2000 Income Tax School

RETIREMENT

INTRODUCTION

During the course of his or her career, the average worker makes substantial contributions to employer plans and/or individual retirement plans such as IRAs. One of the more complicated areas of tax law concerns the financial decisions necessary to withdraw the money. It is much simpler to put it in than to take it out. This chapter begins with general rules for traditional IRAs and employer plans and then considers other areas such as the Roth IRA, business IRAs, periodic and nonperiodic payments, and the impact of retirement income on social security.

DISTRIBUTION RULES DURING LIFETIME [I.R.C. §§408(a)(6) AND 401(a)(9)]

The Tax Reform Act of 1986 established uniform minimum distribution requirements for most qualified employer plans, tax-sheltered annuities, and regular IRAs. While the following discussion focuses on regular IRAs, the same rules generally apply to other plans.

PRE-59½ DISTRIBUTION RULES [I.R.C. §72(t)]

A 10% federal penalty tax is imposed on taxable distributions prior to the IRA owner's attaining 59½ years of age, subject to exceptions. Many states also impose a penalty on early distributions. The most common federal exceptions applicable to **both** employer plans and IRAs are:

1. Distributions made to a beneficiary after the **owner's death**
2. Distributions made because the **owner is disabled**
3. Distributions made as a series of **substantially equal periodic payments** (discussed below)
4. Distributions from **employer** plans—not including any type of IRA—are excepted from the penalty if the employee **separated from the employer's service** during or after the year the employee attained age 55. For this purpose, a self-employed person is not an employee.
5. Distributions to the extent of medical expenses deductible under I.R.C. §213
6. Distributions made to an alternate payee under a qualified domestic relations order—does not apply to IRAs

Example 1. John, who just turned 55, retires from ABC Company. He takes a distribution from his ABC Company profit-sharing plan of $50,000. He is **not** subject to the early distribution penalty because he has separated from service after age 55.

Example 2. Assume the same facts as in Example 1, except that John first rolled his ABC Company profit-sharing plan to an IRA. Now he does **not** qualify under this exception to the early distribution penalty, as one cannot "separate from service" for purposes of distributions from an IRA.

Several other exceptions apply only to IRA distributions, such as:

1. Distributions made to unemployed individuals for health insurance premiums
2. Distributions made for higher education expenses
3. Distributions made for first home purchases

Substantially Equal Periodic Payment Exception

The early distribution penalty does not apply to distributions that are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life expectancy of the owner. Q&A 12 of Notice 89-25 (see edited version below) provides guidance on establishing substantially equal periodic payments. The exception to the 10% penalty tax does not apply if the series of periodic payments is subsequently modified before the later of:

1. The end of five years from the date of the first payment
2. The date the owner reaches age 59½

The series of payments can be changed after five years or when the taxpayer reaches age 59½, whichever is later. The IRA owner will then be able to take distributions of any amount.

Notice 89-25, 1989-1 CB 662 (March 20, 1989)

Question 12. In the case of an IRA or individual account plan, what constitutes a series of substantially equal periodic payments for purposes of I.R.C. §72(t)(2)(A)(iv)?

Answer 12. I.R.C. §72(t)(l) imposes a penalty tax of 10% on the portion of early distributions from qualified retirement plans (including IRAs) includible in gross income. However, I.R.C. §72(t)(2)(A)(iv) provides that this tax shall not apply to distributions that are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and beneficiary. I.R.C. §72(t)(4) provides that the exception to the 10% penalty tax does not apply if the series of periodic payments is subsequently modified before the later of:

1. The end of five years from the date of the first payment
2. The date the owner reaches age 59½

Payments will be considered as substantially equal periodic payments within the meaning of I.R.C. §72(t)(2)(A)(iv) if they are made according to one of the methods set forth below.

1. Payments shall be treated as satisfying I.R.C. §72(t)(2)(A)(iv) if the annual payment is determined using a method that would be acceptable for purposes of calculating the **minimum distribution** required under I.R.C. §401(a)(9). For this purpose, the payment may be determined based on the life expectancy of the employee or the joint life and last survivor expectancy of the employee and beneficiary.
2. Payments will also be treated as substantially equal periodic payments within the meaning of I.R.C. §72(t)(2)(A)(iv) if the amount to be distributed annually is determined by amortizing the taxpayer's account balance over a number of years equal to the life expectancy of the account owner or the joint life and last survivor expectancy of the account owner and beneficiary (the

annuity method) at an interest rate that does not exceed a reasonable interest rate on the date payments commence. For example, a 50-year old individual with a life expectancy of 33.1 and an account balance of $100,000, assuming an interest rate of 8%, could satisfy I.R.C. §72(t)(2)(A)(iv) by distributing $8,679 annually, derived by amortizing $100,000 over 33.1 years at 8% interest.

3. Finally, payments will be treated as substantially equal periodic payments if the amount to be distributed annually is determined by dividing the taxpayer's account balance by an annuity factor (the **amortization method**) with such annuity factor derived using a reasonable mortality table and using an interest rate that does not exceed a reasonable interest rate on the date payments commence. For example, if the annuity factor for a $1 per year annuity for an individual who is 50 years old is 11.109 (assuming an interest rate of 8% and using the UP-1984 Mortality Table), an individual with a $100,000 account balance would receive an annual distribution of $9,002 ($100,000 ÷ 11.109 = $9,002).

Practitioner Note. Both the amortization and the annuity methods result in **much larger payouts** than the minimum distribution method. Over a single life expectancy, a 55-year-old with a $250,000 account balance could withdraw $8,741 the first year under the minimum distribution method. Using the same life expectancy and a 6% interest rate, the annuity distribution would be $21,574.

Proposed regulations require that the distribution rules be applied separately to each plan. In combination with IRA rollover and transfer provisions, this gives IRA owners flexibility in calculating substantially equal payments. Once the taxpayer determines the amount needed annually, IRAs can be divided into separate accounts as required to yield that annual payment under any of the three methods. This means that the **required payments can be reduced** by splitting the IRA into separate accounts before establishing the stream of payments.

REQUIRED BEGINNING DATE ELECTIONS

IRA

The first required distribution for an IRA owner is for the year the owner reaches age 70½. The distribution for that year must be taken by the required beginning date—April 1 of the next year.

Employee

The required beginning date for employee plan distributions is April 1 after the later of the year the employee is 70½ or the year the employee retires from that employer (assuming the employee does not own more than 5% of the company).

Elections

Before the required beginning date, a taxpayer must make three crucial elections that will determine the required minimum distributions during life as well as after death. The three elections are:

1. Who should be the designated beneficiary
2. Whether to use a joint or a single life expectancy
3. Whether to recalculate life expectancy or use a term certain

These decisions determine which life expectancy factor is used in the required minimum distribution.

CALCULATION OF REQUIRED MINIMUM DISTRIBUTION

A taxpayer's required minimum distribution is calculated by dividing the prior December 31 account balance by the life expectancy factor from Treas. Reg. §1.72-9, Table V and Table VI. The tables are reprinted in IRS Publications 590, *Individual Retirement Arrangements,* and 939, *General Rule for Pensions and Annuities.* The equation is illustrated as follows:

$$\text{Required minimum distribution for current year} = \frac{\text{Prior December 31 balance}}{\text{Life expectancy factor}}$$

Example 3. Bob and Bonnie, a married couple, attain ages 75 and 70 in 2000. The value of Bob's IRA was $100,000 on December 31, 1999. Bob and Bonnie's joint life expectancy factor is 18.8. (See portion of Table VI from Treas. Reg. §1.7-9 below.)

TABLE VI:—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	65	66	67	68	69	70	71	72	73	74
65............	25.0	24.6	24.2	23.8	23.4	23.1	22.8	22.5	22.2	22.0
66............	24.6	24.1	23.7	23.3	22.9	22.5	22.2	21.9	21.6	21.4
67............	24.2	23.7	23.2	22.8	22.4	22.0	21.7	21.3	21.0	20.8
68............	23.8	23.3	22.8	22.3	21.9	21.5	21.2	20.8	20.5	20.2
69............	23.4	22.9	22.4	21.9	21.5	21.1	20.7	20.3	20.0	19.6
70............	23.1	22.5	22.0	21.5	21.1	20.6	20.2	19.8	19.4	19.1
71............	22.8	22.2	21.7	21.2	20.7	20.2	19.8	19.4	19.0	18.6
72............	22.5	21.9	21.3	20.8	20.3	19.8	19.4	18.9	18.5	18.2
73............	22.2	21.6	21.0	20.5	20.0	19.4	19.0	18.5	18.1	17.7
74............	22.0	21.4	20.8	20.2	19.6	19.1	18.6	18.2	17.7	17.3
75............	21.8	21.1	20.5	19.9	19.3	**18.8**	18.3	17.8	17.3	16.9
76............	21.6	20.9	20.3	19.7	19.1	18.5	18.0	17.5	17.0	16.5
77............	21.4	20.7	20.1	19.4	18.8	18.3	17.7	17.2	16.7	16.2
78............	21.2	20.5	19.9	19.2	18.6	18.0	17.5	16.9	16.4	15.9
79............	21.1	20.4	19.7	19.0	18.4	17.8	17.2	16.7	16.1	15.6
80............	21.0	20.2	19.5	18.9	18.2	17.6	17.0	16.4	15.9	15.4

Bob's 2000 required minimum distribution is calculated as follows:

$$\$100{,}000 \div 18.8 = \$5{,}319.15$$

When an IRA owner defers the first year's distribution until the April 1 required beginning date, a special rule applies in calculating the required minimum distribution in the succeeding year. Because the prior December 31 balance will not reflect the first year's distribution, it must be reduced by the required minimum distribution received between January 1 and April 1.

