Chapter 9: Retirement

Corrections were made to this workbook through January of 2010. No subsequent modifications were made.

CONVERTING TRADITIONAL IRAs TO ROTH IRAs

For tax years **beginning in 2010,** a taxpayer can convert a traditional IRA to a Roth IRA regardless of the taxpayer's income and filing status. If the taxpayer converts the IRA in 2010, any taxable conversion amount is recognized ratably in 2011 and 2012 unless the taxpayer elects to recognize it all in 2010.[1]

Example 1. Sebastian has a traditional IRA with a value of $30,000, consisting of deductible contributions and earnings. He converts the IRA to a Roth IRA in 2010. Sebastian elects not to recognize the income in 2010. He includes $15,000 in income in both 2011 and 2012.

If the taxpayer takes a distribution from a Roth IRA after a conversion, the distribution **accelerates** the inclusion of income. The amount included in income in the distribution year is increased by the amount distributed. The amount included in 2011 and 2012 is the lesser of:

- Half the amount includable in income as a result of the conversion, or
- The remaining portion of the amount includable in income that was not previously included in income.

Example 2. If Sebastian from **Example 1** takes a $5,000 distribution from the Roth IRA in 2010 after the conversion, he must include the $5,000 in income in 2010 under the accelerated rule. In 2011, he will include $15,000 in income (the lesser of half the income from the conversion or the remaining untaxed income from the conversion). In 2012, Sebastian will have $10,000 to include in income (the remaining untaxed portion of the conversion).

In addition to the special treatment afforded to Roth IRAs converted in 2010 described above, the $100,000 AGI limit for conversions is repealed for **all** tax years **beginning after December 31, 2009.** The removal of the AGI limit for conversions allows a taxpayer to make nondeductible contributions to a traditional IRA and then convert it to a Roth IRA without any tax consequence, thereby effectively eliminating the income limit for contributing to a Roth IRA.

1. IRC §408A(d)(3)(A)(iii).

PROS AND CONS OF CONVERTING AN IRA

With the 2010 elimination of the AGI limit for converting to Roth IRAs, more taxpayers may want to consider whether converting is beneficial for their particular situation. Unfortunately, there is no easy answer. There are many factors to weigh before making this decision, including the following:

- What is the taxpayer's present income tax rate versus the rate expected during retirement? If the taxpayer expects to be in a higher tax bracket after retirement, the option of converting from a traditional IRA to a Roth IRA should be given serious consideration.
- Does the taxpayer need to take distributions from the IRA or does he prefer to pass the investments to heirs? With a Roth, there is no requirement to take mandatory distributions, whereas with a traditional IRA, distributions must generally begin by age 70½.
- Has the taxpayer made deductible or nondeductible contributions to a traditional IRA? If the contributions are mostly nondeductible, the tax impact of converting to a Roth is lessened, because the investment earnings and deductible contributions are the only items taxed at conversion.
- What effect has the recent stock market decline and economic climate had on the taxpayer's IRA? The downward turn in the economy actually makes the question of converting from a traditional IRA to a Roth easier for those that have seen their investments' value significantly drop. If the taxpayer's IRA balances are down considerably, the taxes upon conversion will be much lower.
- What is the taxpayer's **current** income tax rate? If it is lower than usual because of unemployment, for example, it might be a good time to convert the IRA, provided the taxpayer has enough funds available outside the IRA to pay the applicable taxes. On the other hand, if converting to a Roth IRA pushes the taxpayer into a higher tax bracket, it might be advisable to wait until a later year to convert, or make only a partial conversion in the current year.
- What is the taxpayer's expected income during retirement? Roth IRA distributions are not included in gross income when calculating the taxability of social security benefits. However, traditional IRA distributions are included.
- How many years does the taxpayer have before retirement? Generally, the more years until retirement, the more beneficial the conversion will be given that there are more years to "earn back" the taxes due at conversion.
- Does the taxpayer have non-IRA funds to pay the taxes due after conversion? If so, the tax-free growth on the Roth IRA can be dramatic compared to investments subject to tax. If not, the conversion may end up costing the taxpayer money.

Example 3. Kent, age 35, has $50,000 in a traditional IRA. He wants to convert to a Roth IRA but does not have the money to pay the taxes. He decides to proceed with the conversion and retains some of the money in order to pay the applicable taxes.

Kent is in the 15% tax bracket. He owes $7,500 in taxes on the conversion ($50,000 × 15%). He also owes a 10% penalty on the amount he keeps from the conversion to pay the taxes. Including the penalty, Kent needs $8,333 ($7,500 ÷ .90). He can convert the balance of $41,667 to a Roth IRA.

If Kent leaves the money in the Roth IRA for 30 years, assuming an average return of 9%, his balance will be $552,824. If he had not converted and left the money in the traditional IRA, he would have $563,876 after paying taxes at the 15% rate. The Roth conversion did not provide a good opportunity for Kent because he took funds from the IRA to pay the taxes and thus lost the ability to earn a return on that money over the subsequent 30 years.

If Kent had used non-IRA funds to pay the taxes, he would have saved the 10% penalty, and the entire $50,000 would have stayed inside the Roth IRA, earning a tax-free return, resulting in a balance after 30 years of $742,053.

Note. See Planning Suggestion 1 in Chapter 4, Individual Taxpayer Problems, for tax-saving strategies.

RECHARACTERIZATIONS

Another factor in favor of converting to a Roth IRA is the ability to recharacterize the conversion if the taxpayer changes her mind or if circumstances change. Recharacterization means that a contribution made to one type of IRA is treated as having been made to a different type of IRA. This is generally done by having the conversion contribution (plus accumulated earnings or minus losses) transferred from the first IRA to a second IRA in a trustee-to-trustee transfer. Trustee-to-trustee transfers are made directly between financial institutions or within the same financial institution.

If the recharacterization is made by the due date (including extensions) for the tax return for the contribution year, the taxpayer can elect to treat the contribution as having been originally made to the second IRA.

> **Example 4.** On June 1, 2008, Christine converted her traditional IRAs to a Roth IRA. At the time, she expected to have modified AGI of less than $100,000 for 2008. In December, she received an unexpected bonus that increased her modified AGI to more than $100,000. In January 2009, to make the necessary adjustment to remove the prohibited conversion, Christine established a traditional IRA. At the same time, she instructed the trustee of the Roth IRA to make a trustee-to-trustee transfer of the conversion contribution made to the Roth IRA (including net income allocable to it since the conversion) to the new traditional IRA. She also notified the trustee that she was electing to recharacterize the conversion contribution to the Roth IRA and treat it as if it had been contributed to the new traditional IRA. Because of the recharacterization, Christine has no taxable income from the conversion to report for 2008.

> **Example 5.** Jamal converted his traditional IRA to a Roth in January 2008. At that time, the value of the IRA was $85,000. At the end of 2008, the IRA had a value of $40,000. Jamal recharacterizes the Roth IRA back to a traditional IRA in March 2009 so that he doesn't have to pay tax on $45,000 of nonexistent income.

No deduction can be taken for a contribution to a traditional IRA if the amount is recharacterized.

Following is an explanation of the four types of recharacterizations and how to report them:

1. **Conversion and recharacterization.** This occurs when an amount is converted from a traditional, SEP, or SIMPLE IRA to a Roth IRA and later all or part of the amount is recharacterized back to a traditional, SEP, or SIMPLE IRA. If only part of the amount converted is recharacterized, the amount not recharacterized is reported on Form 8606, *Nondeductible IRAs.* If the entire amount is recharacterized, the recharacterization is not reported on Form 8606. In either case, a statement is attached to the return explaining the recharacterization, and the amount converted from the traditional, SEP, or SIMPLE IRA is included in the total on Form 1040, line 15a (IRA distributions). If the recharacterization occurs in the same year as the conversion, the amount transferred back from the Roth IRA is also included on that line. If the recharacterization occurs in the taxable year following the year of conversion, the amount transferred is only reported in the statement attached to the return and is not reported on the tax return for either the year of conversion or the year recharacterization occurs.

Example 6. Boyd and Shanda's filing status is married filing jointly. They converted $20,000 from their traditional IRA to a new Roth IRA on May 20, 2008. On April 7, 2009, they learned that their 2008 modified AGI for Roth IRA purposes exceeded $100,000. They are not allowed to make a Roth IRA conversion. The value of the Roth IRA on that date is $19,000.

Boyd and Shanda recharacterize the conversion by transferring the $19,000 balance to a traditional IRA in a trustee-to-trustee transfer. They report $20,000 on their 2008 Form 1040, line 15a, and enter zero on line 15b (see below). They do not include the $19,000 on line 15a because the Roth conversion did not occur in 2008. They also do not report the $19,000 on their 2009 return. The couple attaches a statement to Form 1040 explaining that they made a conversion of $20,000 from a traditional IRA on May 20, 2008, and they recharacterized the entire IRA balance, which was then valued at $19,000, back to a traditional IRA on April 7, 2009.[2]

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.	9a	Ordinary dividends. Attach Schedule B if required	9a	
	b	Qualified dividends (see page 21) 9b		
	10	Taxable refunds, credits, or offsets of state and local income taxes (see page 22)	10	
	11	Alimony received	11	
	12	Business income or (loss). Attach Schedule C or C-EZ	12	
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐	13	
If you did not get a W-2, see page 21.	14	Other gains or (losses). Attach Form 4797	14	
	15a	IRA distributions 15a 20,000 b Taxable amount (see page 23)	15b	0
	16a	Pensions and annuities 16a b Taxable amount (see page 24)	16b	
Enclose, but do not attach, any	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
	18	Farm income or (loss). Attach Schedule F	18	

2. **Contribution to traditional and recharacterization to Roth.** This occurs when a contribution is made to a traditional IRA and later part or all of the contribution is recharacterized to a Roth IRA. If only part of the contribution is recharacterized, the **nondeductible** traditional IRA portion of the remaining contribution, if any, is reported on Form 8606, Part I. If the entire contribution is recharacterized, the contribution is **not** reported on Form 8606. In either case, a statement is attached to the return explaining the recharacterization. If the recharacterization occurred in the same taxable year as the contribution, the amount transferred from the traditional IRA is included on Form 1040, line 15a. If the recharacterization occurred in the taxable year following the year the contribution was made, the amount transferred is only reported in the statement attached to Form 1040.

Example 7. Tia is single and covered by a retirement plan. She contributed $4,000 to a new traditional IRA on May 27, 2008. On February 24, 2009, Tia learns that her 2008 modified AGI will limit her traditional IRA deduction to $1,000. The value of her traditional IRA on that date is $4,400. She decides to recharacterize $3,000 of the traditional IRA contribution as a Roth IRA contribution, and then transfers $3,300 ($3,000 contribution plus $300 of related earnings) from her traditional IRA to a Roth IRA in a trustee-to-trustee transfer. She deducts the $1,000 traditional IRA contribution on Form 1040.

She is not required to file Form 8606, but she must attach a statement to her return explaining the recharacterization. The statement indicates that Tia contributed $4,000 to a traditional IRA on May 27, 2008; recharacterized $3,000 of that contribution on February 24, 2009, by transferring $3,000 plus $300 of related earnings from her traditional IRA to a Roth IRA in a trustee-to-trustee transfer; and that all $1,000 of the remaining traditional IRA contribution is deducted on Form 1040.

Tia does not report the $3,300 distribution from her traditional IRA on her 2008 or her 2009 Forms 1040.[3]

2. See instructions to Form 8606.

3. Ibid.

3. **Contribution to Roth and recharacterization to traditional.** This occurs when a contribution is made to a Roth IRA and later part or all of it is recharacterized to a traditional IRA. The nondeductible traditional IRA portion, if any, is reported on Form 8606, Part I. If the entire contribution is not recharacterized, the remaining Roth IRA portion of the contribution is not reported on Form 8606. A statement is attached to the return explaining the recharacterization. If the recharacterization occurred in the same tax year as the contribution, the amount transferred from the Roth IRA is included on Form 1040, line 15a. If the recharacterization occurred in the year following the year of contribution, the amount transferred is only reported in the attached statement and is not reported on the tax return for either the year of contribution or the year of recharacterization.

Example 8. Logan is single and contributed $4,000 to a new Roth IRA on June 16, 2008. On December 29, 2008, Logan determines that his 2008 modified AGI allows him to take a full traditional IRA deduction. He decides to recharacterize the Roth IRA contribution as a traditional IRA contribution and transfers $4,200, the balance in the Roth IRA account ($4,000 contribution plus $200 related earnings), from his Roth IRA to a traditional IRA in a trustee-to-trustee transfer.

Logan deducts the $4,000 traditional IRA contribution on Form 1040. He is not required to file Form 8606. However, he must attach a statement to his return explaining the recharacterization. The statement indicates that he contributed $4,000 to a new Roth IRA on June 16, 2008; recharacterized that contribution on December 29, 2008, by transferring $4,200, the balance in the Roth IRA, to a traditional IRA in a trustee-to-trustee transfer; and that $4,000 of the traditional IRA contribution is deducted on Form 1040. Logan includes the $4,200 distribution on his 2008 Form 1040, line 15a, and enters zero on line 15b.[4]

4. **Rollover and recharacterization.** This occurs when an amount is rolled over from a qualified retirement plan to a Roth IRA and later all or part of the amount is recharacterized to a traditional IRA. A statement is attached to the return that explains the recharacterization. The amount of the original rollover is included on Form 1040, line 16a (Pensions and annuities). Also, any taxable amount of the rollover not recharacterized is included on Form 1040, line 16b. If the recharacterization occurred in the same tax year as the rollover, the amount transferred from the Roth IRA is also included on Form 1040, line 15a. If the recharacterization occurred in the year following the year of the rollover, the amount transferred is only reported in the attached statement and is not reported on the tax return for either year. These rollovers or recharacterizations are not reported on Form 8606.

