

e. The participant was in the plan for five or more tax years before the tax year of distribution unless the distribution was paid because the participant died.

f. The distribution was paid in **any** of the following cases:

(1) The plan participant died.

(2) The participant was age 59½ or older at the time of the distribution.

(3) The participant, if a **common-law employee,** quit, retired, was laid off, or was fired.

(4) The participant, if a **self-employed individual or an owner-employee,** became permanently and totally disabled.

Once the practitioner has determined that the client meets the requirements for the special tax savings, he or she must then complete Form 4972, Tax on Lump-Sum Distributions. The form is broken down into four parts. **Part I of the form is in question-and-answer format.** Some clients will not be able to submit the form because they do not meet all requirements.

More Than One Qualifying Lump-Sum Distribution in One Year. Special averaging is available only to taxpayers who elect it for all qualifying lump-sum distributions received in a **single taxable year** [I.R.C §402(e)(4)(B); *Fowler v. Commissioner*].

In the *Fowler* case, the IRS position that all qualifying lump-sum distributions from any type of plan must be **aggregated** for special averaging was **upheld**. This case clarifies the circumstance in which multiple qualifying distributions from different types of plans of one employer were received within the same year. Special averaging, if elected on one distribution, must be elected for other qualifying distributions.

Contrast the requirement of combining all distributions received within a year with the determination of a "qualifying lump-sum distribution." If an employer has several plans and the employee receives the entire balance to his credit in the plan of **one type,** the employee may have a qualifying lump-sum distribution for special averaging provided other conditions are met. If she receives a distribution next year, she may roll that amount over.

If the employee receives all of her plan distributions in **one year,** she must use special averaging on the **entire amount** to be eligible to use averaging on any amount. This assumes all of her distributions are "qualifying lump-sum distributions."

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code	1 Gross distribution $ 2a Taxable amount $	OMB No. 1545-0119 1997 Form 1099-R	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
	2b Taxable amount not determined ☐	Total distribution ☐	**Copy B** Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return.
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $	
RECIPIENT'S name	5 Employee contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	
Street address (including apt. no.)	7 Distribution code / IRA/SEP/SIMPLE ☐	8 Other $ %	This information is being furnished to the Internal Revenue Service.
City, state, and ZIP code	9a Your percentage of total distribution %	9b Total employee contributions $	
Account number (optional)	10 State tax withheld $ $	11 State/Payer's state no.	12 State distribution $ $
	13 Local tax withheld $ $	14 Name of locality	15 Local distribution $ $

Form 1099-R   Department of the Treasury - Internal Revenue Service

Note: See separate 1997 1099 instructions for detailed instructions on how to complete and interpret box entries on 1099-R. Box 7, Distribution code, contains very important information.

Codes For Box 7 of the 1997 Form 1099-R Use the codes below for distributions from IRAs, SEPs, SIMPLEs, Keoghs, qualified plans, commercial annuities, insurance contracts, etc.

A numeric code must be entered, except when Code P, D, E, F, G, H, L, or S is used.

1—Early (premature) distribution, no known exception. Use Code 1 only if the employee/taxpayer has not reached age 59½, and only if none of the exceptions under §§72(q), (t), or (v) are known to apply. For example, if a hardship distribution is made for medical expenses, you probably will not know if the medical expense exception under §72(t) applies. Therefore, use Code 1.

Note: Even if the employee/taxpayer is 59½ or over, use Code 1 if a series of substantially equal periodic payments was modified within 5 years of the date of the first payment (within the meaning of §72(q)(3) or (t)(4)). For example, Mr. B began payments that qualified for the exception for part of a series of substantially equal periodic payments under §72(t)(2)(A)(iv) when he was 57. When he was 61, Mr. B substantially modified the payments. Because the payments were modified within 5 years, use Code 1 in the year the payments were modified, even though Mr. B is over 59½.

2—Early (premature) distribution, exception applies (as defined in section 72(q), (t), or (v)). Use Code 2 only if the employee/taxpayer has not reached age 59½ to indicate that an exception under §§72(q), (t), or (v) applies. However, instead of Code 2, use Code 3 or 4, whichever applies, for an early distribution due to disability or death.

3—Disability.

4—Death. Use Code 4 regardless of the age of the employee/taxpayer to indicate payment to a decedent's beneficiary, including an estate or trust. Also use it for death benefit payments made by an employer but not made as part of a pension, profit-sharing, or retirement plan.

5—Prohibited transaction.