Example 4. Duane turned 70½ in May of 2000 and took his 2000 required minimum distribution on April 1, 2001. To calculate his year 2001 required minimum distribution, he reduces his December 31, 2000 IRA balance by the distribution taken April 1, 2001. Duane has two distributions to report on his 2001 income tax return.

> **Observation.** Taxpayers may always withdraw **more** than the minimum required distribution if they wish.

JOINT VERSUS SINGLE LIFE EXPECTANCY

The basic question of planning for retirement distributions is whether distributions should take place over the life expectancy of the IRA owner or over the life expectancies of the IRA owner and another beneficiary. **The goal is to minimize taxes while maximizing return.** Generally, both of these objectives can be achieved through deferral of distributions. Because longer deferral is obtained by use of two life expectancies, **joint life expectancy should be utilized** to calculate required minimum distributions. This allows the longest payout period and defers tax for a longer period of time.

> **Practitioner Note.** Caution must be exercised to ensure the application of joint life expectancy. If the appropriate elections are not made at the required beginning date, the IRA custodial document or plan document may require use of the single life expectancy method by default.

Designated Beneficiary

A named beneficiary is not necessarily a designated beneficiary for purposes of computing required minimum distributions. A designated beneficiary must be an individual or a certain kind of trust. Charitable organizations do not qualify; if a charity is named as a beneficiary, the owner will be treated as having no beneficiary, and distributions must be taken over the owner's single life expectancy.

If multiple beneficiaries are named, the one with the shortest life expectancy is treated as the designated beneficiary for computing minimum required distributions. If a new beneficiary with a shorter life expectancy replaces a living beneficiary, a new distribution period based on the shorter life expectancy must be computed for subsequent years. If the designated beneficiary predeceases the owner, changes to the distribution period depend on the recalculation elections made by the required beginning date. Both the recalculation election and the joint-versus-single election are typically made when the beneficiary form is completed before the IRA owner's required beginning date.

RECALCULATING LIFE EXPECTANCIES

Recalculating life expectancy will extend the time period over which distributions are taken. Generally, a married IRA owner has three options, though the availability of the calculation elections is governed by the custodial agreement or plan document.

1. Recalculation method: The joint life expectancy of both the IRA owner and his or her spousal beneficiary is recalculated.
2. Nonrecalculation (also referred to as a "fixed-term" or "term-certain") method: Neither the life expectancy of the IRA owner nor that of his or her spousal beneficiary is recalculated.
3. Hybrid method: The IRA owner's life expectancy is recalculated but the spousal beneficiary's is not.

> **Practitioner Note.** If the designated beneficiary is not the IRA owner's spouse, the options are limited to the nonrecalculation method and the hybrid method.

Recalculation Method

When the IRA owner uses the double recalculation method, distributions are made in the smallest amount relative to other options while both the IRA owner and spouse are alive.

However, upon the first death, the recalculated life expectancy of the decedent is zero. If the spousal beneficiary predeceases the IRA owner, required minimum distributions in subsequent years must be based on the recalculated single life expectancy of the owner. While seemingly the best choice during the joint lives, **the double recalculation method will result in the most rapid required minimum distribution after the first death.**

Example 5. Scott's wife, Lori, is the beneficiary of his IRA. She and Scott are the same age. At Scott's required beginning date, he elected the double recalculation method. Several years later, Lori predeceases Scott. Scott is now forced to take distributions based on his single recalculated life expectancy. Assuming a balance in the account of $750,000, if Lori dies at age 75, the required minimum distribution will jump from $45,455 to $60,000.

Example 6. Assume the same facts as in Example 5. Upon Scott's death, his beneficiaries must withdraw the entire IRA balance no later than December 31 of the following year.

The hazards are less if the IRA owner dies first. A surviving spouse who is the designated beneficiary may roll the IRA into his or her own name and designate new beneficiaries. This can allow additional deferral after the second spouse's death.

Example 7. Assume the same facts as Example 5 except that Scott predeceases Lori. Upon Scott's death, Lori may roll the IRA into her own name and make new required beginning date elections.

Nonrecalculation Method

A fixed term is created when the IRA owner's and spouse's life expectancies are not recalculated. Regardless of which spouse dies first, or when they die, the required minimum distributions continue over the fixed term. The obvious disadvantage of this strategy is the relatively higher required distributions during life. It could result in the IRA being used up before both the IRA owner and beneficiary die.

Example 8. Joe elected the double nonrecalculation method using joint life expectancy with his wife, Jill. He received distributions based on their joint nonrecalculated life expectancy. Several years later, Jill predeceases Joe. Joe can continue to receive distributions based on his and Jill's joint nonrecalculated life expectancy. Assuming that Joe and Jill were the same age and the balance in the account was $750,000, when Jill dies at age 75, the required minimum distribution will be $48,077 just as it would if she were still living. His new beneficiary may also use the remainder of the fixed term.

Hybrid Method

The third method of distribution recalculates the IRA owner's life expectancy but not the beneficiary's. There are two distinct advantages to this method. First, required distributions are lower than if no recalculation is made. Second, since the IRA owner's spouse **does not** recalculate life expectancy, there is a fixed-term element. This method hedges against the IRA owner's spouse predeceasing the IRA owner. If the spouse dies first, the survivor may continue to receive required minimum distributions over the same joint life expectancy. Of course, if the IRA owner dies first, the surviving spouse always has the option to roll over the IRA into his or her own name.

Example 9. Ben names his wife, Julie, as the primary beneficiary of his IRA. At his required beginning date he elected the hybrid method. Ben and Julie receive distributions based on the hybrid method (recalculating Ben's life expectancy but not Julie's). Several years later, Julie predeceases Ben. Ben can continue to receive distributions based on his recalculated life expectancy and Julie's "ghost" nonrecalculated life expectancy. Assuming that Ben and Julie were the same age and the balance in the account was $750,000, if Julie died at age 75, the required minimum distribution would be $46,765 just as it would if she were still living.

If the IRA owner's spouse dies first, the hybrid method will result in the lowest required minimum distribution after the spousal beneficiary's death and therefore the longest deferral.

If an IRA owner fails to make an election, the default depends on the plan document. If this document is silent, the default is recalculation for the owner and beneficiary (if the beneficiary is eligible to recalculate) [Prop. Reg. §1.401 (a)(9)-1, Q&A E-7].

Table 1 summarizes the options and consequences when a spouse is the designated beneficiary.

Table 1: Spousal Beneficiary

	Recalculation Method	Nonrecalculation Method	Hybrid Method
IRA owner dies with a surviving spouse.	Spousal rollover, or the IRA owner's life expectancy becomes zero and subsequent distributions are calculated based on the spouse's recalculated single life expectancy.	Spousal rollover, or distributions continue to be made over the joint fixed life expectancy of the IRA owner and spouse.	Spousal rollover, or the IRA owner's life expectancy becomes zero and subsequent distributions are calculated based on the spouse's recalculated single life expectancy.
Spouse dies with IRA owner surviving.	The spouse's life expectancy becomes zero and subsequent distributions are calculated based on the IRA owner's recalculated single life expectancy.	Distributions continue to be made over the joint fixed life expectancy of the IRA owner and spouse.	Distributions continue to be made over the joint life expectancy of the IRA owner (recalculating) and spouse (non-recalculating). The spouse has a "ghost" life expectancy.
IRA owner dies subsequent to spouse's death.	Entire account must be paid out by December 31 following the year of death. Remaining life expectancy becomes zero.	Distributions continue to be made over the joint fixed life expectancy of the IRA owner and spouse.	Distributions continue to the beneficiary over the remaining fixed "ghost" single life expectancy of the spouse, if any.
Spouse dies subsequent to IRA owner's death without spousal rollover.	Entire account must be paid out by December 31 following the year of death. Remaining life expectancy becomes zero.	Distributions continue to be made over the joint fixed life expectancy of the IRA owner and spouse.	Distributions continue to the beneficiary over the remaining fixed "ghost" single life expectancy of the spouse, if any.

MINIMUM DISTRIBUTION INCIDENTAL BENEFIT (MDIB) RULES [Prop. Reg. §1.401(a)(9)-2]

Naming a very young beneficiary (e.g., a grandchild) could yield a much lower required minimum distribution during the IRA owner's lifetime. To put a limit on this reduction, Congress created the MDIB rules in 1986. **The MDIB rules apply only to nonspousal beneficiaries and only during the IRA owner's lifetime.**

If an IRA owner names a nonspousal beneficiary who is more than 10 years younger than the owner, the beneficiary will be treated as being 10 years younger for purposes of calculating the IRA owner's required minimum distributions.

After the death of the IRA owner, the MDIB rules disappear. Distributions after death are based on the joint life expectancies of the IRA owner and the nonspousal beneficiary, or on the single life expectancy of the non-spousal beneficiary, depending on the recalculation method elected at the IRA owner's required beginning date.

Example 10. Dennis named his grandson Bob as primary beneficiary of his IRA and elected the hybrid method. Dennis will receive distributions based upon the MDIB rules. After Dennis' death, Bob can receive distributions based on his single, non-recalculated life expectancy, unencumbered by MDIB rules.