Example 9. Aliza is single. She rolled over $50,000 from her 401(k) plan to a new Roth IRA on July 20, 2008. On March 25, 2009, Aliza learns that her 2008 modified AGI for Roth IRA purposes exceeds $100,000, and she is not allowed to make a Roth IRA rollover. The value of the Roth IRA on that date is $49,000.

Aliza recharacterizes the rollover by transferring the entire amount to a traditional IRA in a trustee-to-trustee transfer. She reports $50,000 on Form 1040, line 16a, and enters zero on line 16b. She does not include the $49,000 on line 15a because the recharacterization did not occur in 2008. She also does not report that amount on her 2009 return. Aliza attaches a statement to Form 1040 explaining that she made a rollover of $50,000 from a 401(k) plan to a Roth IRA on July 20, 2008, and she recharacterized the entire amount, which was then valued at $49,000, to a traditional IRA on March 25, 2009.[5]

4. Ibid.

5. Ibid.

RECONVERSIONS

As discussed above, a conversion from a traditional IRA to a Roth IRA may be subsequently recharacterized to a traditional IRA. The IRA owner may later reconvert the traditional IRA to a Roth IRA. However, the reconversion cannot occur before the later of:

- The beginning of the year following the year in which the amount was converted to a Roth IRA, or
- The end of the 30-day period beginning on the day on which the Roth IRA was transferred back to a traditional IRA in a recharacterization.

If the timing requirement for reconversion is not satisfied, it is considered a **failed conversion.** The result of a failed conversion is that the reconversion is treated as a distribution from the traditional IRA and a regular contribution to the Roth IRA. The deemed traditional IRA distribution is includable in the taxpayer's gross income in the year of the failed conversion, and the 10% early-distribution penalty applies unless one of the exceptions is met. Additionally, a 6% excise tax is assessed on the portion of the deemed Roth IRA contribution that exceeds the individual's contribution limit.

Example 10. Rudy is a very successful used-car salesman for a large dealership, and he is paid on commission. Rudy converts his traditional IRA to a Roth IRA on July 9, 2008. Rudy's employer provides him with a preliminary estimate of his annual earnings, which they predict will be $110,000. Knowing that his modified AGI will be in excess of $100,000 for 2008, he recharacterizes the Roth IRA to a traditional IRA on December 15, 2008.

Rudy's employer made an error in the prediction. Subsequently, he learns that his MAGI will be under $100,000 for 2008. He cannot reconvert before January 14, 2009 (30 days after the Roth-to-traditional recharacterization), or the conversion will fail.

The ramifications of a failed conversion can be corrected through a recharacterization back to a traditional IRA. The amount reconverted, including all earnings from the date of conversion, must be moved into a traditional IRA by the due date (including extensions) of the tax return for the year of the conversion to the Roth IRA. When this is done, the distribution is not included in income.[6]

Example 11. Trudy converts her traditional IRA to a Roth IRA on July 9, 2008. After she realizes her modified AGI is likely to be in excess of $100,000 for 2008, she recharacterizes the Roth IRA to a traditional IRA on December 15, 2008. When Trudy subsequently learns her MAGI will be under $100,000 for 2008 after all, she reconverts to a Roth on January 5, 2009. She then learns she has a failed conversion.

To correct the failed conversion, Trudy recharacterizes her Roth to a traditional IRA, including all applicable earnings while the assets were in the Roth IRA, in a trustee-to-trustee transfer on October 1, 2009 (before her extended 1040 due date of October 15, 2009).

If a taxpayer learns of a failed conversion after the deadline for recharacterization has passed, the taxpayer may submit a private letter ruling request, along with the applicable user fee, to the IRS. Requests for extensions of time in which to recharacterize a traditional IRA to a Roth are granted when the taxpayer provides evidence to satisfy the IRS that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government.[7]

---

6. IRS Pub. 590, *Individual Retirement Arrangements.*

7. Treas. Reg. §301.9100-3.

LIQUIDATING A RETIREMENT ACCOUNT AT A LOSS[8]

TRADITIONAL IRA LOSSES

If a taxpayer has a loss on a traditional IRA investment, she can recognize (include) the loss on her income tax return, but only when **all** the amounts in all her traditional IRA accounts have been distributed and the total distributions are less than her unrecovered basis, if any. Her basis is the total amount of the **nondeductible** contributions in her traditional IRAs.

The taxpayer claims the loss as a miscellaneous itemized deduction, subject to the 2%-of-adjusted-gross-income limit, on Form 1040, Schedule A. Any such losses are added back to taxable income for purposes of calculating AMT.

Example 12. Kira King made nondeductible contributions to a traditional IRA totaling $2,000. Her basis is $2,000 at the end of 2007. By the end of 2008, her IRA earns $400 in interest income. In that year, Kira receives a distribution of $600 ($500 basis + $100 interest), reducing the value of her IRA to $1,800 ($2,000 + $400 – $600) at year's end. Kira figures the taxable part of the distribution and her remaining basis on the following Form 8606.

In 2009, Kira's IRA has a loss of $500. At the end of that year, Kira's IRA balance is $1,300 ($1,800 – $500). Kira's remaining basis in her IRA is $1,500 ($2,000 – $500). Kira receives the $1,300 balance remaining in the IRA. She can claim a loss for 2009 of $200 (the $1,500 basis minus the $1,300 distribution of the IRA balance) as a miscellaneous itemized deduction subject to the 2%-AGI limit.

The activity in Kira's IRA account is detailed below:

	Basis	Earnings/Losses	Total
Dec. 31, 2007 basis	$2,000		$2,000
2008 earnings		$400	400
2008 distribution	(500)	(100)	(600)
Dec. 31, 2008 balance	$1,500	$300	$1,800
2009 losses	(0)	(500)	(500)
Dec. 31, 2009 balance	$1,500	($200)	$1,300

9

8. IRS Pub. 590, *Individual Retirement Arrangements.*

For Example 12

Form **8606**

Department of the Treasury
Internal Revenue Service (99)

Nondeductible IRAs

▶ See separate instructions.

▶ Attach to Form 1040, Form 1040A, or Form 1040NR.

OMB No. 1545-0074

2008

Attachment Sequence No. 48

Name. If married, file a separate form for each spouse required to file Form 8606. See page 5 of the instructions.	Your social security number
Kira King	333 33 3333

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	

Part I **Nondeductible Contributions to Traditional IRAs and Distributions From Traditional, SEP, and SIMPLE IRAs**

Complete this part only if one or more of the following apply.

- You made nondeductible contributions to a traditional IRA for 2008.
- You took distributions from a traditional, SEP, or SIMPLE IRA in 2008 **and** you made nondeductible contributions to a traditional IRA in 2008 or an earlier year. For this purpose, a distribution does not include a rollover (other than a repayment of a qualified disaster recovery assistance distribution), qualified charitable distribution, one-time distribution to fund an HSA, conversion, recharacterization, or return of certain contributions.
- You converted part, but not all, of your traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2008 (excluding any portion you recharacterized) **and** you made nondeductible contributions to a traditional IRA in 2008 or an earlier year.

1	Enter your nondeductible contributions to traditional IRAs for 2008, including those made for 2008 from January 1, 2009, through April 15, 2009 (see page 5 of the instructions)			1	0
2	Enter your total basis in traditional IRAs (see page 6 of the instructions)			2	2,000
3	Add lines 1 and 2			3	2,000
	In 2008, did you take a distribution from traditional, SEP, or SIMPLE IRAs, or make a Roth IRA conversion? No ▶ Enter the amount from line 3 on line 14. Do not complete the rest of Part I. Yes ▶ Go to line 4.				
4	Enter those contributions included on line 1 that were made from January 1, 2009, through April 15, 2009			4	0
5	Subtract line 4 from line 3			5	2,000
6	Enter the value of **all** your traditional, SEP, and SIMPLE IRAs as of December 31, 2008, plus any outstanding rollovers. Subtract any repayments of qualified disaster recovery assistance distributions. If the result is zero or less, enter -0- (see page 6 of the instructions)	6	1,800		
7	Enter your distributions from traditional, SEP, and SIMPLE IRAs in 2008. **Do not** include rollovers (other than repayments of qualified disaster recovery assistance distributions), qualified charitable distributions, a one-time distribution to fund an HSA, conversions to a Roth IRA, certain returned contributions, or recharacterizations of traditional IRA contributions (see page 6 of the instructions)	7	600		
8	Enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2008. **Do not** include amounts converted that you later recharacterized (see page 7 of the instructions). Also enter this amount on line 16	8			
9	Add lines 6, 7, and 8	9	2,400		
10	Divide line 5 by line 9. Enter the result as a decimal rounded to at least 3 places. If the result is 1.000 or more, enter "1.000"	10	× .833		
11	Multiply line 8 by line 10. This is the nontaxable portion of the amount you converted to Roth IRAs. Also enter this amount on line 17	11			
12	Multiply line 7 by line 10. This is the nontaxable portion of your distributions that you did not convert to a Roth IRA	12	500		
13	Add lines 11 and 12. This is the nontaxable portion of all your distributions			13	500
14	Subtract line 13 from line 3. This is **your total basis in traditional IRAs for 2008 and earlier years**			14	1,500
15a	Subtract line 12 from line 7			15a	100
b	Amount on line 15a attributable to qualified disaster recovery assistance distributions (see page 7 of the instructions). Also enter this amount on Form 8930, line 13			15b	
c	**Taxable amount.** Subtract line 15b from line 15a. If more than zero, also include this amount on Form 1040, line 15b; Form 1040A, line 11b; or Form 1040NR, line 16b			15c	100

Note: *You may be subject to an additional 10% tax on the amount on line 15c if you were under age 59½ at the time of the distribution (see page 7 of the instructions).*

For Privacy Act and Paperwork Reduction Act Notice, see page 9 of the instructions. Cat. No. 63966F Form **8606** (2008)

Example 13. Randolph has two traditional IRA accounts, both of which have suffered significant losses recently. Although Randolph is only 54, he considers liquidating the IRAs, thinking that he might be able to mitigate his situation by getting a tax write-off for the losses.

The first IRA account was funded by a $25,000 rollover from a 401(k) plan he had at a previous job. Thus, there were no nondeductible contributions, and the tax basis is zero. The IRA presently has a value of $17,000.

The second IRA was funded by nondeductible contributions totaling $20,000. This IRA has a current value of $10,000.

If Randolph follows through on his plan to liquidate the accounts without seeking advice from a tax professional, he will be shocked to learn that he actually has taxable income of $7,000 (IRA 1 value of $17,000 + IRA 2 value of $10,000 – total traditional IRA basis of $20,000). To make matters worse, Randolph will be assessed a 10% early-distribution penalty of $700 since he is under the age of 59½.

	Beginning IRA Value	Earnings/Losses	Ending IRA Value	Basis
IRA 1	$25,000	($ 8,000)	$17,000	$ 0
IRA 2	20,000	(10,000)	10,000	20,000
Total	$45,000	($18,000)	$27,000	$20,000
			(20,000)	$20,000
Taxable income			$ 7,000	

ROTH IRA LOSSES

The rules for recognizing losses from Roth IRAs are similar to those for losses from traditional IRA accounts. In order to recognize a loss, the following conditions must be met:

- **All** the amounts in **all** of the taxpayer's Roth IRA accounts are distributed, and
- The total distributions from Roth IRAs are less than the taxpayer's unrecovered basis.

The taxpayer's basis is the total amount of contributions to his Roth IRAs. Since all contributions to Roth IRAs are nondeductible and increase basis, there is a greater likelihood that liquidating all Roth IRA accounts will generate a deductible loss.

As with traditional IRA losses, a taxpayer claims the loss as a miscellaneous itemized deduction, subject to the 2%-of-AGI restriction. Any such losses are added back to taxable income for purposes of calculating AMT.

If a Roth IRA was funded by converting a traditional IRA to a Roth IRA (conversion contribution) and subsequently liquidated, a 10% penalty will be assessed if withdrawals of the converted amounts occur within five years of the beginning of the year when the conversion contribution was made.[9] This penalty does not apply to distributions if the taxpayer has attained age 59½ or meets one of the other exceptions under IRC §72(t).