6—Section 1035 exchange. Use Code 6 to indicate the tax-free exchange of life insurance, annuity, or endowment contracts under §1035.

7—Normal distribution. Use Code 7 for a normal distribution from any plan, including an IRA, SEP, or SIMPLE, if the employee/taxpayer is at least 59½. Also use Code 7 to report a distribution from a life insurance, annuity, or endowment contract and for reporting income from a failed life insurance contract under §§7702(g) and (h). (See Rev. Rul. 91-17, 1991-1 C.B. 190.) **Generally, use Code 7 if no other code applies.**

8—Excess contributions plus earnings/excess deferrals (and/or earnings) taxable in 1997. Use Code 8 for an IRA distribution under §408(d)(4), unless Code P applies. Also use this code for corrective distributions of excess deferrals, excess contributions, and excess aggregate contributions, unless Code P or D applies.

9—PS 58 costs. Use Code 9 to report premiums paid by a trustee or custodian for current life or other insurance protection (PS 58 costs).

P—Excess contributions plus earings/excess deferrals taxable in 1996.
See the explanation for code 8. The IRS suggests that anyone using Code P for the refund of an IRA contribution under §408(d)(4) advise payees, at the time the distribution is made, that the earnings are taxable in the year in which the contribution was made.

A—May be eligible for 5- or 10-year tax option. Use Code A to indicate that the distribution is eligible for the tax option method of computing the tax on lump-sum distributions under §402(d). To determine whether the distribution may be eligible for the tax option, you need not consider whether the recipient used this method (or capital gain treatment) in the past.

B—May be eligible for death benefit exclusion. Use Code B to indicate that the distribution is eligible for the death benefit exclusion under §101(b).

Caution: The death benefit exclusion was repealed for payments made because of the death of an employee who died after August 20, 1996. Therefore, do not use Code B (or C) if the employee died after August 20, 1996. You may continue to use Code B (or C) for payments with respect to employees who died before August 21, 1996.

C—May be eligible for both A and B.

D—Excess contributions plus earnings/excess deferrals that are taxable in 1995. See the explanation for Code 8. Generally, do not use Code D for an IRA distribution under §408(d)(4).

E—Excess annual additions under section 415. Use Code E alone. Do not use Code 1 or 2 with Code E.

F—Charitable gift annuity.

G—Direct rollover to IRA. Do not use this code for a distribution from an IRA. Do not use this code with any other code except Code 4, when applicable.

H—Direct rollover to qualified plan or tax-sheltered annuity. Do not use this code with any other code.

L—Loans treated as deemed distributions under §72(p). You may use Code L with other codes, such as Code 1 or 2. Do not use Code L to report a loan offset.

S—Early distribution from a SIMPLE IRA in first 2 years, no known exception. Use Code S if the distribution is from a SIMPLE IRA in the first 2 years, the employee/taxpayer has not reached age 59½, and none of the exceptions under §72(t) are known to apply. The 2-year period begins on the day contributions are first deposited in the individual's SIMPLE by the employer. Do not use Code S if Code 3 or 4 applies.

IV. Nonqualified Deferred Compensation Plans

Corporation	Agreement	Key Employee
• Pays compensation for a set period after retirement or death.		• Gives current service. • Agrees not to compete after retirement. • Gives consultation as needed.
	Benefits	
• Corporation retains key employees.		• Provides extra retirement benefit when tax bracket may be lower.
	Taxation	

• Deductible to the corporation when payments are made.		• Taxed when payments are made or "constructively received."
	General Comments	

1. Deferral must be agreed upon before the compensation is earned.
2. If the plan is "unfunded," the compensation is not taxable until received.
3. If the plan is "funded," the employee's rights must be forfeitable (e.g., if he competes with the employer after retirement, he loses his benefits) and they must be nontransferable. If they become nonforfeitable or transferable they become taxable at that time.
4. The employer can pick and choose which employees to benefit.
5. Nonqualified plans are not subject to the 15% excess accumulation penalty tax imposed on qualified plans, IRAs, etc.
6. Distributions from nonqualified plans are reported on the Form W-2, box 11 (1997 W-2). These amounts will also be subject to social security and Medicare, boxes 3 and 5. The purpose of box 11 is for the SSA to determine if any portion of the amount reported in box 1 or boxes 3 and 5 for 1997 was earned in a prior year.