Table 2 summarizes the options and consequences of naming a non-spousal beneficiary.

Table 2: Nonspousal Beneficiary

	Nonrecalculation Method	Hybrid Method
IRA owner dies with a surviving beneficiary.	Distributions continue to be made over the joint fixed life expectancy of the IRA owner (non-recalculating) and the non-spousal beneficiary (non-recalculating), not subject to the MDIB rules.	The IRA owner's life expectancy becomes zero and subsequent distributions are calculated based on the beneficiary's non-recalculated single life expectancy, not subject to MDIB rules.
Beneficiary dies with IRA owner surviving.	Distributions continue to be made over the joint fixed life expectancy of the IRA owner (non-recalculating) and the non-spousal beneficiary (non-recalculating), subject to the MDIB rules.	Distributions continue to be made over the joint life expectancy of the IRA owner (recalculating) and the non-spousal beneficiary (non-recalculating), subject to the MDIB rules.
IRA owner dies subsequent to beneficiary's death.	Distributions continue to the alternate beneficiary over the remaining fixed joint life expectancy (not subject to the MDIB rules) of the IRA owner and the non-spousal beneficiary, if any.	Distributions continue to the second beneficiary of the IRA over the remaining fixed single life expectancy (not subject to the MDIB rules) of the non-spousal beneficiary, if any.
Beneficiary dies subsequent to IRA owner's death.	Distributions continue to the heirs of the beneficiary of the IRA over the remaining fixed joint life expectancy (not subject to the MDIB rules) of the IRA owner and the non-spousal beneficiary, if any.	Distributions continue to the heirs of the beneficiary of the IRA over the remaining fixed single life expectancy (not subject to the MDIB rules) of the non-spousal beneficiary, if any.

DISTRIBUTION RULES AFTER DEATH

Elections of a designated beneficiary, joint or single life expectancy, and recalculation must be in place as of an IRA owner's required beginning date. Failure to make at least tentative choices earlier, however, can result in loss of deferral and potentially disastrous tax consequences from a premature death.

DEATH PRIOR TO REQUIRED BEGINNING DATE [I.R.C. §401(a)(9)(B)]

If an IRA does not have a designated beneficiary and the owner dies before his or her required beginning date, the IRA must be fully distributed by December 31 of the year containing the fifth anniversary of the owner's death. The distribution can be made in any fashion the default beneficiary or executor chooses. It may be spread over this period of time or in a total distribution on December 31 of the year containing the fifth anniversary of the IRA owner's death. This relatively rapid withdrawal may cause the default beneficiaries or heirs of the IRA to lose many years of deferral.

A designated beneficiary can choose to receive minimum distributions over his or her single life expectancy if the distributions begin by December 31 of the year following the IRA owner's death. This is far more advantageous than the five-year rule. **Therefore, having a designated beneficiary is critical to preserving the deferral that can be achieved with proper planning**. Of course, a beneficiary may always withdraw more than the minimum required distribution.

DEATH AFTER REQUIRED BEGINNING DATE

If the IRA owner dies after the required beginning date, the remaining portion of the IRA must be distributed at least as rapidly as it was required to be distributed before death. Therefore, distributions continue based on the elections in effect at the IRA owner's required beginning date. For this reason, retirement distribution planning is critical, as the effect may last for decades.

If the owner of an IRA dies after his or her required beginning date and did not have a designated beneficiary, the consequences can be disastrous if the owner had chosen the recalculation method. The IRA must be distributed by December 31 of the year after the year of death, eliminating many years of deferral. For many families, this could have a significant impact on the wealth transfer to future generations.

Example 11. IRA owner Will Smith dies in January of 2000 leaving his IRA to his daughter Beth, age 30. His required minimum distributions were $25,000 per year. Beth must continue to receive the payments at that rate unless she chooses to receive more each year. She cannot decrease the payments. If Beth died before Will did, and he had not added a new beneficiary, the entire balance of the account must be distributed by December 31, 2001 and all taxes fall due.

SPOUSAL ROLLOVER PLANNING

When a taxpayer dies after naming his or her spouse as beneficiary of an IRA, the surviving spouse has two options:

1. Rollover the IRA into his or her own name
2. Treat the IRA as an inherited IRA

Usually, rolling the IRA into the surviving spouse's name is more advantageous because of the additional deferral that can occur.

Rollover to a New IRA in the Surviving Spouse's Name

Under typical circumstances, a surviving spouse will roll over an IRA into his or her own name. If the IRA is rolled over to a new IRA, the surviving spouse can name new beneficiaries and make new required beginning date elections. In some cases this can resolve a faulty required beginning date election, since a surviving spouse can roll over an IRA even after the required beginning date (Ltr. Ruls. 9311037 and 9433031).

The law does not provide a procedure for making a rollover election or dictate the timing of when a rollover must take place. From a procedural standpoint, it may be advisable to notify the IRA custodian if a spousal rollover is desired.

An election is considered to have been made by the surviving spouse if either of the following occurs:

1. Any required amount has not been distributed within the appropriate time period applicable to the decedent
2. Any additional amounts are contributed to the account

The spouse can elect rollover treatment or inherited IRA treatment for each specific IRA. For this reason it is critical that inherited IRAs and rollover IRAs are not commingled. If an inherited IRA and a spousal rollover IRA are commingled, all IRAs are deemed to have been rolled over. This becomes very important when dealing with the early distribution penalties on IRAs for spouses who are younger than age 59½.

Spouse May Treat as an Inherited IRA

The surviving spouse may elect to treat the decedent's IRA as an inherited IRA. If this is done, the surviving spouse cannot name a new beneficiary for purposes of I.R.C. §401(a)(9). **The most common use of this election occurs when a surviving spouse is younger than 59½.** If the surviving spouse rolls the IRA into his or her own name, he or she would be subject to the early distribution penalty on any withdrawals. However, an inherited IRA will not be subject to this penalty.

> **Observation.** If a spouse who is younger than 59½ uses the inherited IRA penalty exemption, the spouse waives the right to a rollover of that account. If there is more than one account, the waiver applies only to the accounts from which distributions have been taken (Ltr. Rul. 9418034).

Another situation where a spouse should consider inherited IRA treatment occurs when the **surviving spouse is past his or her required beginning date and the IRA owner dies before reaching his or her required beginning date.** Because the surviving spouse can defer distributions until the decedent would have reached the required beginning date, it may be advisable to treat the IRA as an inherited IRA. The additional deferral that may be achieved by a spousal rollover also must be analyzed before an informed decision can be made.

Special care may be required to prevent IRAs from being automatically given rollover status by uninformed custodians. Many financial institutions are not familiar with the concept of an inherited IRA. As a result, a surviving spouse may be advised that this status is not available, when in fact it is.

The IRA agreement or plan document must be carefully reviewed to ensure that distributions occur as desired. The major provisions that must be investigated are:

1. The default provisions for an IRA owner who does not make timely required beginning date elections
2. Whether an IRA owner and/or spouse may recalculate life expectancy (particularly in the hybrid method)
3. The beneficiary's options after the death of the IRA owner (the beneficiary wants the ability to stretch out distributions over life expectancy)

FAILURE TO TAKE A REQUIRED MINIMUM DISTRIBUTION [I.R.C. §4974 (a)]

An IRA owner must begin distribution when he or she reaches his or her required beginning date. If the owner fails to take the required minimum distribution, a 50% penalty is imposed on the difference between the minimum distribution and any distributions actually taken during the year. This rule also applies to beneficiaries who are entitled to receive distributions after the death of an IRA owner.

Example 12. Since John turned 70½ in May 1999, his required beginning date was April 1, 2000. John failed to take his required minimum distribution of $12,136 by April 1, 2000. The penalty is $6,068 ($12,136 × 50%), which is reported in Part VII of Form 5329.

An exception to the penalty applies under certain circumstances. If a taxpayer establishes to the satisfaction of the IRS that the shortfall was due to "reasonable error" and that reasonable steps are being taken to remedy the shortfall, the IRS may waive the penalty.

THE ROTH IRA

In the midst of the rules and regulations for required minimum distributions and tax consequences of retirement plan withdrawals, there is one bright spot: the Roth IRA. It offers tax-free withdrawals (not merely tax deferred), no required minimum distribution, and no age limitations. Is it the best option for everyone? What information is needed to make a decision?

CONTRIBUTION LIMIT

The first consideration is the same as for a traditional IRA. The contribution is limited to the lesser of $2,000 or the taxpayer's earned income. Alimony included in income counts for this purpose but disability payments, social security, interest, dividends, and pensions do not. Additionally, there is an income restriction. The $2,000 contribution limit to a Roth IRA is phased out over a range of income that differs depending on the filing status of the taxpayer.

1. For married filing jointly the phase-out range is from $150,000 to $160,000 of adjusted gross income.
2. For single taxpayers the phase-out range is from $95,000 to $110,000 of adjusted gross income.
3. For married filing separately the phase-out range is from $0 to $10,000 of adjusted gross income.

Example 13. Barbara is separated from Jim, earns $8,000 working as a hostess in a small restaurant, has no other income or adjustments to income, and files married filing separately.

A. What is her maximum contribution to a Roth IRA? Subtract her AGI from the maximum phase-out amount of $10,000. Multiply the result ($2,000) times 20%. She is allowed a contribution of $400.

B. That doesn't seem fair. Does she have any alternative? Yes, she can contribute the remaining $1,600, disallowed for Roth purposes, to a traditional IRA. Note that, because of her filing status, her traditional IRA **deduction** would also be limited if she participated in an employer-sponsored retirement plan. (See phase-out table later in this chapter.)