9. IRC §408A(d)(3)(F).

IRA INVESTMENTS

Although there is no list of approved investments for retirement plans, there are special rules contained in the Employee Retirement Income Security Act of 1974 (ERISA) that apply to retirement plan investments. In general, a plan sponsor or plan administrator of a qualified plan who acts in a fiduciary capacity is required, when investing plan assets, to exercise the judgment that a prudent investor would use in investing for her own retirement.[10] In addition, certain rules apply to specific plan types. For example, there are different limits on the amount of employer stock and employer real property that a qualified plan can hold, depending on whether the plan is a defined benefit plan, a 401(k) plan, or another kind of qualified plan.[11]

Under the Code, both participant-directed accounts and IRAs cannot invest in collectibles, such as art, antiques, gems, coins, or alcoholic beverages, and they can invest in certain precious metals only if they meet specific requirements.[12] IRAs also are not permitted to invest in life insurance.[13]

SELF-DIRECTED IRAs

Self-directed IRAs allow the account owner to have greater control over investment decisions. The custodian of a self-directed IRA carries out the instructions of the IRA owner. This gives the self-directed IRA owner the opportunity to invest in nonpublicly traded assets, such as real estate.

However, self-directed IRA owners must be particularly mindful of the rules regarding prohibited transactions.

Prohibited Transactions

Certain transactions between a plan and a "disqualified person" are specifically prohibited by law. Disqualified persons include an IRA holder, immediate family, and fiduciaries.[14]

Prohibited transactions generally include the following:

- A transfer of plan income or assets to, or use of them by or for the benefit of, a disqualified person
- Any act of a fiduciary by which plan income or assets are used for his own interest
- The receipt of consideration by a fiduciary for his own account from any party dealing with the plan in a transaction that involves plan income or assets
- The sale, exchange, or lease of property between a plan and a disqualified person
- Lending money or extending credit between a plan and a disqualified person
- Furnishing goods, services, or facilities between a plan and a disqualified person

If an IRA holder engages in a prohibited transaction which remains uncorrected, the Code provides that the account is no longer considered an IRA and is treated as if all the assets were distributed on the first day of the taxable year in which the prohibited transaction occurred.[15] Additionally, if the IRA owner is under age 59½ on the date of the deemed distribution, the IRA owner is subject to the 10% additional tax on premature distributions.

---

10. ERISA Sect. 404.
11. ERISA Sect. 407.
12. IRC §408(m).
13. IRC §408(a)(3).
14. IRC §4975(e)(2)(F)(6).
15. IRC §408(e)(2).

Real Estate IRAs

To open a real estate IRA, the investor must generally seek the advice of a specialist. Performing an Internet search for "real estate IRA" or "self-directed IRA" yields several firms that specialize in establishing and maintaining such accounts. These firms typically charge a set-up fee plus a yearly maintenance fee which is a percentage of the value of the assets held in the account. Other administrators use fee-based billing, wherein the account is charged for each transaction that occurs. Still others use a blend of these two approaches.

Real estate held in an IRA can be single- or multi-family houses, condominiums, apartment buildings, land, or commercial property. The IRA owner identifies the property to be purchased, and then the IRA custodian purchases the property in an arm's-length transaction. The IRA owner or the owner's relatives (i.e., spouse, ancestor, lineal descendant, and any spouse of a lineal descendant) cannot live in a home owned by the IRA or sell property to the IRA because these are prohibited transactions.

The "self-dealing" restrictions also prohibit IRA owners from managing the property in their IRAs. Thus, a manager must be hired to deal with property held in a real estate IRA.

To fund a real estate IRA, the investor can transfer all or a portion of an existing IRA, or roll over funds from a qualified retirement plan into a self-directed account. If the value of an existing IRA is insufficient to purchase a desired property, the investor might consider forming a limited partnership, C corporation, or limited liability company which allows each investing entity (such as an IRA) the right to purchase an undivided interest in the property.

Another financing option is to obtain a nonrecourse loan with the IRA plan identified as the borrower. However, the portion of the property that is financed is subject to unrelated business income tax (UBIT). The income attributable to the leveraged portion of the asset is taxed, as is a portion of the gain on the sale of a leveraged asset. The basic reason for imposing the UBIT is to prevent the unfair advantage of receiving tax-free or tax-deferred benefits (depending on whether the asset is held by a Roth or traditional IRA) on assets that were not acquired with IRA funds.

Advantages of Real Estate IRAs

- Real estate IRAs give the account owner the opportunity to diversify beyond the typical blend of stocks, bonds, and mutual funds if only a portion of the investor's retirement funds are held in a real estate IRA.
- The real estate IRA owner has more control over the investment property than is the case with stocks or bonds.
- Real estate has **typically** been considered a relatively safe investment with good returns. The recent housing market crash and the resulting lower prices may make this a good time to invest in real estate (if one believes the downturn in prices is at or near the end of the cycle).

Disadvantages of Real Estate IRAs

- Thorough research is required to ensure the best decisions are made.
- The prohibited transaction rules are complex, and the penalties for breaking them are significant (see above discussion).
- The typical tax advantages for real estate ownership — such as the deductibility of interest and real estate taxes for individuals and depreciation for real estate owned in a business — are not available to the IRA.
- A gain on the sale of property held by a **traditional** IRA is taxed at ordinary income rates. (However, the profits are tax-free on property sold by a Roth IRA.)
- The asset(s) held in the IRA need to produce sufficient cash flow, along with annual contributions, to pay the expenses on the property held in the real estate IRA. Rent or other income generated by the property in the IRA must go directly into the IRA and not pass through the owner's hands.

- UBIT is assessed on income from debt-financed property in an IRA (see above explanation), and these taxes must be paid from the IRA. The tax is calculated on Form 990-T, *Exempt Organization Business Income Tax Return.* This tax effect is partially offset by the ability to deduct interest and depreciation expense on the debt-financed portion of the asset.
- Annual property appraisals may be necessary after the IRA owner reaches age 70½ in order to determine the amount of the RMD when real estate is held in a traditional IRA.
- In order to take RMDs, it may be necessary to sell the property in the real estate IRA.

Distributions from Real Estate IRAs

After the account owner attains age 59½, real estate can be withdrawn from the IRA for personal use. This is accomplished through an in-kind distribution. The IRA owner pays income tax on the current appraised value of the property, when it is held in a traditional IRA, and the IRA custodian reassigns the title to the property. No taxes are incurred at distribution for property held in a Roth IRA.

Another option is to direct the custodian of a traditional IRA to sell the property held in the IRA, after which the account owner may take periodic cash distributions upon reaching age 59½. Property can always be sold prior to the time the account owner reaches retirement age as long as the sale is not to a disqualified person and the proceeds stay in the IRA.

If the owner of a traditional IRA invested in real estate is approaching age 70½ and does not wish to sell the IRA property, the custodian needs to ensure that there is enough cash flow in the IRA to not only cover property expenses but to pay the RMD each year. Annual property appraisals are required to determine the requisite amount of the RMD.

ROLLOVERS AS BUSINESS STARTUPS[16]

Recently, arrangements called rollovers as business startups (ROBS) are being marketed as a means for prospective business owners to access accumulated tax-deferred retirement funds to cover new business start-up costs. These arrangements seek to avoid distribution taxes otherwise assessable.

Typically, a ROBS transaction involves the following steps:

- An individual establishes a shell corporation that sponsors an associated and purportedly qualified retirement plan.
- The retirement plan document states that all participants may invest the entirety of their account balances in employer stock.
- The individual becomes the only employee of the shell corporation and the only participant in the retirement plan.
- The individual then initiates a rollover or directs a trustee-to-trustee transfer of available funds from a prior qualified plan or personal IRA into the newly-created qualified plan. The sole participant in the plan directs investment of his account balance into a purchase of employer stock. The employer stock is valued to reflect the amount of plan assets that the taxpayer wishes to access.
- The individual then uses the transferred funds to purchase a franchise or begin some other form of business enterprise.
- After the business is established, the retirement plan may be amended to prohibit further investments in employer stock. As a result, only the original individual benefits from this investment option.
- A portion of the proceeds of the stock transaction may be remitted back to the promoter, in the form of a professional fee.

---

16. See Treasury Department memorandum available at www.irs.gov/pub/irs-tege/rollover_guidelines.pdf. Accessed on July 13, 2009.

According to a Treasury Department memorandum,[17] ROBS transactions may violate law in several ways. First, the arrangement may create a prohibited transaction between the retirement plan and its sponsor. Additionally, a ROBS transaction may only be available to the business's principal individual and thus may not satisfy the benefits, rights, and features requirement of IRC §§401 and 410. The memorandum concluded that specific facts related to ROBS transactions are evaluated on a case-by-case basis to determine whether the plan complies with established guidance.

EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM

Employers offering qualified retirement plans must navigate a maze of complex regulations to maintain tax-qualified status. The consequences for a retirement plan that loses its tax-favored status are severe and include the following:

- Contributions are includible in the participants' income to the extent they are vested.
- The employer loses the tax deduction for contributions.
- Earnings on accounts are taxed immediately.
- Distributions are not eligible for rollover treatment.

The IRS is well aware that mistakes in the administration of qualified retirement plans can and do happen. They put in place a system to help employers bring their plans back into compliance without losing tax benefits: the employee plans compliance resolution system (EPCRS). The EPCRS was updated in August 2008 by the publication of Rev. Proc. 2008-50.

EPCRS encompasses three distinct correction programs:

1. The **self-correction program (SCP)** permits a plan sponsor to correct certain plan failures without contacting the IRS.
2. The **voluntary correction program (VCP)** permits a plan sponsor to pay a limited fee and receive the IRS's approval for correction of plan failures. The VCP is available any time before an audit.
3. The **audit closing agreement program (Audit CAP)** permits a plan sponsor to pay a sanction and correct a plan failure while the plan is under audit.

9

Eligibility for correction under any part of EPCRS is limited to plan failures that do not involve the misuse or diversion of assets from the plan.

Qualification failures may be corrected under VCP; and certain types of qualification failures may be corrected under SCP. This category is defined as any failure that adversely affects the qualification of a plan. There are four types of qualification failures:

- **Plan document failure.** A plan document failure involves a plan provision (or the absence of a plan provision) that violates the Code requirements for qualified plans, SEPs, or SIMPLE IRA plans. There is currently no plan document failure involving §403(b) plans because there is no Code requirement that a §403(b) plan must have a plan document.[18]
- **Operational failure.** With respect to qualified plans, SEPs, and SIMPLE IRA plans, an operational failure is generally the failure to follow the terms of the plan document.

  For §403(b) plans, an operational failure is any failure to satisfy the requirements listed in Rev. Proc. 2008-50, section 5.02(2)(a). Some of the more common operational failures include: (1) the failure to satisfy the universal availability of salary reduction contributions; (2) failures involving contributions or allocations of excess amounts; and (3) the failure to pay RMDs.

17. Ibid.

18. IRS Notice 2009-3 delayed the effective date of the requirement to have a written §403(b) plan document in place from January 1 to December 31, 2009.

- **Demographic failure.** A demographic failure involves a failure to satisfy the nondiscrimination requirements of IRC §401(a)(4), the minimum-participation requirements of IRC §401(a)(26), or the coverage requirements of IRC §410(b) with respect to qualified plans, §403(b) plans, SEPs, or SIMPLE IRA plans. The correction of a demographic failure generally requires a corrective amendment to the plan that adds more benefits or increases existing benefits.[19]

- **Employer eligibility failure.** For qualified plans, an employer eligibility failure involves the adoption of a plan intended to be a qualified plan by an employer that is not eligible to maintain a qualified plan.

  For SEPs or SIMPLE IRA plans, an employer eligibility failure involves the adoption or maintenance of a plan intended to be a SEP or SIMPLE IRA plan by an employer that is not eligible to maintain such a plan (e.g., an employer with more than 100 employees adopts a SIMPLE IRA plan).

  For 403(b) plans, an employer eligibility failure involves any of the following:

  1. The adoption of a plan intended to satisfy the requirements of §403(b) by an employer that is not a tax-exempt organization described in IRC §501(c)(3) or a public educational organization described in IRC §170(b)(1)(A)(ii)
  2. A failure to satisfy the nontransferability requirement of IRC §401(g)
  3. A failure to initially establish or maintain a custodial account as required by IRC §403(b)(7)
  4. A failure to purchase (initially or subsequently) either an annuity contract from an insurance company (unless grandfathered under Rev. Rul. 82-102, 1982-1 CB 62) or a custodial account from a regulated investment company utilizing a bank or an approved nonbank trustee/custodian

SELF-CORRECTION PROGRAM (SCP)

SCP is available only for operational failures. A plan sponsor with established compliance practices and procedures may, at any time without paying any fee or sanction, correct insignificant operational failures under a qualified plan, a 403(b) plan, a SEP, or a SIMPLE IRA plan provided that the SEP or SIMPLE IRA plan is established and maintained on a document approved by the IRS. In addition, for a 403(b) plan or a qualified plan that is the subject of a favorable determination letter from the IRS, the plan sponsor generally may correct even significant operational failures without fees or sanctions.

The plan sponsor or administrator of a plan must have established practices and procedures reasonably designed to promote and facilitate overall compliance with applicable Code requirements in order to be eligible for SCP. For example, the plan administrator of a qualified plan that may be top-heavy under IRC §416 may include in its plan's operating manual a specific annual step to determine whether the plan is top-heavy and, if so, to ensure that the minimum contribution requirements of the top-heavy rules are satisfied. A plan document alone does not constitute evidence of established procedures.

In order for a plan sponsor or administrator to use SCP, these established procedures must be in place and routinely followed, and an operational failure must have occurred through an oversight or mistake in applying them. In addition, SCP may also be used in situations in which the operational failure occurred because the procedures that were in place, while reasonable, were not sufficient to prevent the occurrence of the failure.