V. Simplified Employee Pension IRAs

A. General Facts

- A simplified employee pension (SEP) is a written arrangement (a plan) that allows an employer to make contributions toward his or her own (if a *self-employed individual*) and employees' retirement, without becoming involved in more complex retirement plans. The contributions are made to IRAs (SEP-IRAs) of the participants in the plan. Under a SEP, IRAs are set up for, at a minimum, each *qualifying employee*. IRAs may have to be set up for *leased employees*, but they do not have to be set up for *excludable employees*.
- The aggregation rules require an owner-employee with multiple controlled businesses to cover all employees who have met minimum participation standards.

1996 Tax Law Change Reminder: Changes affecting 1997 and later years are in the **1996 Tax Legislation** chapter. Special aggregation rules have been **repealed** for tax years that begin after December 31, 1996. **See pages 295, 297, and 304 for details.**

- An employer can use *Form 5305-SEP* to satisfy the written arrangement requirement for a SEP. A SEP can be established at any time during a year. However, the time for making contributions for a year under a SEP agreement is limited.

Note: The SEP plan under which contributions are made can be established **after** the close of the year for which contributions are made. **However, the plan must exist at the time the contributions are made, and they must be made within the time limit.** One major advantage of SEP plans over Keogh plans is the ability to establish **and** contribute to it **after** December 31 of the current tax year. The deadline for establishing **and** contributing to a SEP plan is the **due date of the return, including extensions.**

- An employer who signs a SEP agreement *is not required to make any contribution* to the SEP-IRAs that are established. But if the employer does make contributions, the contributions must be based on a written allocation formula and must **not** discriminate in favor of *highly compensated employees.*
- A SEP may be used by sole proprietorships, partnerships, and corporations (unlike a Keogh plan, which is used **only** by sole proprietorships and partnerships).

B. Definitions

1. **A *self-employed individual* is an employee for SEP purposes.** He or she is also the employer. Even if the self-employed individual *is the only qualifying employee,* he or she can have a SEP-IRA.

   A *qualifying employee* is one who

   (a) Is at least 21 years old,

   (b) Has worked for the employer during at least three of the five years immediately preceding the tax year, and

   (c) Has received from the employer at least $400 in compensation during 1997.

Note: See Question and Answer 32 on pages 249–50 for more details on this topic.

Note: An employer can establish **less** restrictive participation requirements for its employees than those listed, but not **more** restrictive ones.

2. Leased employees who are treated as your employees and meet participation requirements must be included in the SEP.

1996 Tax Law Change Reminder: Changes affecting 1997 and later years are in the **1996 Tax Legislation** chapter. The definition of a "leased employee" has been changed for tax years that begin after December 31, 1996. **See page 296 for details.**

3. For tax years that begin after 1996, a *leased employee* is any person who is not an employee of the recipient and who is hired by a leasing organization, but who performs services for another (the recipient of the services).

   A person is a leased employee if

   (a) The services are provided under an agreement between the recipient and the leasing

(b) The person performs services for the recipient on a substantially full-time basis, and for a period of at least one year; and

(c) The person's services are performed under the primary direction and control of the recipient.

Note: Under the repealed law that applied prior to 1997, 3(c) stated: "The services are of a type historically performed by employees in the recipients' business field."

4. *Excludable employees:* The following employees can be excluded from coverage under a SEP:
   (a) Employees who are covered by a union agreement and whose retirement benefits were bargained for in good faith by their union and their employer; and
   (b) Nonresident alien employees who have no U.S. source earned income from their employer.
5. A *highly compensated employee* is an employee who during the year or preceding year
   (a) Owns more than 5% of the capital or profits interest in the employer (if not a corporation); or more than 5% of the outstanding stock or more than 5% of the total voting power of all stock of the employer corporation; **OR**
   (b) Received annual compensation from the employer of more than $80,000 for 1996 [the previous year].

1996 Tax Law Change Reminder: Changes affecting 1997 and later years are in the **1996 Tax Legislation** chapter. The definition of "highly compensated employee" has been simplified for tax years that begin after December 31, 1996. (See page 297 for details.)

C. Contributions for Employees

The SEP rules permit an employer to contribute (and deduct) each year to **each** employee's SEP-IRA up to 15% of the employee's compensation or $24,000, whichever is less. These contributions are funded by the employer.

Figuring the 15% Limit

For purposes of determining the 15% limit, *compensation does not include* the employer's contribution to the employee's SEP-IRA and it is limited to $160,000 for 1997.

Problem 1. Barry's employer has a SEP for its employees. Barry's compensation for 1997, before his employer's contribution to his SEP-IRA, was $20,000. How much can Barry's employer contribute to his SEP-IRA for 1997?