EFFECT OF CONTRIBUTIONS TO OTHER RETIREMENT PLANS

There is a restriction of $2,000 total contribution to Roth and traditional IRAs. That means the taxpayer's contributions to the two added together must equal no more than the lesser of:

1. $2,000 ($4,000 if married filing jointly)
2. The taxpayer's earned income

Contributions to a Roth, however, are not limited by contributions to SEPs, SIMPLEs, Education IRAs, and company retirement plans. For example, a taxpayer who participates in a 401K at work, has a side business with an SEP, and wants to put $2,000 in a Roth IRA can do so as long as he or she meets the income requirements.

DEADLINE FOR MAKING A CONTRIBUTION TO A ROTH IRA

Like the traditional IRA, the deadline for making contributions is the due date of the return without extensions.

HOW DOES A ROTH IRA DIFFER FROM A NONDEDUCTIBLE IRA?

There is a big difference. When money is withdrawn from a nondeductible IRA, the earnings are taxed. A formula–basis divided by total value–is used so that part of each withdrawal will be a tax-free return of basis. The Roth, on the other hand, is **totally tax-free**, including even the earnings (if all of the qualifications are met).

WHAT IS THE CATCH?

With the traditional IRA, the taxpayer generally must be 59½ to withdraw the funds without paying a penalty, and all of the deductible contributions and earnings he or she withdraws will be taxable. In order to avoid paying tax and penalties on a Roth IRA, the taxpayer not only has to be 59 ½ years old, but must also wait five years after making the initial contribution to any Roth IRA before making the first withdrawal. On the bright side, five years is not as long as it appears, thanks to a liberal method of counting.

Example 14. On April 17, 2000, Bob makes his initial contribution to a Roth IRA. The contribution was for 1999. Therefore, the starting date for the five-year period is considered to be January 1, 1999, and he will have fulfilled his five-year requirement at the end of December 2003. Can he pull his money out tax-free and penalty-free in January 2004? Yes, **if** he is also 59½ years of age.

Example 15. Same situation as Example 14 except that Bob continues to make contributions to the same Roth IRA. He now has contributed for 2000, 2001, and 2002. How does that affect the five-year rule? It doesn't. There is only a one-time start date, so whether you continue to make contributions or not, the five years begin to run at the beginning of the year for which you make the first contribution.

Practitioner Note. Each conversion from a regular IRA has its own 5-year period beginning on January 1 of the year of conversion for purposes of applying the early distribution penalty.

EXCEPTIONS TO THE PENALTY FOR UNDER AGE 59½ DISTRIBUTIONS

Unless one of the exceptions listed below applies, the 10% additional tax on premature distributions applies to the taxable part of any distributions that are not qualified distributions.

The 10% additional tax on premature distributions does not apply in the following situations.

- The taxpayer has reached age 59½
- The taxpayer is disabled
- The taxpayer is the beneficiary of a deceased IRA owner
- The taxpayer uses the distribution to pay certain qualified first-time home buyer amounts
- The distributions are part of a series of substantially equal payments
- The taxpayer has significant nonreimbursed medical expenses
- The taxpayer is paying medical insurance premiums after losing his or her job
- The distributions are not more than qualified higher education expenses
- The distribution is due to an IRS levy of the qualified plan

Example 16. Janice, age 47, opened a Roth IRA in 1999. She contributed $2,000 in both 2000 and 2001. In February of 2002, she became disabled. With a traditional IRA, she would have met one of the exceptions and no penalty would be due when the IRA was distributed to her. Under the Roth rules, this would not be a qualified distribution for tax-free purposes, but she would not be liable for the 10% penalty.

Example 17. Even if Janice had been 57 when she opened the Roth IRA and thus over 59½ when she became disabled, she still would not have qualified for a totally tax-free withdrawal because of the five-year rule.

SO IT'S POSSIBLE TO TAKE MONEY OUT OF A ROTH AND OWE TAX ON IT?

Yes. If the five-year rule is not satisfied and/or the taxpayer is not 59½, it is not a qualified distribution, and tax may be due. There are, however, ordering rules that minimize the tax liability.

Distributions are taken out in the following order:

1. Contributions
2. Conversions (on a first-in-first-out basis)
3. Earnings

Example 18. Janice had contributed $6,000 to her Roth IRA prior to her becoming disabled. With the earnings, the account was valued at $6,500 when she withdrew it. If she withdraws the entire amount because she is disabled, $6,000 will be a tax-free return of contributions, and the $500 in earnings will be taxable. She will not owe the 10% tax on premature distributions because she meets the disability exception.

Example 19. If, in Example 18, Janice had not been disabled or otherwise qualified for an exception, she would have also owed the 10% penalty tax on the $500 in taxable earnings.

Observation. The key to taking money out of a Roth IRA before the age of 59½ and/or before the end of the five-year period is to withdraw only **contributions.** They will not be taxable or subject to penalty.

IRA CONVERSIONS

In addition to contributions (the allowable $2,000 per person put into the Roth IRA each year), there is another way to put money into a Roth IRA: a traditional IRA can be converted into a Roth IRA.

RULES FOR MAKING A CONVERSION TO A ROTH IRA

There are two rules that must be met.

A. The conversion must be a qualified rollover. There are three options for meeting this requirement.

1. **Rollover**. A distribution from a traditional IRA must be rolled over (contributed) to a Roth IRA within 60 days after the distribution.
2. **Trustee-to-trustee transfer**. The trustee of the traditional IRA can be directed to transfer an amount from the traditional IRA to the trustee of the Roth IRA.
3. **Same trustee transfer**. If the trustee of the traditional IRA also maintains the Roth IRA, the trustee can be directed to transfer an amount from the traditional IRA to the Roth IRA. Conversions made with the same trustee can be made by redesignating the traditional IRA as a Roth IRA, rather than opening a new account or issuing a new contract.

B. The taxpayer's **adjusted gross income cannot be over $100,000**.

1. This applies to taxpayers who are married filing jointly, single, or head of household.
2. Taxpayers who are married filing separately do not qualify for a conversion.
3. Adjusted gross income for this purpose does **not** include the amount converted.

Example 20. John, age 50, files jointly with his wife. Last year he earned $70,000 and his wife $20,000. They have no other income. This year he wants to convert his traditional IRA valued at $50,000 to a Roth IRA. Does he qualify? Yes, his AGI is not in excess of $100,000 because the conversion amount is not included.

Example 21. Mary, age 42, is married and files separately. Last year she received a salary of $20,000 and $15,000 in interest and dividends. Her traditional IRA is valued at $30,000. Does she qualify to convert? No, the married filing separately filing status does not qualify, regardless of the AGI.

TAX ON THE CONVERSION

The conversion amount is excluded from adjusted gross income for purposes of the $100,000 limit. After that exclusion, it goes right back into income. For tax purposes, John (Example 20) has an actual adjusted gross income of $140,000.

> **Practitioner Note.** For the 1998 tax year, the conversion amount could be spread over four years, but that rule no longer applies. Beginning in 1999, the tax is due in the year of conversion.

ADVANTAGES OF CONVERTING TO A ROTH IRA

There are different reasons for converting to a Roth IRA. The taxpayer's decision about what is best for his or her needs will depend upon his or her personal situation. Things to consider are:

- Once the five-year rule and the 59½ years of age rules are met, money can be taken out at any time and in any amount with no tax or penalty.
- There are no minimum distribution rules; the money can be left in the account as long as desired without a distribution penalty.
- If the taxpayer will be in a higher tax bracket when the money is withdrawn, a conversion can result in more after-tax dollars.
- If the regular IRA consists of nondeductible contributions, only the earnings will be taxed on the conversion.
- Upon death of the IRA owner, his or her beneficiaries can withdraw the money in the Roth IRA tax-free if the five-year rule has been met.

CALCULATING THE COST OF CONVERSION

The cost of converting a traditional IRA to a Roth IRA depends on the tax bracket of the owner and whether some of the proceeds from the conversion are used to pay the income tax resulting from the conversion. If part of the amount rolled out of the traditional IRA is used to pay the income tax from the conversion, that part is not considered to be rolled over and is subject to the 10% penalty tax for early withdrawal. Calculations can be done with a financial calculator or using on-line calculators found through web sites.

Example 22. Carol is in the 31% tax bracket and converts $50,000 from her traditional IRA to a Roth IRA. She pays the tax out of the $50,000. Tax on the conversion is $15,500 and the 10% penalty will add another $1,550 of cost. By the time she rolls over her IRA, she will only have $32,950 remaining.

Assuming she can earn 7% per year on her account, she will have a total of $127,506 in 20 years. Had she left her traditional IRA alone, she would have had $193,484 in 20 years, a difference of $65,978, before taxes. If the $193,484 is taxed at 31%, Carol will owe $59,980 on the traditional IRA withdrawals. That leaves an after-tax advantage of $5,998 for the traditional IRA.

Observation. If Carol had been able to pay the tax out of other sources, she would still have the same amount of earnings as the traditional IRA, but could withdraw whenever she wanted to without owing tax or penalty. Be aware, however, that she will sacrifice the earnings she could have had on the money she used to pay the tax. Unless that money was kept in a box in the backyard or under the mattress (i.e., a non-interest-bearing location), she needs to factor in the lost revenue before making a decision.