[19] Treas. Reg. §1.401(a)(4)-11(g).

SCP is not available to correct operational failures that are egregious. Egregious failures include:

- A plan that consistently and improperly covers only highly-compensated employees,
- A plan that provides more favorable benefits for an employer's owner based on a purported collective bargaining agreement in which there has in fact been no good-faith bargaining between employee representatives and the employer, or
- A defined contribution plan in which a contribution is made on behalf of a highly-compensated employee that is several times greater than the dollar limit set forth in §415(c).

Significant operational failures may be corrected within two years of the end of the plan year in which the operational failures occurred. Operational failures which are insignificant, in the aggregate, may be corrected after the 2-year window has passed. Factors considered in determining whether or not an operational failure under a plan is insignificant include, but are not limited to the following:

- Whether other failures occurred during the period being examined (for this purpose, a failure is not considered to have occurred more than once merely because more than one participant is affected by the failure)
- The percentage of plan assets and contributions involved in the failure
- The number of years the failure occurred
- The number of participants affected relative to the total number of participants in the plan
- The number of participants affected as a result of the failure relative to the number of participants who could have been affected by the failure
- Whether the correction was made within a reasonable time after discovery of the failure
- The reason for the failure (for example, data errors such as errors in the transcription of data, the transposition of numbers, or minor arithmetic errors)

Example 14. Benchwarmer Co. maintains a money-purchase pension plan established in 1992. The plan document satisfies the requirements of IRC §401(a). The formula under the plan provides for an employer contribution equal to 10% of compensation, as defined in the plan. During its examination of the plan for the 2007 plan year, the IRS discovered that the employee responsible for entering data into the employer's computer made minor arithmetic errors in transcribing the compensation data for six of the plan's 40 participants, resulting in excess allocations to those six participants' accounts.

Under these facts, the number of participants affected by the failure relative to the number of participants that could have been affected is insignificant, and the failure is due to minor data errors. Thus, the failure occurring in 2007 would be insignificant and therefore eligible for correction under SCP.

9

Note. If a plan is under examination, insignificant operational failures can be corrected under SCP. If correction of significant operational failures was substantially completed before the examination started, correction of those failures can be completed under SCP.

The plan sponsor using SCP should maintain adequate records to demonstrate correction in the event of a plan audit.

VOLUNTARY CORRECTION PROGRAM

VCP provides general procedures for correcting all qualification failures: operational, plan document, demographic, and employer eligibility. VCP also provides general procedures for correcting participant loans that did not comply with the requirements of §72(p)(2).

To use VCP, a plan sponsor must pay a compliance fee and receive IRS approval, in the form of a **compliance statement,** for correcting a qualified plan, 403(b) plan, SEP, or SIMPLE IRA plan. Appendixes D and F of Rev. Proc. 2008-50 provide information to help the applicant satisfy the VCP submission requirements, which vary depending on the type of plan involved and the failures needing to be corrected.

The fee schedule is as follows:

Number of Participants	Fee
20 or fewer	$ 750
21 to 50	1,000
51 to 100	2,500
101 to 500	5,000
501 to 1,000	8,000
1,001 to 5,000	15,000
5,001 to 10,000	20,000
Over 10,000	25,000

If the IRS determines that a VCP submission is seriously deficient or that the application of VCP would be inappropriate or impracticable, the IRS may return the submission without contacting the plan sponsor. If no substantive processing of the case occurred, the IRS refunds the compliance fee submitted with the request.

An IRS representative generally contacts the plan sponsor or a representative if additional information is required to process a submission. The plan sponsor has 21 calendar days from the date of this contact to provide the requested information. If the information is not received within 21 days, the matter is closed, the compliance fee is not returned, and the case may be referred for examination. Any request for an extension of the 21-day time period must be made in writing within the 21-day time period and must be approved by the IRS.

In a situation in which the IRS initially determines that it cannot issue a compliance statement because the parties cannot agree upon correction or a change in administrative procedures, the plan sponsor is contacted by an IRS representative and offered a conference with the IRS. The conference can be held either in person or by telephone and must be held within 21 calendar days of the date of contact. The plan sponsor has 21 calendar days after the date of the conference to submit additional information in support of the submission. Any request for an extension of the 21-day time period must be made in writing within the 21-day time period and must be approved by the IRS. Additional conferences may be held at the IRS's discretion.

If the IRS and the plan sponsor cannot reach agreement about the submission, the matter is closed, the compliance fee is not returned, and the case may be referred to Employee Plans Examinations.

If agreement is reached, the IRS sends the plan sponsor a compliance statement specifying the corrective action required. If the original submission is materially modified, the plan sponsor is required to sign the compliance statement. In such cases, the IRS sends the plan sponsor an unsigned compliance statement specifying the corrective action required. Within 30 calendar days of the date that the compliance statement is sent, the plan sponsor must sign the compliance statement and return it and any required compliance fee. The IRS then issues a signed copy of the compliance statement to the plan sponsor. If the plan sponsor does not sign and send the compliance statement to the IRS (with a compliance fee, if applicable) within 30 calendar days, the plan may be referred to Employee Plans Examinations.

The plan sponsor must implement the specific corrections and administrative changes set forth in the compliance statement within 150 days of the date of the compliance statement. Any request for an extension of this time period must be made in writing prior to the expiration of the correction period and must be approved by the IRS.

An anonymous submission procedure permits submission of qualified plans, 403(b) plans, SEPs, and SIMPLE IRA plans under VCP without initially identifying the applicable plan, the plan sponsor, or the organization. Once the IRS and the plan representative reach agreement about the submission, the IRS contacts the plan representative in writing to indicate the terms of the agreement. The plan sponsor has 21 calendar days from the date of the letter of agreement to identify the plan and plan sponsor. If the plan sponsor does not submit the identifying material within 21 calendar days of the letter of agreement, the matter is closed and the compliance fee is not returned.

AUDIT CLOSING AGREEMENT PROGRAM

An audit closing agreement program (Audit CAP) is available for qualified plans, 403(b) plans, SEPs, and SIMPLE IRA plans for correcting all qualification failures found on examination that were not corrected in accordance with SCP or VCP. Audit CAP also provides general procedures for the correction of participant loans that did not comply with all applicable requirements.[20]

Under this program, the plan sponsor pays a reasonable fee that is based on an amount directly related to the amount of tax benefits preserved. The imposed fee bears a reasonable relationship to the nature, extent, and severity of the failure, taking into account the extent to which correction occurred before the audit.[21]

Generally, under the Audit CAP:

- The plan sponsor or plan is **under examination.**
- The plan sponsor enters into a closing agreement with the IRS.
- The plan sponsor effects correction prior to entering into the closing agreement.
- The plan sponsor pays a fee negotiated with the IRS.
- For plans intended to be qualified, the fee under Audit CAP is a negotiated percentage of the maximum payment amount, which is the approximate amount of tax the IRS could collect if the plan was disqualified.

9

20. See IRC §72(p)(2).

21. Rev. Proc. 2008-50, IRB 2008-35 (Sep. 2, 2008).

401(k) FIX-IT GUIDE

The IRS provides the following chart, which lists the most common errors found in 401(k) plans. This chart can be found at **www.irs.gov/pub/irs-tege/401k_fixit_guide_printer.pdf.**

--------Trends--------	----------Tips----------			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
1) Has your plan document been updated within the past few years to reflect recent law changes? (More)	Review annual cumulative list published close to year-end to see if plan made all required law changes (e.g., Notice 2008-108). (More)	EPCRS Adopt amendments for missed law changes. Appendix D, Part II (More)	VCP Audit CAP (More)	Resort to a calendar (tickler) that notes when you must complete amendments. Review your plan document annually. Maintain regular contact with the company that sold you the plan. (More)
2) Are the plan's operations based on the terms of the plan document? Failure to follow plan terms is a very common mistake. (More)	Independent review of plan and its operation. (More)	EPCRS Apply reasonable correction method that would place affected participants in the position they would have been in if there were no operational plan defects. (More)	SCP* VCP Audit CAP (More)	Plan sponsors need to develop a communication mechanism to make all relevant parties aware of changes on a timely and accurate basis (best practices). Due diligence on at least an annual basis to ensure plan terms are being followed. (More)
3) Is the plan's definition of compensation for all deferrals and allocations used correctly? (More)	Review the plan document. (More)	EPCRS Corrective contribution or distribution. (More)	SCP* VCP Audit CAP (More)	Perform annual reviews of compensation definitions and ensure that person in charge of determining compensation is properly trained to understand the plan document. (More)
4) Were employer matching contributions made to all appropriate employees under the terms of the plan? (More)	Review the plan document to determine the correct matching contribution formula and compare to what is used in operation. (More)	EPCRS Base correction upon the terms of the plan and other applicable information at the time of the mistake. (More)	SCP* VCP Audit CAP (More)	Contact plan administrators to ensure that they have adequate and sufficient employment and payroll records to make calculations. (More)
5) Has your plan satisfied the nondiscrimination tests (ADP and ACP)? (More)	Independent review to determine if highly compensated and nonhighly compensated employees are properly classified. (More)	EPCRS Correction method for ADP/ACP test failures: Make qualified nonelective contributions (QNECs) on behalf of the nonhighly compensated employees Appendix B (section 2.01) One-to-one correction method. (More)	SCP* VCP Audit CAP (More)	Consider a safe harbor plan. Communicate with plan administrator to ensure proper employee classification. Ensure both you and the plan administrators are familiar with the terms of the plan. (More)

IRS 401(k) Fix-It Guide *(continued)*

--------Trends--------	------------------------------------Tips------------------------------------			
Potential Mistake	**How to Find the Mistake**	**How to Fix the Mistake**		**How to Avoid the Mistake**
		Corrective Action	**Correction Program(s) Available**	
6) Were all eligible employees identified and given the opportunity to make an elective deferral election (exclusion of eligible employees)? (More)	Review plan document sections on eligibility and participation. Check with plan administrators to find out when employees are entering the plan. (More)	EPCRS 6.02(7), Appendix A (section .05), Appendix B (section 2.02) Employer must make a qualified nonelective contribution (QNEC) to the plan on behalf of the employee that compensates for the missed deferral opportunity. (More)	SCP* VCP Audit CAP (More)	Plan sponsors need to monitor census information and apply participation requirements. (More)
7) Are elective deferrals limited to the amounts under IRC §402(g) for the calendar year and have any excess deferrals been distributed? (More)	Inspect deferral amounts for plan participants to ensure that the employee has not exceeded the limits. (More)	EPCRS Appendix A (section .04) Distribute excess deferrals. (More)	SCP* VCP Audit CAP (More)	Employers should work with plan administrators to ensure that the administrators have sufficient payroll information to verify that the deferral limitations of §402(g) were satisfied. (More)
8) Have you timely deposited employee elective deferrals? (More)	Determine the earliest date you can segregate deferrals from general assets; compare that date with the actual deposit dates and any plan document requirements. (More)	Usually DOL through VFCP for prohibited transaction. May also be EPCRS. For both VFCP and EPCRS, deposit into the plan's trust all elective deferrals withheld and applicable earnings resulting from the late deposit of amounts to the trust. (More)	SCP* VCP Audit CAP (More)	Close coordination with payroll provider to determine the earliest date the deferral deposits can reasonably be segregated from general assets and then set up procedures to ensure you make deposits by that date. (More)
9) If the plan was top-heavy, were the required minimum contributions made to the plan? (More)	Review the rules and definitions for top-heavy found in your plan document. Make a determination whether your plan is top-heavy or not for each plan year. (More)	EPCRS Appendix A (section .02) Properly contribute and allocate the required top-heavy minimum, adjusted for earnings, to the affected non-key employees. (More)	SCP* VCP Audit CAP (More)	Perform a top-heavy test each year. (More)
10) Were hardship distributions made properly? (More)	Review all in-service distributions and determine that hardship distributions met the requirements of the plan. (More)	EPCRS Appendix B (section 2.07). Amend plan retroactively to allow for hardship distributions. If impermissible hardship distribution, have participant return hardship distribution amount plus earnings. (More)	SCP* VCP Audit CAP (More)	Employers should be familiar with the hardship provisions included in their plan document and implement procedures to ensure that the provisions are followed in operation. Employers need to ensure that the plan administrators and payroll offices share information regarding hardship distributions that are made from the plan. (More)

9

IRS 401(k) Fix-It Guide *(continued)*

--------Trends--------	----------Tips----------			
Potential Mistake	**How to Find the Mistake**	**How to Fix the Mistake**		**How to Avoid the Mistake**
		Corrective Action	**Correction Program(s) Available**	
11) Have you filed a Form 5500 series return and have you distributed a Summary Annual Report (SAR) to all plan participants this year? (More)	Find your signed copy of the return and determine if you filed it timely. (More)	File all delinquent returns. (More)	For Form 5500 filers, see DFVC→ DOL web site Form 5500-EZ filers must file and ask for abatement of penalties. (More)	Understand your filing requirement and know who filed and when. Don't assume someone is taking care of it for you. (More) See 401(k) Resource Guide - Plan Sponsors - Filing Requirements