Answer. Barry's employer can contribute up to $3,000 (15% × $20,000).

Contributions for the Self-Employed Person—Worksheet

If you are self-employed and contribute to your own SEP-IRA, special rules apply when you figure your maximum deduction for these contributions. Use the same rules described in the Keogh section of this chapter. This special computation is necessary for both Keoghs and SEPs because of the way "compensation" is defined.

When figuring the deduction for contributions made for yourself, "compensation" is your net earnings from self-employment taking into account:

1. The deduction allowed for one-half of the self-employment tax (Form 1040, line 26), and
2. The deduction for contributions on behalf of yourself to the plan

Problem 2. You are a sole proprietor and have employees. The terms of your SEP provide that you contribute for yourself 15% of your net earnings, and for your employees 15% of their pay. Your net earnings from your business (not taking into account a deduction for contributions to your own SEP-IRA) are $96,000. In figuring this amount, you deducted your employees' pay of $60,000 and contributions for them of $9,000 (15% of $60,000). (1997 SE tax is $10,681.)

What is the maximum deduction for contributions to your own SEP-IRA?

Answer

Self-Employed Person's Rate Worksheet---1997

1) Plan contribution rate as a decimal (for example, 10% would be 0.10)	.15
2) Rate in line 1 plus 1, as a decimal (for example, 0.10 plus 1 would be 1.10)	1.15
3) Divide line 1 by line 2. This is your self-employed rate as a decimal.	.130435

Step 1		
	Enter your rate from the *Self-Employed Person's Rate Table* or *Self-Employed Person's Rate Worksheet.*	.130435
Step 2		
	Enter the amount of your net earnings from line 31, Schedule C (Form 1040) or line 36, Schedule F (Form 1040)	$96,000
Step 3		
	Enter your deduction for self-employment tax from line 26, Form 1040.	5,340
Step 4		
	Subtract Step 3 from Step 2 and enter the amount.	$90,660
Step 5		
	Multiply Step 4 by Step 1 and enter the amount.	11,825
Step 6		
	Multiply $160,000 by your **plan** contribution rate. Enter the result but not more than $24,000.	$24,000
Step 7		
	Enter the **smaller** of Step 5 or Step 6. This is your deductible contribution. Enter this amount on line 28, Form 1040.	$11,825

Time Limit for Contributions

To deduct contributions for the current year, the employer must make the contributions **not later than the due date (including extensions)** of the *employer's return for the current year*.

Overall Limit—Employer with Defined Contribution and SEP Plans

Even though the SEP was designed to be useful to the employer who wants one "simple" employer plan for retirement savings, it may be used with other plans. If an employer contributes to a **defined contribution** retirement plan (a plan under which an individual account is set up for each participant), annual additions to an account are limited to the lesser of (1) $30,000 or (2) 25% of the participant's compensation (up to $160,000 for 1997). Moreover, for purposes of these limits, contributions to more than one such plan must be added.

Note: Since a SEP is considered a defined contribution plan for purposes of these limits, employer contributions to a SEP must be added to other contributions to defined contribution plans.

Example. A medical professional corporation has seven highly paid doctor/employees. Each receives a salary in excess of $160,000 in 1997. Prior to 1997, the corporation had adopted a **15% SEP profit sharing plan.** In 1997, the corporation established a **second** retirement plan for its employees, **a 10% money purchase plan.** This will enable the corporation to contribute to and deduct the maximum $30,000 for **each** employee's retirement plans (2) in 1997.

Computation

Step 1:	(**Money purchase plan**—mandatory contribution) $160,000 × 10% =	$16,000
Step 2:	(**15% SEP profit sharing plan**—optional contribution) $30,000 **overall** limitation less $16,000 (Step 1 amount)	$14,000
	1997 contribution **and** deduction for **each** employee	$30,000

D. Tax Treatment of Employer's Contributions

Unlike contributions to IRAs, contributions to a taxpayer's SEP-IRA by the employer are *excluded* from a taxpayer's income rather than deducted from it. The employer's contributions to the taxpayer's SEP-IRA should **not** be included in wages on Form W-2, Wage and Tax Statement, unless there are contributions in excess of the applicable limit, or unless there are contributions under a salary reduction arrangement.

- *Contributions under a salary reduction arrangement.* Form W-2 should include contributions under a salary reduction arrangement for social security and Medicare tax purposes only.
  - (a) *If there are no excess contributions,* the taxpayer does not include any contributions in gross income or deduct any of them.