RECHARACTERIZATION

If a regular IRA is converted to a Roth IRA and the taxpayer's adjusted gross income exceeds the conversion limit, the tax laws allow the taxpayer to **recharacterize** the IRA. In other words, the taxpayer can wipe out the entire transaction and reestablish the original traditional IRA. This must be done by the due date of the return for the year of conversion, including extensions. If the taxpayer was ineligible to make a conversion and the IRA is not recharacterized, the Roth IRA must be closed and taxes and penalties on the premature distribution must be paid.

RECONVERSION

A regular IRA that was converted to a Roth IRA and recharacterized as a regular IRA can be reconverted to a Roth IRA. Beginning in 2000, the reconversion to a Roth cannot occur before either of the following dates:

- The beginning of the year following the year in which the amount was originally converted to the Roth IRA if the recharacterization was made the same year
- The end of the 30-day period following the day on which the Roth IRA was recharacterized as a traditional IRA if the recharacterization was made in the following year

Taxpayers are limited to two changes a year. They can either convert and recharacterize **or** recharacterize and reconvert.

Example 23. Dave converts his traditional IRA to a Roth IRA in March of 2000. He decides that the conversion was a mistake on July 1, 2000 and chooses to recharacterize the IRA as a traditional IRA. If he changes his mind again and decides he wants a Roth, he must wait until January 1, 2001.

WITHDRAWAL AFTER CONVERSION

The 10% early withdrawal penalty tax applies to any part of the conversion amount that is withdrawn before the five-year period ends. If the conversion was made in 1998 and the taxpayer took advantage of the four-year spread available that year, any amounts that were withdrawn but not yet taxed are also included in income.

Example 24. Ann, age 50, converted her $60,000 traditional IRA to a Roth in 1998. With the four-year spread, she would report $15,000 in income each year since she had deducted all of her contributions in prior years. In 2000, she decides to withdraw $10,000 from the account. Because the withdrawal is not considered as coming from already taxed money, she will have to add it to her required reporting amount. In 2000 she will pay tax on $15,000 plus $10,000, or $25,000 total. To summarize the amount that will be taxed:

1998	$15,000
1999	15,000
2000	25,000
	$55,000

That will leave only $5,000 to be reported in 2001. For 2000, she will also owe a 10% penalty of $1,000 because of her withdrawal of $10,000.

Example 25. Same as Example 24 except that Ann made $2,000 contributions in 1998 and 1999. Now her withdrawal comes out of contributions first, so the $10,000 taxable withdrawal is reduced to $6,000 ($10,000 – $2,000 contributed in 1998 – $2,000 contributed in 1999 = $6,000). To summarize the amount that will be taxed:

1998	$15,000
1999	15,000
2000	21,000
	$51,000

In 2001, she will report the remaining $9,000. For 2000, she will owe a 10% penalty of $600 on the $6,000.

Example 26. Same as Example 24 except that Ann converted her traditional IRA to a Roth in 1999. Since the four-year spread was not available, she paid all of the tax on the conversion. If she makes a $10,000 withdrawal in 2000, she will owe no tax, but she will be subject to the 10% early withdrawal penalty of $1,000.

Observation. Contributions can always be withdrawn without owing tax or penalties, but conversion amounts **may** be subject to tax and **will** be subject to penalty if the taxpayer is not 59½ years of age or covered by one of the exceptions.

WORKSHEET FOR CALCULATING THE TAXABLE PART OF A DISTRIBUTION FROM A ROTH IRA

The worksheet below is from IRS Publication 590, *Individual Retirement Arrangements*.

Caution. If you converted amounts from a traditional IRA in 1998 and are including the taxable part ratably over a four-year period, do not use this worksheet.

1. Enter the total of all distributions made from your Roth IRA(s) during the year	$ ______
2. Enter the amount of qualified distributions made during the year	______
3. Subtract line 2 from line 1	______
4. Enter the amount of distributions made during the year to correct excess contributions made during the year	______
5. Subtract line 4 from line 3	______
6. Enter the amount of distributions made during the year that were contributed to another Roth IRA in a qualified rollover contribution	______
7. Subtract line 6 from line 5	______
8. Enter the amount of all prior distributions from your Roth IRA(s) (whether or not they were qualified distributions)	______
9. Add lines 1 and 8	______
10. Enter the amount of the distributions included on line 8 that were previously includible in your income	______
11. Subtract line 10 from line 9	______
12. Enter the total of all your contributions to all of your Roth IRAs	______
13. Enter the total of all distributions made (this year and in prior years) to correct excess contributions	______
14. Subtract line 13 from line 12. (Do not enter less than 0.)	______
15. Subtract line 14 from line 11. (Do not enter less than 0.)	______
16. Enter the smaller of the amount on line 7 or the amount on line 15. This is the taxable part of your distribution	$ ______

TREATMENT OF ROTH IRA AFTER THE DEATH OF THE OWNER

The Roth IRA is treated in the same manner as a traditional IRA when the owner dies before his or her required beginning date for distributions. In general, the entire balance must be distributed by the end of the fifth calendar year after the year of the owner's death. The exception occurs if the balance is paid out over the life or life expectancy of the beneficiary. In that case, the payments must begin before the end of the calendar year following the year of death. No matter which way it is handled, the distributions are tax- and penalty-free for the beneficiary if the five-year holding requirement is met.

If the owner's spouse is the sole beneficiary, he or she can delay receiving the distribution until the owner would have turned 70½, if the owner had lived. A surviving spouse also has the option of treating the Roth IRA as if it were his or her own.

Example 27. On October 17, 2000, Allen dies at age 57. The beneficiary of his Roth IRA is his daughter Sandra, age 37. If she takes payments spread out over her life expectancy, she must start receiving them by December 31, 2001. If she does not make that choice, she must withdraw the entire account by December 31, 2005. Either way the money comes to her tax- and penalty-free if either the decedent or the decedent and the beneficiary meet the five-year requirement. If Sandra has her own Roth IRA, she cannot add the inherited Roth to her account. She could, however, combine accounts that were inherited from Allen in the event that he left her more than one Roth IRA.

Example 28. Same as Example 26 except that Allen's wife Barbara is the beneficiary. Barbara can wait until 2014, the year Allen would have turned 70½, to start taking required distributions from the account. She also has the option to treat the Roth as her own; in that case she can combine it with her own Roth account and defer taking any distributions during her lifetime.

SEPs AND SIMPLEs

There are two other types of IRAs to consider: Simplified Employee Pensions (SEPs) and Savings Incentive Match Plans for Employees (SIMPLEs).

THE SEP

The Simplified Employee Pension is a plan under which the employer makes contributions directly to an IRA that satisfies the statutory requirements of I.R.C. §408(k). The investment provisions of the individual's SEP will determine how the funds are invested.

Who Must Be Included?

Employees must be allowed to participate in a SEP if the following conditions are met:

- Employee must be 21 years of age.
- Employee must have worked for employer during at least three of the last five years.
- Employee must have received at least \$450 (for 2000) in compensation from the employer in the current year.

Contributions for Employees

Contributions to a SEP are limited to a percentage of the participant's qualified compensation. Annual contributions by an employer are excluded from the participant's gross income if they do not exceed the lesser of 15% of \$170,000 (for 2000) up to a maximum of \$30,000.

Example 29. Michael works for a company that has a SEP. In 2000 he earned \$180,000. The company can contribute \$25,500 (\$170,000 maximum times 15% = \$25,500) to his SEP for the year. Because Michael's employer contributes to his SEP and because of the amount of his income, Michael cannot make a deductible contribution to his SEP-IRA.

Example 30. Ellen works for a company that has a SEP. In 2000 she earned \$40,000. The company can contribute \$6,000 (\$40,000 times 15% = \$6,000). Because Ellen files jointly with her husband and her total family income is less than \$52,000 (the beginning of the phase-out range for full deductibility of IRA contributions), she can also contribute a deductible \$2,000 to her SEP-IRA or a separate traditional IRA.

2000 Phase-out Ranges for Deductible Contributions to IRAs When Covered by an Employer Plan

Single	\$32,000–\$42,000
Married filing jointly	\$52,000–\$62,000
Head of household	\$32,000–\$42,000
Married filing separately	\$ 0–\$10,000

Contributions for the Self-Employed

For SEP purposes, net earnings are gross income from a business minus allowable deductions for that business. Allowable deductions include contributions to employees' SEP-IRAs. A self-employed person also takes into account the deduction allowed for one-half of self-employment tax, and the deduction for contributions to his or her own SEP-IRA.

A self-employed person deducts employer contributions for his or her own SEP-IRA as adjustments to gross income on line 29 of the Form 1040, and personal contributions to his SEP-IRA or any other IRA on line 23 of Form 1040.

Example 31. Marla is a sole proprietor and has employees. She contributes 10% of their compensation to SEP-IRAs. The employees earned $60,000 this year and Marla's net earnings from her Schedule C were $70,000. Marla's net earnings include a deduction of $60,000 for her employees' wages, and a deduction of $6,000 for her contribution to their SEP-IRAs, which is reported on line 19 of Schedule C (Form 1040). She figures the contribution to her own account as follows:

Schedule SE net income	$70,000
Less 1/2 SE tax due	4,945
Allowable income	$65,055
Times rate	.095023 (.10 ÷ 1.10)
Deduction	$ 6,182

Her maximum contribution would be figured by multiplying $170,000 by her rate of 10%, resulting in $17,000. Since she is well below that amount, she takes the deduction shown above.