*** In order to utilize SCP, the plan sponsor must have established practices and procedures reasonably designed to promote and facilitate overall compliance with applicable Internal Revenue Code requirements. Also, an analysis of whether mistakes in the aggregate are significant or insignificant needs to be made. If insignificant, correction generally can be made at any time. However, if the mistakes are significant in the aggregate, then the plan sponsor only has two years following the year in which the mistake occurred to correct under SCP.**

SEP PLAN FIX-IT GUIDE

The IRS provides the following chart, which lists the most common errors found in SEP plans. This chart can be found at **www.irs.gov/pub/irs-tege/sep_fixit_guide.pdf.**

---------Trends-------	------------------------------------Tips---			
Potential Mistake	**How to Find the Mistake**	**How to Fix the Mistake**		**How to Avoid the Mistake**
		Corrective Action	**Correction Program(s) Available**	
1) Has your SEP been amended for current law? (More)	Determine if your Form 5305-SEP is the current revision (December 2004). (More)	EPCRS Adopt revised Form 5305-SEP. (More)	VCP Audit CAP (More)	Maintain regular contact with the company that sold you the plan. (More)
2) Are all eligible employees participating in the SEP? (More)	Review the section of your plan document concerning eligibility and participation. Check when employees are entering the plan. (More)	EPCRS Apply reasonable correction method that would place affected employees in the position they would have been in if there were no operational plan mistakes. (More)	SCP* VCP Audit CAP (More)	You should review the participation status of all employees at least once a year. (More)
3) Is the business that the SEP covers the only business that you own? (More)	You should identify any companies that you own or with which you have a financial relationship. (More)	EPCRS Corrective contribution. (More)	SCP* VCP Audit CAP (More)	Determine if you own any other businesses. (More)
4) Are you determining each eligible employee's compensation using the definition in your SEP document? (More)	To determine if you are using the proper compensation for allocations, you'll need to review the plan document. (More)	EPCRS Correction is based upon the terms of the plan and other applicable information at the time of the mistake. (More)	SCP* VCP Audit CAP (More)	When calculating allocations, it is important for you to carefully review the plan terms to ensure that the correct amount of compensation is being considered. (More)
5) Are SEP contributions to each employee's IRA limited as required by the Internal Revenue Code (Code)? (More)	Calculate 25% of each employee's compensation and compare the total contribution made for the employee to the lesser of that amount or the dollar limitation for that year ($49,000 in 2009). (More)	EPCRS Correction for a failure to limit contributions allocated to employees is to either distribute or retain the excess amount. (More)	SCP* VCP Audit CAP (More)	After the initial calculation of allocations based on the terms of the plan, you should check to make sure none of the proposed allocations would violate the Code. (More)

*** In order to utilize SCP, you must have established practices and procedures reasonably designed to promote and facilitate overall compliance with applicable Internal Revenue Code requirements. Also, an analysis of whether mistakes in the aggregate are significant or insignificant needs to be made. If insignificant, correction generally can be made at any time. However, if the mistakes are significant in the aggregate, then you must use VCP to correct the mistake.**

9

SIMPLE IRA FIX-IT GUIDE

The IRS provides the following chart, which lists the most common errors found in SIMPLE IRA plans. This chart can be found at **www.irs.gov/pub/irs-tege/simple_fixit_guide.pdf.**

------Trends--------	----------Tips----------			
Potential Mistake	**How to Find the Mistake**	**How to Fix the Mistake**		**How to Avoid the Mistake**
		Corrective Action	**Correction Program(s) Available**	
1) Do you have more than 100 employees who earned at least $5,000 in compensation for the prior year? (More)	Review prior year's compensation data (from payroll records, W-2s, quarterly filings with the state) and determine if there were more than 100 employees who earned $5,000 or more in compensation during the previous year. (More)	EPCRS If the number of employees is in excess of 100, you must cease contributions to the SIMPLE IRA. You cannot make any new contributions, either from the employer or from the employee, to the SIMPLE IRA plan as long as the number of employees remains in excess of 100. (More)	VCP Audit CAP (More)	Prior to establishing a SIMPLE IRA plan, determine whether you are eligible to have a SIMPLE IRA plan. Do you have more than 100 employees? Are you a member of a controlled group or affiliated service group? (More)
2) Do you sponsor a SIMPLE IRA plan and also maintain another retirement plan? (More)	Determine whether any employee received an allocation of contributions or accrued a benefit in another qualified plan that you sponsored for any part of the calendar year. (More)	EPCRS If you maintain other retirement plans, you must cease all contributions to the SIMPLE IRA plan. (More)	VCP Audit CAP (More)	Verify that you and any members of a controlled group or affiliated service group of which you are a member do not maintain another qualified retirement plan. (More)
3) Does the plan document reflect the recent SIMPLE IRA law changes? (More)	Review the plan document and compare to the most recent IRS Model plan (Form 5304-SIMPLE, 5305-SIMPLE) or IRS approved SIMPLE IRA plan prototype, whichever is applicable. (More)	EPCRS Adopt a current IRS Model plan or IRS approved SIMPLE IRA prototype. (More)	VCP Audit CAP (More)	Make sure that the SIMPLE IRA plan document is the most current IRS Model plan or IRS approved SIMPLE IRA plan prototype, whichever is applicable. Monitor the IRS web site for IRS guidance on SIMPLE IRA plans. (More)
4) Were all eligible employees allowed to participate according to the SIMPLE IRA plan's eligibility requirements? (More)	Review plan document sections to understand the eligibility provisions. Review past payroll information. (More)	EPCRS If you have excluded eligible employees from the plan, you must contribute: (a) an amount that compensates the employee for the "missed deferral opportunity" and (b) an amount equal to the employer contribution required under the plan. (More)	SCP* VCP Audit CAP (More)	Establish plan administrative procedures that include a review of employees' census data each year to determine the employees that are eligible to participate in the SIMPLE IRA plan. (More)

SIMPLE IRA Fix-It Guide *(continued)*

------Trends--------	----------Tips----------			
Potential Mistake	**How to Find the Mistake**	**How to Fix the Mistake**		**How to Avoid the Mistake**
		Corrective Action	**Correction Program(s) Available**	
5) Were correct employer contributions made on behalf of the eligible employees? (More)	Review plan document provisions relating to employer contributions and compare to actual contributions. (More)	EPCRS Determine the correct employer contribution based on the selected option in the plan. (More)	SCP* VCP Audit CAP (More)	Establish plan administrative procedures to ensure that you make the correct employer contributions to the employees' SIMPLE IRAs. (More)
6) Is the plan's definition of compensation for all deferrals and allocations used correctly? (More)	Review employee compensation data. (More)	EPCRS You must contribute an amount equal to (a) 50% of the employee's deferral percentage under the plan times the excluded compensation and (b) the employer contribution required under the plan times the excluded compensation. Adjust the amounts contributed for earnings. (More)	SCP* VCP Audit CAP (More)	Establish plan administrative procedures that require an annual review of employees' compensation. (More)
7) Were employee salary deferral contributions timely deposited to employees' SIMPLE IRAs after withholding from the employees' salary? (More)	Review the date on which you withheld the salary deferral contributions from the employees' salary and compare with the date on which you contributed the salary deferral contributions to the employees' SIMPLE IRA accounts. (More)	EPCRS Make a contribution on behalf of each employee equal to the earnings for the period you did not deposit the employee contributions in the employees' accounts. (More)	SCP* VCP Audit CAP DOL (Voluntary Fiduciary Correction Program) (More)	Establish plan administrative procedures to ensure that you make employees' salary deferral contributions to the employees' SIMPLE IRAs timely. (More)
8) Were employer contributions made timely to the employees' SIMPLE IRAs? (More)	Review employee data, payroll remittances, and other applicable records. (More)	EPCRS You must make a contribution on behalf of each participant. (More)	SCP* VCP Audit CAP (More)	Review the SIMPLE IRA plan rules concerning the timing of employer contributions and adopt administrative procedures to implement proper timing. (More)
9) Have all SIMPLE IRA plan notification requirements been satisfied? (More)	Review the SIMPLE IRA plan notification requirements and verify you have followed them. (More)	EPCRS Correct the plan administrative procedures to ensure that you meet the notice requirement for future years. (More)	SCP* VCP Audit CAP (More)	Establish plan administrative procedures to alert you of the timing of the notice requirements. (More)

9

SIMPLE IRA Fix-It Guide *(continued)*

------Trends--------	---------------Tips---------------			
Potential Mistake	**How to Find the Mistake**	**How to Fix the Mistake**		**How to Avoid the Mistake**
		Corrective Action	**Correction Program(s) Available**	
10) Did you make employer contributions to all eligible employees whether or not they terminated during the plan year? (More)	Review employee payroll data. (More)	EPCRS Make an employer contribution for all eligible employees whether or not they terminated employment during the plan year. (More)	SCP* VCP Audit CAP (More)	Review the SIMPLE IRA plan rules concerning employer contributions. Establish administrative procedures that include listing all eligible employees for each plan year. (More)

*** In order to utilize SCP, the plan sponsor must have established practices and procedures reasonably designed to promote and facilitate overall compliance with applicable Internal Revenue Code requirements. Also, an analysis of whether mistakes in the aggregate are significant or insignificant needs to be made. If insignificant, correction generally can be made at any time. However, if the mistakes are significant in the aggregate, then you must use VCP to correct the mistake.**

2009 CONTRIBUTION LIMITS

DEFINED-BENEFIT PLANS

For 2009, the maximum annual benefit for a participant under a defined-benefit plan is the lesser of:

- $195,000, or
- $100% of the participant's average compensation for the highest three consecutive calendar years.

DEFINED-CONTRIBUTION PLANS

For 2009, an employee covered by a 401(k), 457, 403(b), SARSEP, or Thrift Savings Plan who is under age 50 may elect to contribute up to a maximum of $16,500 to the plan. An employee age 50 or over can elect an additional $5,500 catch-up contribution for a total of $22,000.

§401(k) Plans

For 2009, the maximum compensation that can be factored into the equation used for computing contributions and benefits is $245,000 per employee; the maximum addition to an employee's 401(k) account (by both the employee and employer) is the lesser of $49,000 or 100% of compensation.

For employers, the 2009 maximum deductible amount is 25% of each employee's wages. If more than 25% of an employee's wages is contributed to the plan, the employer may carry over the excess and deduct it in subsequent years, always subject to 25% of the wages for that year.

§457 Plans

In 2009, employees of state or local government agencies covered by a §457 plan may defer up to the lesser of $16,500 ($22,000 if age 50 or older) or 100% of compensation. This limitation is the sum of employee deferrals **plus** employer contributions. This dollar amount is **in addition** to any other contributions made to other types of retirement plans.

Example 15. Sasha is 40 years old and employed by the state of Illinois. Sasha earns $60,000 per year. She participates in a §457 plan as well as a §403(b) plan. Sasha may defer up to $16,500 through her participation in a §457 plan. She may also contribute up to $16,500 by participating in a §403(b) plan.

Catch-Up Provision. There is a special catch-up amount available to §457 plans. An eligible plan may provide that, for one or more of the employee's last three tax years ending before the employee attains the plan's normal retirement age, the plan ceiling is an amount not exceeding the lesser of:

- Twice the applicable dollar amount in effect for that tax year, or
- The sum of the plan ceiling for the tax year **plus** the excess of the plan ceiling for **any** prior year or years over the amount that was actually contributed for the prior year or years.

Participants utilizing the special catch-up provision for employees in the last three years before retirement are not also allowed the additional $5,500 catch-up amount for employees age 50 or older.[22]

Example 16. Drew is age 64 in 2009. He is employed by the state of Illinois and qualifies for the special catch-up provision for §457 plans. For 2009, he can contribute the **lesser** of:

- Twice the amount of the deferral limit ($16,500 × 2 = $33,000), or
- Sum of the plan ceiling for the tax year ($16,500) plus any plan ceiling not used in prior years.

Drew contributed the full amount up to the plan ceiling into his §457 plan for every year except 2007 and 2008. He made the following contributions during the last three years:

	2007	2008	2009
§457 plan ceiling	$15,500	$15,500	$16,500
Actual contribution	(14,500)	(5,000)	(16,500)
Unused limit	$ 1,000	$10,500	$ 0

Drew's special catch-up contribution for 2009 is a maximum of $28,000 ($1,000 + $10,500 + $16,500). This is greater than the otherwise applicable maximum contribution amount of $22,000 available to employees over age 50 because he is in the last three years before normal retirement age.

A taxpayer who participates in a §457 plan is **not** treated as an active participant in a qualified retirement plan for purposes of the rules pertaining to deducting contributions to an IRA.

22. IRC §§414(v)(6)(C) and 457(e)(18).

§403(b) Plans

The maximum contribution to a §403(b) plan for 2009 is $16,500, with an additional $5,500 contribution available for taxpayers who are age 50 or older. However, the deferral limit for a §403(b) plan must be aggregated with the deferral limit allowed for a §401(k) plan to arrive at the total allowed for an individual during the calendar year.