(b) *If there are excess employer contributions,* the amount must be included in gross income, without any offsetting deduction, and the Form W-2 should include the amount.

E. Contributions Made to SEP-IRA by the Employee

If a taxpayer makes contributions to his SEP-IRA independent of employer SEP contributions or a SEP salary reduction (elective deferral), he can deduct them the same way as contributions to a regular IRA. **However, the deduction may be reduced or eliminated because, as a participant in a SEP, he is covered by an employer retirement plan.** (Note the restriction on IRA deductibility.)

F. Tax Treatment by Self-Employed Individuals

If the taxpayer is self-employed (a sole proprietor or partner) and has a SEP plan, she should take her deduction for her employer contributions to her own SEP-IRA on line 28, Form 1040. If she also makes deductible contributions to her SEP-IRA (or any other IRA she owns) independent of her employer contributions, her deduction is shown on line 23, Form 1040.

G. Salary Reduction Arrangement (SARSEPs)

1. A SEP may include a salary reduction arrangement. Under the arrangement, a taxpayer can elect to have her employer contribute part of her pay to her SEP-IRA. Only the remaining portion of her pay is currently taxable. The tax on the contribution is deferred. Thus, this choice is called an *elective deferral.* Form 5305A-SEP can be used by an employer to set up such an arrangement.
2. *Restrictions on election.* She can choose elective deferrals only if

   (a) At least 50% of employees eligible to participate choose elective deferrals,

   (b) There were no more than 25 eligible employees at any time during the preceding year, and

   (c) The amount deferred each year by each eligible highly compensated employee as a percentage of pay is no more than 125% of the average deferral percentage of all other eligible employees (*ADP test*). Compensation in excess of $160,000 cannot be considered in figuring an employee's deferral percentage.

3. *Exceptions.* An elective deferral arrangement is not available for a SEP maintained by a state or local government, or any of their political subdivisions, agencies, or instrumentalities, or to a tax-exempt organization.
4. *Limits on deferrals.* In general, the total income a taxpayer can defer under a salary reduction arrangement included in his or her SEP and certain other elective deferral arrangements, for 1997, is limited to **$9,500.** This limit applies only to the amounts that represent a reduction from the taxpayer's salary, not to any contributions from employer funds.

   Elective deferrals, not exceeding the ADP test, are excluded from a taxpayer's income in the year of deferral, but are included in wages for social security, Medicare, and unemployment (FUTA) tax purposes.

1996 Tax Law Change Reminder: SARSEPs have been **repealed** for tax years that begin after December 31, 1996, **unless** the SARSEP had been established **prior** to January 1, 1997.

H. Overall Limits on SEP Contributions

Contributions, **including elective deferrals** (salary reductions), made by a taxpayer's employer to the SEP-IRA are subject to the overall limit of 15% of compensation (up to $160,000 for 1997) or $24,000, whichever is less.

Problem 3. *Your employer established a SEP prior to 1997 and contributes 10% of your annual salary to the plan. You wish to contribute as much as you can during the 1997 tax year. Your annual salary is $28,000. How much can you contribute to the plan by making an elective deferral?*

Answer. The employer has contributed $2,800 (10% of $28,000) to the SEP-IRA. Your elective deferral and the employer's contribution cannot exceed $4,200 (15% of $28,000). Therefore, your elective deferral for 1997 cannot exceed $1,400.

Problem 4. Can you make a $2,000 contribution to the SEP-IRA as an IRA contribution for 1997 in addition to the elective deferral?

Answer. Yes. You can contribute up to $2,000 to any IRA including your SEP-IRA for 1997. However, **your** IRA deduction **may be limited** because of your participation in a qualified plan during the year and the amount of your modified AGI.

I. Distributions (Withdrawals)

An employer cannot prohibit withdrawals from a SEP-IRA. Also, an employer cannot condition contributions to a SEP-IRA on the keeping of any part of them in the account.

Distributions (withdrawals) from a SEP-IRA are subject to IRA rules. When distributions begin, the SEP-IRA loses the separate status it had for **contribution** rules. For **basis recovery** and **minimum distribution** rules, **all** IRAs (including SEP-IRAs and SIMPLE-IRAs) must be considered.

Note: IRA distributions that must be included in income are taxed as **ordinary income.** They may also be subject to the 10% early withdrawal penalty. In computing the tax, you **cannot use the special averaging method** that applies to lump-sum distributions from qualified plans.