The $6,182 is reported on line 29, Form 1040. She will not qualify for an IRA deductible contribution to her account because her income is too high and she is covered under an employer plan.

Observation. Prior to 1996, an employer could also have a salary reduction SEP (SARSEP), but new ones are no longer allowed. Those already in place can continue and new employees can be added to the plan.

Establishing a SEP

An employer may use Form 5305-SEP to satisfy the written arrangement requirement for creating a calendar year SEP. In addition, SEPs must be opened for each eligible employee. The SEP 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. The deadline for establishing and contributing to a SEP plan is the due date of the business's income tax return, including extensions.

Withdrawals from the SEP

The employer cannot control withdrawals from the SEP-IRA, nor can he or she require that part of the contributions remain in the account. Distributions from the account, however, are subject to the traditional IRA rules and will be taxed as ordinary income.

Once an amount in a SEP has been converted to a Roth IRA, future contributions under the SEP cannot be made to the Roth (Treas. Reg. §1.408A-4, Q&A 4). That is because the contribution limit for the SEP is much larger than the $2,000 contribution limit for the Roth.

SIMPLE-IRA

The Savings Incentive Match Plan for Employees may be established by employers with no more than 100 employees who earned $5,000 or more in the prior year. A SIMPLE-IRA plan allows employees to elect to defer compensation up to specific limitations. All contributions are deposited into SIMPLE-IRAs maintained with an institution licensed to maintain IRAs. A separate SIMPLE-IRA is maintained for each participant. Employer contributions may be matching (going only to employees who elect a salary deferral) or nonelective (on behalf of all eligible employees).

Who Must Be Included?

An employee must be allowed to participate in a SIMPLE-IRA if the following conditions are met:

- The employee received at least $5,000 in compensation during any **two** preceding years (whether or not they were consecutive)
- The employee is reasonably expected to receive at least $5,000 in compensation during the **current** year

Contribution Limits

The year 2000 maximum annual salary deferral for a SIMPLE-IRA is $6,000. The minimum annual employer contribution required is either (1) a 3% match or (2) a 2% nonelective contribution. The 3% match can be reduced to 1% in two out of five years, with prior notification to the employees. The percentage is applied to the employee's compensation **before** adjustment for the salary deferral.

Contributions for the Self-Employed

A person who is self-employed uses net earnings from self-employment (line 4, Section A of Schedule SE) before subtracting any contributions made to a SIMPLE-IRA on his behalf to calculate the maximum contribution to a SEP.

Example 32. Bob established a SIMPLE for his unincorporated consulting business with a 3% employer match. He elects to defer $6,000 of his 2000 $20,000 net earnings into a SIMPLE. The employer contribution is $600 (3% of $20,000). Bob will show his $6,000 deferral and the employer contribution of $600 for a total of $6,600 on line 29, Form 1040.

Example 33. Tom is an employee of Bob's consulting firm and has elected to defer $400 of his 2000 compensation of $20,000. Even though Bob has established a 3% employer matching contribution, he is only required to contribute $400 to Tom's SIMPLE-IRA. An employer is required to match the employee deferred amount up to the 3% maximum or the 1% reduced matching contribution.

Example 34. Millie is an employee of Bob's consulting firm and made $250,000 this year. She elected to defer the maximum $6,000 into a SIMPLE. There is no salary limit for the 3% employer contribution; the only limitation is the match to the amount the employee contributed. Since $250,000 times 3% is $7,500, the employer must match the employee contribution of $6,000. In other words, the maximum yearly contribution to anyone's account is limited to $12,000 under the matching formula.

Example 35. If Bob's consulting firm in Example 34 had elected to make only a 2% nonelective contribution, Millie's income would have been limited to the $170,000 maximum. She still could have deferred $6,000, but her employer would only have contributed 2% of $170,000, or $3,400.

Establishing a SIMPLE-IRA

There are two steps in establishing a SIMPLE-IRA: (1) the plan document is executed to establish the program and authorize the employer to make contributions, (2) a SIMPLE-IRA document is signed by the employee to establish the IRA vehicle that accepts SIMPLE contributions.

A SIMPLE-IRA plan year must be a calendar year. A plan must be established before October 1 for contributions in the current calendar year (Notice 98-4, Q&A K-1). Employer contributions may be made by the due date of the employer's income tax return, including extensions. However, an employee's elective deferral contributions must be deposited within 30 days after the end of the month in which they were withheld. The employee's salary reduction contributions must be taken out of the current compensation during the tax year.

Withdrawals from the SIMPLE-IRA

In general, the same distribution rules that apply to traditional IRAs apply to SIMPLE-IRAs. An employer cannot restrict employees from making withdrawals.

There is, however, a two-year rule that places limitations on tax-free transfers or rollovers. The two-year period begins on the first day on which contributions **made by an employer** are deposited into an employee's SIMPLE-IRA. Until the two-year period expires, only transfers or rollovers to another SIMPLE-IRA are allowed tax-free.

Distributions from a SIMPLE are fully taxable as ordinary income and may be subject to the additional tax on premature distributions if withdrawn before the age of 59½. In addition, a premature distribution during the two-year period is subject to a 25% tax instead of the 10% early withdrawal penalty tax.

Like the SEP, once an amount in a SIMPLE-IRA has been converted to the Roth IRA, future contributions under the SIMPLE cannot be made to the Roth. The Roth contribution limit remains at $2,000 per year.

QUALIFIED EMPLOYEE PLAN DISTRIBUTIONS

In addition to, or instead of IRAs, many people are covered by a pension plan where they work. That plan might be in the form of a 401(k), a defined contribution plan, or a defined benefit plan. When it comes time to take distributions from the plan, the taxability is dependent upon the type of payments received: periodic or nonperiodic.

PERIODIC PAYMENTS (ANNUITY)

Periodic payments are defined as those paid at a regular interval (monthly, weekly, or yearly) for a period of time that is longer than one year. If the employee has a cost in the pension or annuity that can be recovered tax-free over the life of the payments, the remainder of the payment is taxable. If the employee has no cost, each payment is fully taxable.

How Much Is Taxable?

The tax-free portion of periodic payments is determined by the following formula:

$$\frac{\text{Cost}}{\text{Total Number of Anticipated Payments}} = \text{Tax-free Portion of Payment}$$

Cost is computed as follows: first, determine the total amount the employee paid toward his or her retirement

1. Include after-tax premiums and contributions paid by the employee
2. Include amounts contributed by the employer that were taxable to the employee
3. Do **not** include health or accident benefits or deductible contributions

Then, subtract

1. Refunded premiums, rebates, or dividends
2. Unrepaid loans not included in the employee's income

Anticipated payments depend upon whether the number of monthly payments is known (stated in the contract) or whether is it payable over the life or lives of the recipients.

Example 36. Andy retires in 2000. Over the course of his employment with ABC Company, he has paid $12,000 toward his retirement. Per his contract, he will receive $700 per month for 20 years. The tax-free portion of each payment is:

$$\frac{\$12{,}000}{240} = \$50$$

Example 37. Same as Example 36 except that Andy will receive the payments over his life. Now he must use the following table to determine the number of payments he can expect to receive. Assuming that Andy is 65 when he retires, his anticipated number of payments is 260, and the tax-free portion is:

$$\frac{\$12{,}000}{260} = \$46$$

Table 1: Payments for a Single Life

	AND Your Annuity Starting Date Was . . .	
	Before November 19, 1996	After November 18, 1996
If the age at annuity starting date was …	Deemed Number of Payments	Deemed Number of Payments
55 and under	300	360
55–60	260	310
61–65	240	260
66–70	170	210
More than 70	120	160

Table 2: Payments for Joint Lives For Annuity: Starting Date after 1997

Combined Ages at Annuity Starting Date	Deemed Number of Payments
110 or less	410
111–120	360
121–130	310
131–140	260
141 and over	210

Example 38. Andy (Example 36) decided to take his payments as a joint and survivor annuity. If he is 65 and his wife is 64, their combined age is 129. Therefore, the $12,000 cost is divided by 310 payments (see chart above), and the tax-free amount is $39 (rounded) per payment.

> **Practitioner Note.** A person who dies leaving no surviving annuitant and before recovering all of the cost basis is allowed a miscellaneous itemized deduction on his or her final return for the remaining cost of the pension or annuity. If the payments were being received under the joint and survivor option, the exclusion continues to apply for the survivor. Any remaining cost is allowed as an itemized deduction on the final return of the last to die. The 2% of AGI limitation does not apply in either case.

The Simplified Method described above must be used when a person meets both of the following requirements:

- Paid under a qualified plan

  1. Qualified employee pension (I.R.C. §401(a))
  2. Qualified employee annuity (I.R.C. §403(a))
  3. Tax-sheltered annuity plan or contract (TSA) (I.R.C. §403(b))

- Under age 75 or entitled to fewer than five years of guaranteed payments if age 75 or older

NONPERIODIC PAYMENTS

Nonperiodic payments consist of anything that does not qualify as an annuity, and can include cash withdrawals, distributions of employer securities, certain loans, and lump-sum distributions.

Cash Withdrawals

The key to taxability is the annuity starting date, which is either the first time the employee receives a payment under the contract or the date the obligation becomes fixed, whichever is later.

If the amount is received prior to the annuity start date, the following formula is used

$$\text{Amount Received} \times \frac{\text{Cost of Contract}}{\text{Account Balance}} = \text{Tax-free Amount}$$

Note that the 10% early withdrawal penalty tax will still apply to the taxable portion if the recipient is not 59½ years of age or qualified under one of the exceptions.