Special Tax-Sheltered Annuities (TSA) Catch-Up for Certain Organizations. Special catch-up rules apply for qualified employees of the following qualified organizations:

- Educational organizations
- Hospitals
- Health and welfare service agencies
- Church-related organizations
- Tax-exempt organizations controlled by or associated with a church or a convention or association of churches

A qualified employee is an employee who has completed at least 15 years of service with a qualified organization. For qualified employees, the elective deferral limitation is increased by the lesser of:

- $3,000,
- $15,000 less the total special TSA catch-up elective deferrals made for the qualified employee by the qualified organization for prior years, or
- $5,000 multiplied by the number of years of service with the qualified organization minus the total elective deferrals made for the employee by the organization for prior years.[23]

When an employee is eligible for both the age 50 and the special TSA catch-ups, the contributed amount is first attributed to the special TSA catch-up and then to the age 50 catch-up.[24]

IRAs

Individuals under age 70½ can contribute up to the lesser of their compensation or the applicable annual dollar limit to an IRA, which is $5,000 for 2009. In the case of a married couple filing a joint return, the taxpayers are allowed to use either spouse's compensation in order to contribute to the IRA. Thus, an IRA may be funded for both husband and wife, even if only one spouse had compensation for the year.

Individuals who are age 50 or older by the end of the year may make additional catch-up contributions. For 2009, this IRA catch-up provision is $1,000, for a total of $6,000.

Traditional IRAs. Contributions to a traditional IRA are fully deductible if the taxpayer and the taxpayer's spouse are not active participants in an employer-sponsored retirement plan and are not age 70½ by the end of the tax year. The deductible contribution is reduced if the taxpayer is an active participant in an employer-sponsored plan and if the taxpayer's modified adjusted gross income (MAGI) falls within certain ranges based on the taxpayer's filing status.[25]

Taxpayer Covered by Employer's Plan	MAGI Phaseout Range
Married filing jointly (MFJ), qualifying widow(er) (QW)	$89,000–109,000
Single or head of household (HoH)	55,000–65,000
Married filing separately (MFS)	0–10,000

23. Treas. Reg. §1.403(b)-4(c)(3)(i).

24. Treas. Reg. §1.403(b)-4(c)(3)(iv).

25. See Pub. 590, *Individual Retirement Arrangements*, for calculation of MAGI.

If a couple uses the MFJ filing status and only one of the spouses is eligible to participate in an employer's qualified retirement plan, deductible contributions are limited for the noncovered spouse if the MAGI of the tax return exceeds $166,000.

Taxpayer Covered by Employer's Plan	MAGI Phaseout Range
Married filing jointly: one spouse not covered	$166,000–176,000

Roth IRAs. Contributions to a Roth IRA are based upon filing status and MAGI of the taxpayer, as shown in the following table:

	MAGI		
Filing Status	**Full Contribution Allowed**	**Contribution Limit Reduced**	**No Contribution Allowed**
MFS (lived with spouse)	N/A	Greater than $0 but less than $10,000	$10,000 or more
Single, HoH, MFS (did not live with spouse)	Less than $105,000	At least $105,000 but less than $120,000	$120,000 or more
MFJ, QW	Less than $166,000	At least $166,000 but less than $176,000	$176,000 or more

STRETCHING INHERITED IRAs[26]

IMPORTANCE OF STRETCH PLANNING FOR INHERITED IRAs

What Is "Stretch Planning"?

A stretch IRA is not a particular type of IRA. Rather, stretch, as used in connection with an IRA or other retirement plan, refers to a planning strategy. This planning strategy involves delaying withdrawal of assets from the IRA or retirement plan for the longest period of time allowed by the tax law. The goal of the stretch period is to obtain maximum wealth accumulation on the retirement account. Proper naming of the beneficiary who will receive the IRA proceeds at the account owner's death controls whether the maximum stretch period is obtained.

As used in this chapter, an inherited IRA or inherited retirement account simply means any retirement account that is payable after the account owner's death. There is some confusion in the terminology used in this area of tax law. Certain articles and books on the subject of handling retirement accounts after death distinguish an inherited IRA from a surviving spouse's right to roll over a deceased spouse's IRA into the surviving spouse's own IRA.[27]

Wealth Accumulation Advantages

During the stretch period, the underlying assets in the IRA or retirement account can accumulate without being subject to income taxation. In essence, the growth accrues on money that would otherwise be paid in income taxes.

26. The author acknowledges the following helpful works writing about distributions from IRAs: Choate, Natalie, *Life and Death Planning for Retirement Benefits* (6th ed., Ataxplan Publications, 2006); Trytten, Steven E., *Estate Planning for Retirement Assets: Where Are We Now?* (National Law Foundation, 2005); and Siegel, Steven G., *Retirement Plan Distributions To Trusts: How To Make Them Work* (National Law Foundation, 2007).

27. IRC §408(d)(3)(C)(ii).

The compound growth in a tax-deferred account can yield significantly greater wealth compared to simply taking a lump-sum distribution. A lump-sum distribution is immediately subject to income taxation, and the income earned on the lump sum incurs taxation in the future. While some may conclude that incurring income taxation earlier as opposed to incurring income taxation later is really no big deal, case study illustrations prove otherwise.

Attorney and author Steven E. Trytten prepared elaborate case studies showing that at least a 70% increase in wealth accumulation can be achieved by electing deferral rather than a lump-sum distribution at death. The case studies use calculations that compare deferral to lump sum on an "apples to apples" approach.[28] Natalie Choate, the preeminent writer on retirement distributions, illustrates the dramatic wealth accumulation possible with an example of a nonspouse individual age 38 who is the sole beneficiary of a $500,000 IRA. After 30 years (assuming an 8% yearly return and a tax rate of 39.6% on all income), the difference between a lump-sum distribution to the beneficiary and deferral with only required minimum distributions (RMDs) can be summarized as follows:

Value after 30 Years	Lump-Sum Received at Death Reinvested	Stretch RMD 30 Years Reinvested
Outside IRA	$1,517,000	$1,696,000
Inside IRA		1,432,000
Total	$1,517,000	$3,128,000[29]

WHY THE RULES ARE IMPORTANT

Taxes Involved

IRAs are complicated because three different types of taxes are **potentially** involved:

1. Income tax both during the life and after the death of the account owner, because the IRA is considered income in respect of a decedent;
2. Federal estate tax inclusion as an asset of the account owner; and
3. Excise taxes for failure to withdraw RMD amounts during the account owner's life and after his death.

This section focuses primarily on the rules that apply to after-death income tax consequences of IRAs. It is important to understand the rules and techniques that are available in order to achieve the greatest deferral allowed under the RMD rules.

IRA Cannot Continue Indefinitely

Retirement accounts are granted significant tax advantages in allowing tax deductible contributions and tax-deferred earnings on the retirement account balance. Nevertheless, Congress in enacting IRC §401(a)(9) determined a retirement account is not allowed to exist indefinitely.[30] The RMD rules were enacted to mandate that IRA or other retirement accounts be withdrawn over certain maximum time periods both during the life and after the account owner's death.

50% Penalty for Failure to Withdraw RMD

As mentioned earlier in this chapter, Congress provided that a 50% penalty is imposed on the amount representing the difference between the actual distribution and the RMD amount in order to ensure compliance with the RMD rules.[31]

28. Trytten, Steven E., *Estate Planning for Retirement Assets: Where Are We Now?,* pp. 26–28 (National Law Foundation, 2005).
29. Choate, Natalie, *Life and Death Planning for Retirement Benefits,* p. 28 (6th ed., Ataxplan Publications, 2006).
30. IRS Pub. 590, *Individual Retirement Arrangements.*
31. IRC §4974.

Exception from Immediate Recognition at Death

A traditional IRA is considered income in respect of a decedent (IRD). For income tax purposes, this means there is no step-up in basis for the IRA at the account owner's death. This further means the recipient of the IRA is taxed on withdrawals in substantially the same manner as the deceased account owner would have been taxed.

The Code provides an income tax recognition advantage to an IRA that underlies all the tax rules on stretch planning. Under IRC §691(a)(2), there is **no** automatic acceleration of the recognition of IRD upon the account owner's death or any successor beneficiary of the IRA. There is no constructive receipt doctrine applied to the beneficiary for having the right to withdraw the IRA but choosing to delay withdrawal. Instead, IRC §691(a)(2) clearly authorizes the beneficiary of an IRA to continue to defer recognition for income tax purposes after the death of the account owner until the beneficiary either:

- Voluntarily takes a distribution from the IRA, or
- Is forced to take a distribution under the RMD rules.

After the account owner's death, inherited IRA transfers to successor beneficiaries can be made over the stretch period without triggering taxable income at the time of the transfer.

Beneficiaries' Opportunity for Maximum Deferral

Even with stock market declines, many taxpayers have significant account balances in retirement plans. Most retired employees roll over employer-sponsored retirement account balances to the retired employee's own IRA. In many cases, beneficiaries who receive a deceased account owner's IRA expect to have the opportunity to defer recognition of income to the maximum extent allowed under the RMD rules.

COMPLEXITY OF THE RULES

General Rules

Unfortunately, the rules governing IRA and retirement plan distributions after the account owner's death are complex and confusing. Every rule seems to have at least one exception. The final IRS regulations issued in 2002 changed what appeared to be tax rules set forth in the Code.[32]

Thus far, the IRS has not issued many revenue rulings in this area of tax law. Instead, the tax practitioner is left with private letter rulings as the sole IRS guidance on various RMD issues. Private letter rulings are not precedent and may only be relied upon by the taxpayer who requested the ruling.[33] Nevertheless, private letter rulings represent the available guidance for dealing with RMD rules, particularly when trusts are named as beneficiaries.

Conflict Between Income Tax Planning and Estate Planning

The income tax rules for IRAs received after the account owner's death conflict with the tactics of many typical estate-planning arrangements. The IRA's required minimum distribution rules tend to promote outright distributions to individuals as the cleanest way to obtain maximum stretch treatment for the IRA. For estate-planning purposes, many clients wish to retain "dead-hand" control over assets by creating trust arrangements. Married taxpayers with assets exceeding the estate-tax exemption create marital trust and bypass trust arrangements to minimize estate taxes of both spouses by taking full advantage of each spouse's estate-tax exemption amount. Instead of making outright gifts, many other taxpayers use trusts to control the distribution of property to children and grandchildren. As discussed later, any time a trust receives IRA benefits, the rules for complying with the RMD rules become complicated.

32. Choate, Natalie, *Life and Death Planning for Retirement Benefits,* p. 31 (6th ed., Ataxplan Publications, 2006).

33. IRC §6110(k)(3).

Planning in Advance Versus Reacting after Death

Fortunately, the tax rules offer some flexibility to cure a beneficiary designation that fails to qualify for stretch treatment under the RMD rules. The three most common techniques used to cure a faulty beneficiary designation are:

1. "Cash out by September 30 after death" rule;[34]
2. "Separate accounts by December 31 after death" rule (does not apply to trusts);[35] and
3. "Disclaimer within nine months of death" rule.[36]

While these after-death techniques may preserve stretch-planning opportunities for some IRAs, many beneficiary designations simply cannot be fixed by after-death actions. The tax practitioner should consider advising clients with significant IRA balances to review beneficiary designations. Careful lifetime planning to properly name primary beneficiaries and secondary beneficiaries can achieve maximum deferral. The IRS does not allow the beneficiary designation to be rewritten in an attempt to add a qualifying beneficiary after the account owner's death.[37]

Note. The three techniques are discussed in detail later in this chapter.

RELATIONSHIP OF BENEFICIARY AND LIFETIME RMD RULES

With only a few exceptions, the RMD that a beneficiary designated by an IRA account owner receives after the account owner's death has **no** relationship to the lifetime RMD rules. The RMD tax rules for an IRA during an account owner's life are considerably easier to understand than the RMD tax rules for an IRA after the account owner's death.

While an account owner is living, RMDs in yearly installments must generally begin when the account owner reaches age 70½. The IRS publishes the "Uniform Lifetime Table" to be used by nearly all account owners during their lifetimes to compute the yearly RMD amounts.[38] There is a special rule that applies to the required distribution to the account owner for the first year after attaining age 70½. An election can be made to delay the first-year distribution until April 1 of the year following the date on which the account owner reaches age 70½.

Example 17. Travis will reach age 70½ on August 1, 2010. By April 1, 2011, Travis must take an RMD from his IRA which is equal to his IRA account balance as of December 31, 2009 (year before reaching age 70½) divided by 27.4 (the applicable distribution period from the Uniform Lifetime Table). Before December 31, 2011, he must also take an RMD for the 2011 calendar year, which is computed by dividing his IRA account balance as of December 31, 2010, by 26.5 (again, from the Uniform Lifetime Table). This calculation must be made yearly to determine the RMD amounts during Travis's lifetime, regardless of who Travis has named as the plan beneficiary on his death (with the exception noted below).

EXCEPTION

If the account owner names his spouse as the **sole** beneficiary of the IRA and the surviving spouse is more than 10 years younger than the account owner, the account owner can use an even more favorable distribution table called the Joint and Last Survivor Table for determining RMD.

34. Treas. Reg. §1.401(a)(9)-4, A-4(a).
35. Treas. Reg. §1.401(a)(9)-8, A-2(a)(2).
36. IRC §2518.
37. Ltr. Rul. 200849019.
38. IRS Pub. 590, *Individual Retirement Arrangements,* Table III.

RMD TABLES

There are only two IRS tables that must be consulted for calculating RMDs during the owner's lifetime. They are:

1. The Uniform Lifetime Table[39] (most often used), and
2. The Joint and Last Survivor Table[40] (only used when spouse is named sole beneficiary and the spouse is more than 10 years younger than the account owner).

Both tables are published in IRS Pub. 590, *Individual Retirement Arrangements*.

RMD BEGINNING DATE FOR EMPLOYER-SPONSORED PLANS

An employee covered by a retirement plan who has 5% or less ownership of his employer does not need to begin RMDs from the retirement plan until the **later** of reaching age 70½ or separation from service with that employer. An employee covered by a retirement plan with more than 5% ownership of the employer must begin RMDs on reaching age 70½ even though the employee still works for the employer.[41]

50% EXCISE TAX

Failure to take the RMD results in the IRS assessing a 50% excise tax on the difference between the distribution taken and the RMD.

> **Example 18.** Buzz is retired and turned 70½ on August 8, 2007. He must make a minimum distribution from his qualified retirement plan by April 1, 2008, or incur an excise tax penalty of 50%. He must also take an additional distribution by December 31, 2008, based on his retirement account balance on December 31, 2007.

The 50% penalty can be waived under the regulations if the beneficiary establishes that:

1. The shortfall in the amount distributed was due to reasonable error, and
2. Reasonable steps are being taken to remedy the shortfall.[42]

The penalty is reported on Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, which is filed with the beneficiary's Form 1040. If the beneficiary attaches a letter of explanation to the Form 5329 requesting a waiver of the penalty and withdraws the shortfall amount, the IRS often waives assessing the penalty.

2009 WAIVER OF RMD

Many retirement account balances declined substantially in 2008. Congress was concerned that mandating retirees to take 2009 required minimum distributions from their IRAs could impose a future hardship by forcing them to sell their stocks when the market is low. The Worker, Retiree, and Employer Recovery Act of 2008 (WRERA) was signed into law on December 23, 2008, and included a provision aimed at mitigating the impact of the stock market decline on retirees. It suspended the 2009 RMD requirement from retirement plans that hold each participant's benefit in an individual account, such as 401(k) and 403(b) plans, and certain 457(b) plans. The Act also waives any RMDs for 2009 from individual retirement arrangements (IRAs). This means most participants and beneficiaries otherwise required to take minimum distributions from these types of accounts are not required to withdraw any amount in 2009. If they choose to make a withdrawal in 2009 (which is not an RMD taken for 2008), they might be able to roll over the withdrawn amount into an eligible retirement plan if the rollover occurs within 60 days of the withdrawal. They must include any previously untaxed portion of the withdrawal that they do not roll over in their gross income.

---

39. Treas. Reg. §1.401(a)(9)-9, A-2.
40. Treas. Reg. §1.401(a)(9)-9, A-3.
41. IRC §401(a)(9)(C).
42. Treas. Reg. §54.4974-2, A-7(a).

The Act did not waive any 2008 RMDs, even for individuals who were eligible and chose to delay taking their 2008 RMDs until April 1, 2009 (e.g., retired employees and IRA owners who turned 70½ in 2008). These individuals were required to take their full 2008 RMD by April 1, 2009, or face a 50% excise tax on the amount not withdrawn. The 2009 RMD waiver under the Act applies to individuals who may be eligible to postpone taking their 2009 RMD until April 1, 2010 (generally, retired employees and IRA owners who attain age 70½ in 2009). However, the Act does not waive any RMDs for 2010.

Example 19. Suella reached age 70½ on August 3, 2008. Her 2008 RMD must be taken no later than April 1, 2009. No RMD is required for 2009. Suella's next required RMD is for 2010 and should be made by December 31, 2010.

If a beneficiary receives distributions over a 5-year period, she can waive the distribution for 2009, effectively taking distributions over six years rather than five years.[43]

Note. For further information on the 5-year rule for distributions to beneficiaries, see Chapter 7 of the 2007 *University of Illinois Federal Tax Workbook*, included on the accompanying CD. See also **Example 20** later in this chapter.

DISTRIBUTION FOR YEAR OF DEATH

If an account owner has attained age 70½ and dies without having received an RMD in the calendar year of death, the after-death plan beneficiary must withdraw the RMD the deceased account owner would have received for that year. This withdrawal must occur in the year of death or as soon as possible in the following year. The beneficiary must begin receiving after-death RMDs beginning the calendar year **after** the year of the account owner's death.[44]

NO 10% PENALTY FOR DISTRIBUTIONS AFTER DEATH

Regardless of the age of the beneficiary receiving an inherited IRA, the beneficiary can withdraw all or any part of the inherited IRA without incurring a 10% early withdrawal penalty.[45] (The exception is a surviving spouse under age 59½ who elects a rollover.) The beneficiary recognizes the normal income tax consequences arising from withdrawing the IRA. No maximum distribution penalty is imposed on a beneficiary of an inherited IRA. For personal reasons, many beneficiaries elect to simply withdraw all the IRA proceeds and forgo the wealth accumulation advantages of deferral.

TAKING MORE THAN THE RMD

If more than the RMD amount is withdrawn in a particular year, this does not change the calculation of the RMD in future years. This applies to the IRA both during the life of the account owner and after the death of the account owner.[46]

MEASURING DATE

In calculating RMDs, the value of the IRA on the preceding December 31 is always divided by the applicable life expectancy factor for the year for which the RMD is being calculated.[47]

43. IRS Notice 2009-9, IRB 2009-5 (Feb. 2, 2009).
44. IRS Pub. 590, *Individual Retirement Arrangements.*
45. IRC §72(t)(2)(A)(ii).
46. Treas. Reg. §1.401(a)(9)-5, A-2.
47. IRS Pub. 590, *Individual Retirement Arrangements.*

RELATIONSHIP OF PLAN BENEFICIARY AND AFTER-DEATH RMD RULES

DESIGNATED BENEFICIARY

The key to understanding the RMD rules after the account owners' death is to understand the definition of designated beneficiary under the Code and regulations. Every IRA has a beneficiary who will receive the account owner's remaining IRA balance when the account owner dies. Even if an account owner does not complete a beneficiary designation form, the IRA will pass to the default beneficiaries specified in the IRA plan documents. If no default beneficiaries are stated in the IRA plan documents, the IRA will pass to the account owner's estate.

The term **designated beneficiary,** as used in the Code, means a beneficiary who qualifies for the longest extension under the RMD rules. For a nonspouse individual beneficiary who is younger than the account owner, the applicable RMD period generally is the life expectancy of the beneficiary. A beneficiary who does not qualify as a designated beneficiary must withdraw the IRA under the default rules, which are discussed later. The goal of income tax planning in this area is to qualify an individual as a designated beneficiary in order to obtain stretch treatment beyond the RMD default rules period.

Treas. Reg. §1.401(a)(9)-4, A-1 provides:

> *"A* ***designated beneficiary*** *is an individual who is designated as a beneficiary under the plan. An individual may be designated as a beneficiary under the plan either by the terms of the plan or . . . by an affirmative election by the employee . . . specifying the beneficiary. A beneficiary designated as such under the plan is an individual who is entitled to a portion of an employee's benefit. . . . The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible, to identify the class member with the shortest life expectancy. The fact that an employee's interest under the plan passes to a certain individual under a will or otherwise under applicable state law does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan. . . ."*

Who Is a Designated Beneficiary?

The term designated beneficiary (DB) includes the following:

Individuals. The simplest and most straightforward plan beneficiary designation is naming one individual. That individual's life expectancy can then be used as the measuring life for purposes of computing the RMD amount.

Multiple Individuals. The regulation clearly states that if multiple individual beneficiaries are named, the life expectancy of the oldest beneficiary is used to compute the RMD amount. An important exception to this regulation may be available if the separate account rule applies. Under the separate account rule, the life expectancy of each beneficiary of a separate account can be used to make the RMD calculation. This is discussed in more detail later in this chapter.

Certain Trusts. A trust generally does not qualify as a DB **unless** the trust meets the requirements under the regulations of a **see-through trust.**[48]

The regulations also establish a safe harbor **conduit trust.** A conduit trust requires that the current individual trust beneficiary receive a distribution from the trust each year of at least the RMD amount.[49]

---

48. Treas. Reg. §§1.401(A)(9)-4, Q&A-5(a) and (b).

49. Treas. Reg. §1.401(a)(9)-5, Q&A-7(c)(3), Example 2.

Cash-Out Rules

The determination of whether a beneficiary qualifies as a DB is generally made as of the date of the account owner's death. The most important after-death planning tool is provided in Treas. Reg. §1.401(a)(9)-4, A-4(a). This regulation allows any beneficiary to cash out by September 30 of the year following the account owner's death and **not** be counted in determining the account owner's DB. Stated differently, the cashed-out beneficiary can be ignored for purposes of determining the distribution period for RMDs after the account owner's death. This technique is a powerful tool to remove a beneficiary who would otherwise jeopardize qualification as a designated beneficiary for other beneficiaries in the group.

Who Is Not a Designated Beneficiary?

Charities. For IRA owners who are charitably inclined, a charity is an excellent choice of beneficiary. A charity as an IRA beneficiary takes the IRA proceeds free from income tax and free from estate tax. The problem is that a charity does not qualify as a DB eligible for stretch planning. Therefore, a charity cannot be named as a beneficiary with other individual beneficiaries, especially in a trust, without potentially disqualifying the other individual beneficiaries or trust from DB status.

Estates. Generally, an estate does not qualify as a DB even if individuals ultimately receive the IRA under the deceased account owner's will. Accordingly, if the IRA benefits pass to an estate, the benefits are not eligible for stretch treatment. An exception that permits a rollover is available if a surviving spouse is the sole beneficiary under the will.

Certain Trusts. A trust other than one qualifying as a see-through or conduit trust does not qualify as a DB.

If an inherited IRA received by a see-through or conduit trust uses the IRA proceeds to pay estate taxes or inheritance taxes, the trust may not qualify as a DB since arguably payment of estate taxes is a distribution to a nonindividual.

Entities. A partnership, corporation, or any other type of business entity does not qualify as a DB eligible for stretch treatment since such entities are not individuals.

RMD DEFAULT RULES

The Code contains RMD default rules if the plan beneficiary does **not** qualify as a DB. Although the deferral might not be as favorable as the DB RMD rules allow, the default rules do permit some deferral as described below. The default rules for determining the RMD time period depend on whether the deceased account owner at the time of death was under or over age 70½.

Deceased Account Owner Under Age 70½ with No DB

If the IRA account owner has not reached age 70½ at the time of death and there is no DB, the IRA must be distributed within five calendar years after the date of the account owner's death.

Example 20. Tyler dies in 2010 at age 50. He was unmarried and had a $1 million IRA. Tyler named his estate as his IRA beneficiary. Under his will, Tyler's estate passes outright to his two children: Alan, age 25, and Brett, age 20. However, an estate does not qualify as a DB. Since Tyler was under age 70½, the maximum period of time the IRA balance can be withdrawn is five calendar years beginning the calendar year after the year of Tyler's death. There is no life expectancy table used in computing this distribution.

The executor of Tyler's will creates two equal separate sub-IRAs. The first sub-IRA is titled "IRA of Tyler, deceased, for benefit of Alan," using Alan's social security number. The second sub-IRA is titled "IRA of Tyler, deceased, for benefit of Brett," using Brett's social security number. No Form 1099 is required to be issued in connection with the creation of these sub-IRAs.

Thereafter, Alan and Brett each manage their own separate inherited sub-IRA. However, Alan and Brett must withdraw their respective sub-IRA balance within five calendar years after Tyler's death. The withdrawals do not need to be made in installments during that 5-year period. Unequal withdrawals can be made at any time up to the end of the 5-year period. There is no maximum withdrawal amount imposed on Alan or Brett during the 5-year deferral term. Regardless of the ages of Alan and Brett, there is no 10% penalty on any withdrawal by Alan or Brett from their sub-IRAs. They simply need to recognize normal income taxation on the withdrawals.[50]

9

50. IRS Pub. 590, *Individual Retirement Arrangements.*

Deceased Account Owner Over Age 70½ with No DB

If the IRA account owner dies after reaching age 70½ and no DB is named, the IRA must be distributed over the deceased account owner's hypothetical life expectancy in accordance with the Single Life Table.[51] The calculation involves determining the hypothetical life expectancy of the account owner in the year of death and then subtracting one from the factor each year beginning the year after death.

Example 21. Gracie dies unmarried on July 10, 2010, at age 75 with a $1 million IRA. Before her death, she received her RMD for 2010. Gracie names her estate as the beneficiary of her IRA. She has one child, George, age 40, who is the sole beneficiary under Gracie's will.

Because an estate does not qualify as a DB, the RMD default rules apply. In this case, since Gracie is over age 70½, the RMD amount is calculated using her hypothetical life expectancy based on the Single Life Table. At the time of her death in 2010, the Single Life Table factor is 13.4. (See portion of Single Life Table that follows.) Each succeeding year thereafter, the factor is calculated by multiplying the December 31 account balance the year before by a fraction. For 2011, the year after death, the fraction is 1 ÷ 12.4 (year of death life expectancy of 13.4 minus 1); for 2012 the fraction will be 1 ÷ 11.4 (year before factor of 12.4 minus 1); for 2013 the fraction will be 1 ÷ 10.4, and so on. George's life expectancy is not considered.[52]

Table I
(Single Life Expectancy)
(For Use by Beneficiaries)

Age	Life Expectancy	Age	Life Expectancy
56	28.7	84	[illegible]
74	14.1	102	2.5
75	13.4	103	2.3
76	12.7	104	2.1
83	8.6	111 and over	1.0

Publication 590 (2008) Page 95

51. Treas. Reg. §1.401(a)(9)-5, A-5(a)(2); see the Single Life Table, located in the "Reference Materials" section at the end of this book.