If the amount is received on or after the annuity start date, it will generally be fully taxable. An exception applies if the withdrawal reduces the annuity payments. In that case, the following formula applies to determine the tax-free portion of the nonperiodic distribution:

$$\text{Cost of Contract} - \text{Previously Allowed Cost} \times \frac{\text{Reduction in the Annuity Amount}}{\text{Original Amount of Annuity Payment}} = \text{Tax-free Amount}$$

Example 39. Lucy has been receiving retirement payments for five years. Her original cost was $15,000 and she receives a monthly payment of $1,000. Her exclusion amount was $58 per payment. After she took a cash distribution of $10,000, her monthly payment dropped to $800. The tax-free portion of that cash distribution is as follows

$$(\$15,000 - \$3,480^*) \times \frac{\$200}{\$1,000} = \$2,304$$

*$58 per payment × 60 payments

Distribution of Employer Securities

Sometimes employers elect to distribute securities, such as stocks, bonds, and debentures, from a qualified retirement plan. It is possible to defer the tax on the increase in value that occurred while the securities were in the plan. If the distribution qualifies as a lump-sum distribution (see below), tax can be deferred on the entire net unrealized appreciation (NUA) unless the taxpayer chooses to include it in income for the year received. If it does not qualify as a lump-sum distribution, tax can only be deferred on the part of the NUA that was the result of employee contributions that were not deductible. The tax-deferred portion of the NUA will be shown in box 6 of the Form 1099-R received from the payor.

Certain Loans

An unplanned taxable distribution can occur when someone borrows money from a retirement plan. Unless the loan qualifies under one of the exceptions listed below, it is treated as a nonperiodic distribution. The taxable treatment results when the interest is originally pledged or assigned or when a previously qualified loan is renegotiated or renewed. If it does not qualify for the exception, the investment in the contract must be reduced to equal the tax-free portion of the distribution; loan repayments will increase the investment to the extent that the distribution is taxable.

If a loan is treated as a distribution, the taxpayer should receive a Form 1099-R showing code "L" in box 7.

Exception for Qualified Plans, TSA Plans, and Government Plan Loans

- Applies only to a loan that either is used to buy the taxpayer's main home **or** must be repaid within five years
- Loan must require substantially level payments at least quarterly over the life of the loan
- All loans from plans of the taxpayer's employer (and certain related employers including members of a controlled group of corporations, businesses under common control, or members of an affiliated service group) cannot exceed the lesser of $50,000 or half the present value (not less than $10,000) of the employee's nonforfeitable accrued benefit under the plan

If the loan does not have to be treated as a distribution because the exception applies, no deduction will be allowed for interest on a loan that meets either of the following criteria:

1. The loan is secured by amounts from elective deferrals from a 401(k) plan or a salary reduction agreement for a TSA
2. The loan is made to a key employee

Lump-Sum Distributions

The term "lump-sum distribution" brings to mind the possibility of special tax calculations made in order to save money. The problem is that the special break is available to a very narrowly defined group: **taxpayers born before 1936.**

A lump-sum distribution is the payment of the participant's entire balance from all of the employer's qualified plans of a single type (i.e., pension, profit-sharing, or stock bonus plans). The participant must have been in the plan for at least five years. The payment must be done within a single tax year and paid because of one of the following:

- The participant dies
- The participant becomes age 59½
- The employee participant leaves the job
- The self-employed participant becomes totally and permanently disabled

Example 40. Jeanette, age 60, leaves her job with XYZ Company in 2000. She has worked there for 10 years and participated in the profit-sharing plan. When she resigns, she receives her entire balance of $80,000 in cash. What are her options?

Answer. She was not born **before 1936,** so she does not qualify for any special calculations. Her only two choices are to roll the amount over into an IRA or another employer's plan **or** to pay tax. The employer's contributions and the income earned on the account will be taxable for her although she will be able to recover any cost she had in the plan.

Practitioner Note. The **5-year averaging** option available to people who were over age 59½ when they received a lump-sum distribution was **repealed for tax years after December 31, 1999.**

Example 41. If Jeanette in Example 40 had been 65 when she resigned, she would be eligible for **10-year averaging** because she would have been born **before 1936.** In that case, she could have filed Form 4972. Her tax on the $80,000, assuming she had no cost, is computed on Form 4972 as follows:

Form **4972**
Department of the Treasury
Internal Revenue Service (99)

Tax on Lump-Sum Distributions
(From Qualified Retirement Plans of Plan Participants Born Before 1936)
► **Attach to Form 1040 or Form 1041.** ► **See separate instructions.**

OMB No. 1545-0193
2000
Attachment Sequence No. **28**

Name of recipient of distribution: *Jeanette (Example 41)*
Identifying number: *123 45 6789*

Part III **Complete this part to choose the 10-year tax option** (see instructions)

8	Ordinary income from Form 1099-R, box 2a minus box 3. If you did not complete Part II, enter the taxable amount from box 2a of Form 1099-R	8	*80,000*
9	Death benefit exclusion for a beneficiary of a plan participant who died before August 21, 1996	9	
10	Total taxable amount. Subtract line 9 from line 8	10	*80,000*
11	Current actuarial value of annuity (from Form 1099-R, box 8)	11	
12	Adjusted total taxable amount. Add lines 10 and 11. If this amount is $70,000 or more, **skip** lines 13 through 16, and enter this amount on line 17	12	*80,000*
13	Multiply line 12 by 50% (.50), but **do not** enter more than $10,000 — 13		
14	Subtract $20,000 from line 12. If the result is less than zero, enter -0- — 14		
15	Multiply line 14 by 20% (.20) — 15		
16	Minimum distribution allowance. Subtract line 15 from line 13	16	
17	Subtract line 16 from line 12	17	*80,000*
18	Federal estate tax attributable to lump-sum distribution	18	
19	Subtract line 18 from line 17. If line 11 is blank, **skip** lines 20 through 22, and go to line 23	19	*80,000*

22	Subtract line 21 from line 11	22			
23	Multiply line 19 by 10% (.10)			23	8,000
24	Tax on amount on line 23. Use the Tax Rate Schedule in the instructions			24	1,111*
25	Multiply line 24 by ten (10). If line 11 is blank, **skip** lines 26 through 28, and enter this amount on line 29 and go to line 30			25	11,110
26	Multiply line 22 by 10% (.10)	26	0		
27	Tax on amount on line 26. Use the Tax Rate Schedule in the instructions	27	0		
28	Multiply line 27 by ten (10)			28	0
29	Subtract line 28 from line 25. (Multiple recipients, see instructions.)			29	11,110
30	Tax on lump-sum distribution. Add lines 7 and 29. Also include this amount in the total on Form 1040, line 40, or Form 1041, Schedule G, line 1b, whichever applies ▶			30	11,110

*The 1999 rates were used to calculate the tax on line 24 because the instructions for the 2000 Form 4972 were not published at the time this book went to press.

In preparing her 2000 tax return, Jeanette would calculate her tax without the distribution and then enter the $11,110 from line 30 of Form 4972 on line 40 on her Form 1040.

Example 42. Rose died in 2000 at the age of 65. Her daughter Irene was her beneficiary and received the lump-sum distribution that year. Because Rose was born before 1936, Irene is eligible to use the 10-year averaging to determine the tax on the distribution.

Example 43. Jerry and Jean were divorced in 2000, and the court determined that Jean was entitled to part of Jerry's qualified lump-sum distribution. She received $70,000. Because Jerry was born before 1936, Jean can use 10-year averaging to determine the tax, or roll the amount over into an IRA or her employer's plan.

Practitioner Note. A person born prior to 1936 is also eligible to elect capital gain treatment for distribution amounts (pre-1974 only). The amount will be shown in Box 3 of Form 1099R.

NONQUALIFIED EMPLOYEE PLAN DISTRIBUTIONS

When a plan does not meet the Internal Revenue Code requirement, it is said to be nonqualified and does not receive most of the tax benefits of a qualified plan. This designation also applies to commercially purchased annuity/insurance products and personal annuities.

- Unless a nonqualified annuity was purchased before August 14, 1982, any withdrawals are allocated first to earnings, upon which tax must be paid, and then to cost.

Example 44. Buck bought an annuity from an insurance company after August 14, 1982. Before the contract starting date for the annuity, he received a $7,000 distribution. At the time of the distribution, the annuity had a cash value of $16,000, and his investment in the contract was $10,000. Because the distribution is allocated first to earnings, he must include $6,000 ($16,000 – $10,000) in his gross income. The remaining $1,000 is a tax-free return of part of his investment.

- Annuity payments must be calculated under the General Rule instead of the Simplified Method. The General Rule requires determining the tax-free part of each payment based on the ratio of the cost of the contract to the total expected return. Life expectancy tables, available in Publication 937, are needed to complete the calculations.

Example 45. Gloria, age 65, will receive payments of $1,000 per month over her life expectancy.

She has a cost basis of $30,000 in her plan. Using the table in Publication 939, *General Rule for Pensions and Annuities* we find that she has a multiple of 20.0. Her tax-free portion of $125 per month is computed below:

$$\frac{\text{Cost} = \$30{,}000}{\text{Expected return} = \$1{,}000\ \ 3\ 12\ \text{months}\ \ 3\ \text{multiple of}\ 20} = \frac{\$30,000}{\$240,000} = 12.5\%\ \text{tax free or}\ \$125$$

- Distributions are not eligible for 10-year averaging even if the recipient was born before 1936.
- Repayments of loans that were treated as taxable distributions do not affect the investment in the contract.
- Tax-free rollovers are not allowed.

OTHER TYPES OF PAYMENTS

In addition to the various forms of IRAs and retirement plans discussed so far, there are also special treatments required for other plans. Included in this category are §457 plans, disability payments, and railroad retirement.

I.R.C. §457 PLANS

Deferred compensation plans available to people who work for a state or local government or for a tax-exempt organization fall under §457. No tax is due on pay that is deferred until it is distributed to the employee.

Key elements of I.R.C. §457 plans include:

- The annual salary reduction limit is the lesser of $7,500 ($8,000 as indexed for 2000) or one-third of includible compensation.
- No distributions are allowed until age 70½ unless due to emergency or separation from service.
- Nongovernment plans are subject to the minimum distribution requirements; government plans are not.
- In the last three years before he or she retires, an employee can use catch-up provisions if he or she did not defer the full $7,500 in prior years. Maximum additional deferral is $22,500 over the three years.
- After a minimum of two years of participation, a participant is allowed a one-time in-service withdrawal of up to $3,500.
- A participant is allowed a one-time election to defer a qualified distribution before it is made.
- Benefit payments received will be taxed as ordinary income.
- Lump-sum payments are not eligible for 10-year averaging.
- Plan distributions are reported on Form W-2, not on Form 1099-R, unless paid to the beneficiary of a deceased employee.

DISABILITY PAYMENTS

When a person retires on disability, the pension payments are taxable as wages until he reaches the age at which he would first be qualified to receive the annuity. Immediately after that date, the payments are treated as a pension or annuity and any cost can be recovered. Until that minimum retirement age is reached, all of the taxable disability payments are reported just like wages on line 7 of Form 1040.

RAILROAD RETIREMENT

Railroad Retirement Act benefits fall into two categories, each of which have different tax treatments.

Tier 1 benefits equal the social security benefit that a railroad employee or beneficiary would have been entitled to receive under the social security system and are treated in the same manner. See the following section on social security for the effects of other income on the taxability of this benefit.

Tier 2 benefits are treated as if they were payments from a qualified employee plan. This treatment allows the recipient to recover his costs from this portion, bearing in mind that any vested dual benefits or supplemental annuity benefits are fully taxable.

THE IMPACT OF RETIREMENT INCOME ON SOCIAL SECURITY

Benefits received from social security and Tier 1 of Railroad Retirement can become taxable depending upon other income reported. Although Congress passed a law this year allowing people aged 65–70 to earn an unlimited amount of income without affecting their social security benefits, that income can affect the taxability of their benefits. In the same manner, distributions and payments from retirement plans can affect the taxability of the benefits.

DETERMINING TAXABILITY

In order to determine if any portion of social security benefits is taxable, compare one-half of the benefits **plus** all other income (including tax-exempt interest) to a base amount. The income should not be reduced by exclusions for the following:

- Interest from qualified U.S. savings bonds (used for higher education expenses)
- Employer-provided adoption benefits
- Foreign earned income or foreign housing
- Income earned in American Samoa or Puerto Rico by bona fide residents

BASE AMOUNT

The base amount depends upon the filing status:

- $25,000 if single, head of household, or qualifying widow(er)
- $25,000 if married filing separately and lived apart from spouse for all of 2000
- $32,000 if married filing jointly
- $-0- if married filing separately and lived with spouse at any time during 2000

QUICK CHECK METHOD

Use the following quick check method to determine if some of the benefits might be taxable for this year:

1. Write in the amount from box 5 of all Forms SSA-1099 and RRB-1099. Include the full amount of any lump-sum benefit payments received.
2. Enter 1/2 of the amount on line 1.
3. Write in the total of taxable pensions, wages, interest, dividends, and other taxable income.
4. Write in any tax-exempt interest plus any exclusions from income (see list above).
5. Total lines 2, 3, and 4.

If line 5 equals or is less than the base amount for your filing status, none of the benefits are taxable. If it exceeds the base amount, benefits may be taxable.

Example 46. Dan, a single taxpayer, received $6,000 in social security benefits in 2000 and a lump-sum payment of $8,000 for prior years that had been under dispute. He also received taxable pension payments of $15,000 and interest on his certificates of deposit of $1,000.

1. Total received from social security	$14,000
2. One-half of line 1	7,000
3. Taxable income total	16,000
4. Tax-exempt and exclusion total	-0-
5. Total of lines 2, 3, and 4	$23,000

Because his base amount is $25,000, none of his social security is taxable.

MAXIMUM TAXABLE AMOUNT

Up to 85% of the benefits can be taxable if either of the following situations applies:

- One-half of the benefits plus all other income exceeds $34,000 ($44,000 if married filing jointly)
- Taxpayer is married filing separately and lived with spouse at any time during 2000

Example 47. What if Dan, in Example 46, converted his $50,000 traditional IRA to a Roth in 2000?

1. Total received from social security	$14,000
2. One-half of line 1	7,000
3. Total taxable income	66,000
4. Tax-exempt and exclusion total	-0-
5. Total of lines 2, 3, and 4	$73,000

Because of the amount of Dan's taxable income, a full 85% ($11,900) of his social security will be taxable, as shown below:

6. Subtract $25,000 from line 5 above	$48,000
7. Subtract $9,000 from line 6	39,000
8. Enter the smaller of line 6 or $9,000	9,000
9. Enter 1/2 of line 8	4,500
10. Multiply Line 7 by 85%	33,150
11. Add lines 9 and 10	37,650
12. Multiply line 1 by 85%	11,900
13. Taxable amount is the smaller of line 11 or 12	$11,900

LUMP-SUM ELECTION

A taxpayer who receives a retroactive payment of benefits must still include the payment in income for the current year. There is, however, an election that allows the taxpayer to figure the taxable part of a payment for an earlier year separately, using the income for the earlier year.

Practitioner Note. This should not be confused with the **nontaxable lump-sum death benefit** paid by Social Security and Railroad Retirement to many of their beneficiaries.

Example 48. Dan (Example 46) received a lump-sum payment of $8,000, $6,000 for 1998 and $2,000 for 1999, and social security benefits of $6,000 for 2000. His AGI was $30,000 in 1998 and $17,000 in 1999. By making the lump-sum election, his taxable portion of social security is $6,100 ($1,000 for 1998, $0 for 1999, and $5,100 for 2000) instead of the $11,900 that would have been taxable without the election.

1998

1. Total received from Social Security ($6,000 benefits for 1998 + $6,000 lump sum)	$12,000
2. One-half of line 1	6,000
3. AGI for 1998	30,000
4. Total of lines 2 and 3	36,000
5. Less taxable benefits reported in 1998	3,000
6. Line 4 minus line 5	33,000
7. Base amount	25,000
8. Line 6 minus line 7	8,000
9. One-half of line 8	4,000
10. Benefits previously taxed	3,000
11. Taxable for 1998 (line 9 minus line 10)	$1,000

1999

1. Total received from Social Security ($6,000 benefits for 1999 + $2,000 lump sum)	$8,000
2. One-half of line 1	4,000
3. AGI for 1999	17,000
4. Total of lines 2 and 3	21,000
5. Less taxable benefits reported in 1999	-0-
6. Line 4 minus line 5	21,000
7. Base amount	25,000
8. Line 6 minus line 7 (amount taxable)	-0-

2000

1. Total received from Social Security ($6,000 benefits)	$6,000
2. One-half of line 1	3,000
3. AGI for 2000	66,000
4. Total of lines 2 and 3	69,000
5. Base Amount	25,000
6. Line 4 minus line 5	44,000
7. Subtract $9,000 from line 6	35,000
8. Enter the smaller of line 6 or $9,000	9,000
9. Enter 1/2 of line 8	4,500
10. Multiply Line 7 by 85%	29,750
11. Add lines 9 and 10	34,250
12. Multiply line 1 by 85%	5,100
13. Taxable amount is the smaller of line 11 or 12	$5,100

Practitioner Note. There are **no** amended returns for the prior years. The appropriate tax has already been paid for those years and taken into account with the calculations shown above. Write in “LSE” (lump-sum election) to the left of line 20a on Form 1040 and show the full amount of benefits received in the current year. Line 20b will then be the reduced taxable amount determined using the election.

THE BOTTOM LINE

A taxpayer who receives a lump-sum distribution from Social Security can make an election to figure the taxable amount more advantageously. A taxpayer who receives a lump-sum distribution from any other type of retirement is subject to tax in full **unless** he or she was born before 1936 and meets all of the requirements for a lump-sum distribution.

People who do not qualify for special treatment of these distributions need to be aware of the potential effects on their tax situation before they make the decision to withdraw the money, assuming they have a choice.

When Dan (Example 46) made the decision to convert his IRA to a Roth, he not only increased his taxable income by $50,000, but he also added $11,900 of taxable social security benefits. If he had spread his conversion over several years, he could have avoided most of the tax on the social security benefits and he would never have needed to include 85% of his benefits in income.

CONCLUSION

With the wide variety of retirement options, there is also a wide variety of tax treatments. This is an area that requires advance tax planning, not after-the-fact quick fixes. It is also an area that is politically popular–nothing is carved in stone. Stay alert. There is nothing "old" about retirement.

2000 Income Tax School

INVESTMENTS