52. IRS Pub. 590, *Individual Retirement Arrangements.*

SURVIVING SPOUSE IS "SUPER BENEFICIARY"

A surviving spouse is an individual who qualifies as a DB. But the surviving spouse also occupies a unique position as a super beneficiary of an IRA received after death. The spouse has more than just the right to delay recognition of the IRA over the surviving spouse's life expectancy. The spouse has these rights:

- **Rollover.** The surviving spouse can roll over the deceased's retirement account balance to the surviving spouse's own IRA. The surviving spouse can also further delay any distribution until age 70½. In addition, the surviving spouse can designate a third party to receive the IRA at the surviving spouse's death to further extend the IRA over the third party's life expectancy. Alternatively, the surviving spouse can elect to treat the deceased account owner's IRA as the surviving spouse's IRA. No other beneficiary has these rights.[53]
- **Using Account Owner's Life Expectancy.** The surviving spouse can continue to receive payments over the deceased account owner's life expectancy under the Single Life Table if the deceased account owner is over 70½. If the decedent was under age 70½, the surviving spouse can wait to begin distributions until the deceased account owner would have reached age 70½.[54]
- **Using Surviving Spouse Life Expectancy.** The surviving spouse can receive benefits over the surviving spouse's life expectancy under the Single Life Table, with life expectancy recalculated annually.[55]

Partial Rollover Permitted

The surviving spouse is not required to take an all-or-nothing approach to roll over or retain the deceased spouse's IRA. The spouse has the option to roll over only part of the IRA to her own IRA. A rollover can be elected by the surviving spouse for all or part of the IRA, even after the surviving spouse has taken distributions from the deceased spouse's IRA.[56]

Liberal Rollover Treatment for Surviving Spouse

In a series of letter rulings, the IRS permits a surviving spouse to obtain IRA rollover status in situations that would not be eligible for IRA stretch treatment for a nonspouse beneficiary. For example, in Ltr. Rul. 200644031, the account owner made the IRA payable to his estate. The surviving spouse received the entire estate under the deceased account owner's will. The IRS allowed the surviving spouse to rollover the IRA to the surviving spouse's own IRA even though the spouse was not the beneficiary named on the IRA form.[57]

---

53. Treas. Reg. §1.408-8, A-5(a).
54. Treas. Reg. §1.401(a)(9)-3, A-3(b); Choate, Natalie, *Life and Death Planning for Retirement Benefits,* p. 79 (6th ed., Ataxplan Publications, 2006); and IRS Pub. 590, *Individual Retirement Arrangements.*
55. Treas. Reg. §1.401(a)(9)-5, A-5(c)(2).
56. Treas. Reg. §1.408-8, A-5(a); Ltr. Rul. 200242044; and Choate, Natalie, *Life and Death Planning for Retirement Benefits,* p. 167 (6th ed., Ataxplan Publications, 2006).
57. See also Ltr. Ruls. 200621020 and 200615032.

NORMAL DB RULE FOR NONSPOUSAL BENEFICIARIES

If a nonspousal DB is named, the RMD period is the **longer** of the beneficiary's life expectancy or the deceased account owner's hypothetical life expectancy.[58] The Single Life Expectancy Table is used for calculating the applicable factor. This is the **only** IRS table used for determining factors for after-death RMDs.[59]

Example 22. Terrence, age 50, dies July 15, 2010, with a $1 million IRA. He names his only child, Alex, age 22, as the beneficiary of his IRA. Since Alex is an individual, he qualifies as a DB.

The RMD rules permit withdrawals over Alex's life expectancy. Alex's life expectancy is measured the year **after** Terrence's death. Alex turns 23 in 2011. His life expectancy from the Single Life Table in 2011 (the year after Terrence's death) is 60.1. (See following portion of Single Life Table from Pub. 590.) Each year thereafter, the RMD is computed by multiplying the IRA balance on December 31 of the prior year by a fraction; the numerator is one and the denominator is the beneficiary's life expectancy in the year following the year of the owner's death reduced by one for each year following the owner's death. For 2012, the fraction is 1 ÷ 59.1, for 2013 the fraction is 1 ÷ 58.1, and so on. The inherited IRA is titled "IRA of Terrence, deceased, for benefit of Alex," and Alex's social security number is used for tax reporting.[60]

Table I
(Single Life Expectancy)
(For Use by Beneficiaries)

Age	Life Expectancy	Age	Life Expectancy
22	61.1	50	34.2
23	60.1	51	33.3
24	59.1	52	32.3
25	58.2	53	31.4
26	57.2	54	30.5
27	56.2	55	29.6

Page 94 **Publication 590 (2008)**

LIFE EXPECTANCY FOR MULTIPLE INDIVIDUALS

If multiple beneficiaries are designated on the IRA, the age of the oldest beneficiary is used for measuring life expectancy.

Example 23. Julio dies at age 79 in 2010 with a $1 million IRA. He names his sons Alfonso, age 50, Bart, age 40, and Chad, age 30, as beneficiaries. Unless the separate-accounts rule applies (discussed below), the life expectancy of the oldest beneficiary is used. Alfonso, age 50, is the oldest beneficiary; therefore, his life expectancy is used for calculating RMD. Alfonso's life expectancy is used even if the IRA at a later time is allocated into separate sub-IRAs for the benefit of Alfonso, Bart, and Chad.

58. Treas. Reg. §1.401(a)(9)-5, A-5(a)(1).

59. IRS Pub. 590, *Individual Retirement Arrangements.*

60. Ibid.

Separate-Accounts Rule

The separate-accounts rule offers an important exception to the oldest beneficiary being the measuring life when multiple beneficiaries are named. Under Treas. Reg. §1.401(a)(9)-8,A-2(a)(2), if separate accounts are established by December 31 of the year following the account owner's death, the life expectancy of the beneficiary of the separate account is the measuring life for RMD purposes.

> **Example 24.** Use the same facts as **Example 23,** except Julio's IRA is titled in separate inherited sub-IRAs for the benefit of Alfonso, Bart, and Chad by December 31 of the year following the year of death. In this situation, the separate account for Alfonso uses Alfonso's life expectancy, the separate account for Bart uses Bart's life expectancy, and the separate account for Chad uses Chad's life expectancy. Each separate sub-IRA for the children is titled "IRA of Julio, deceased, for benefit of [child's name]," using the child's social security number for identification purposes.

Separate-Account Rule Does Not Apply to Trusts

The IRS consistently states in a number of private letter rulings that the separate-account rule does not apply if a trust is named as a beneficiary.[61] This applies even if the express provisions of the trust split the trust into separate subtrusts with separate individual beneficiaries.

CHARITIES

As mentioned earlier, charities do not qualify as DBs. Nevertheless, charities remain attractive beneficiaries of IRAs. A gift of an IRA to a charity avoids income taxation on the IRA and qualifies for the estate tax charitable deduction.

TRUSTS

All things being equal, naming individuals as beneficiaries is the easiest way to stretch the IRA distribution over the life expectancy of a younger beneficiary. However, often clients wish to name trusts as beneficiaries of their IRAs for a number of valid estate-planning reasons. Reasons for naming trusts as beneficiaries include:

- Married couple estate-tax exemption planning,
- Second marriage,
- Disabled child,
- Spendthrift child, and
- Minor child.

The RMD rules applicable to trusts are discussed below.

General Rule

Naming a trust as an IRA beneficiary complicates eligibility for stretch treatment. The general rule is that a trust is generally not eligible to be a DB entitled to stretch treatment. The only trusts that qualify as DBs are see-through trusts and conduit trusts. In all trusts eligible to be DBs, the life expectancy of the oldest trust beneficiary is the applicable life expectancy to use because the separate accounts rule does not apply to trusts.

[61] Ltr. Ruls. 200317041, 200317043, and 200317044.

See-Through Trust Requirements. There are essentially five requirements which must be satisfied under Treas. Reg. §1-401(a)(9)-4, Q&A-5(b) for a see-through trust to qualify as a DB. Those five requirements are as follows:

1. The trust must be valid under state law.
2. The trust must be irrevocable upon the death of the participant.
3. Certain trust documentation must be provided to the plan administrator.
4. The beneficiaries of the trust must be "identifiable."
5. All trust beneficiaries must be "individuals."

The requirements that the beneficiaries be "identifiable" and "individuals" can be met either on the date of death or by September 30 of the year following the date of death of the account owner.

The **first two requirements** are easily satisfied: (1) The trust must be valid under state law; (2) The trust must be irrevocable upon the death of the account owner.

The **third requirement** is an administrative task: (3) Documentation must be provided to the plan administrator by October 31 of the calendar year following the year of death. Documentation includes either a copy of the actual trust document or a final list of all beneficiaries.

The **fourth requirement** is confusing and creates potential qualification problems for many trusts: (4) The trust beneficiaries must be identifiable at the death of the account owner. This requirement appears to be based on the rule that the life expectancy of the oldest beneficiary of a trust must be used for RMD purposes. The requirement to be identifiable assures the IRS that the oldest beneficiary's life expectancy will be used for RMD calculations.

If for any reason the oldest beneficiary of the trust cannot be identified or determined, the trust fails the "identifiable" test. Under IRS interpretation, "identifiable" requires even contingent beneficiaries who may be unlikely to receive trust benefits to be counted in the group of beneficiaries.[62] Many trusts provide that heirs at law or distant relatives could be possible contingent beneficiaries. Unfortunately, these heirs at law or distant relatives could be older than the child or other primary beneficiary named in the trust who would normally be thought to be the oldest beneficiary. This uncertainty of identifying the oldest possible beneficiary can cause the trust to fail the "identifiable" requirement. Even if the heirs at law can be determined at the death of the account owner, the oldest heir would become the measuring life for RMD purposes. The oldest heir may have a short life expectancy, which reduces the deferral otherwise available.

Additionally, some trusts grant powers of appointment to beneficiaries. The possibility that permissible appointees under a power of appointment are unknown and could be older than the oldest known trust beneficiary may violate the "identifiable" rule.

> **Example 25.** Caleb, age 50, dies in 2010 with a $1 million IRA. Caleb designates a trust as the IRA beneficiary. The trust is held for the benefit of his child, Artismo, who is age 30. The trust benefits Artismo during his life, and on Artismo's death, it passes to Artismo's natural descendants.
>
> Income and principal can be accumulated by the trustee during Artismo's life. In addition, Artismo is granted a general power of appointment at his death to appoint the trust assets to any living person he may designate in his will. Since Artismo could potentially appoint the trust property to a person older than himself and that person would not be known at the time of Caleb's death, the trust likely fails the requirement that all trust beneficiaries be identifiable. Consequently, it is likely the trust does not qualify as a DB. Accordingly, the 5-year RMD default rule applies because Caleb was under age 70½ at the time of his death.

---

62. Ltr. Rul. 200610026.

The **fifth requirement** is particularly onerous if the account owner is charitably inclined: (5) All beneficiaries must be "individuals." This requirement may cause disqualification for stretch treatment if a charity is named as a contingent beneficiary of a trust. See **Example 26** below.

Conduit Trust Requirements. By regulation, the IRS established a safe harbor for a trust to qualify as a DB. A conduit trust is not a defined term in the regulations; rather, it is a name that has been given to a trust which meets the requirements of Treas. Reg. §1.401(a)(9)-5, A-7(c)(3), Example 2. **A conduit trust requires the trustee to annually distribute the RMD amount to the current individual beneficiary.** No accumulation can occur at the trust level. If all RMDs must be distributed to the current individual trust beneficiary, that beneficiary's life expectancy can be used for RMD purposes. Unlike an accumulation see-through trust, a conduit trust avoids the issues of whether the other trust beneficiaries are "identifiable" or whether the other trust beneficiaries are "individuals."

> **Note.** If the beneficiary's life expectancy is the same as the beneficiary's actual lifetime, the beneficiary will have received 100% of the IRA under a conduit trust.

Example 26. Tillie, age 60, dies in 2010 unmarried with a $1 million IRA. Tillie designates her trust as the IRA beneficiary. At Tillie's death her trust divides trust assets into two shares:

- One-half to the University of Illinois outright, and
- One-half to a subtrust for child Alexis, age 40, for life and then to the United Way. The subtrust expressly requires all RMDs received by the trust to be paid to Alexis. The subtrust therefore qualifies as a conduit trust under the regulations.

The trust is valid and becomes irrevocable at Tillie's death, and proper documentation was furnished to the plan administrator.

Question 26A. Is stretch treatment available?

Answer 26A. No, unless after-death planning techniques are implemented.

The trust does not qualify as a DB because not all beneficiaries are individuals. The subtrust for Alexis is not treated as a separate account. Because Tillie is under age 70½ at the time of her death, the default rules apply. This requires distribution within five years.

Question 26B. Can anything be done after Tillie's death to make the trust comply with the DB rules?

Answer 26B. Yes. The share of cash can be distributed to the University of Illinois by September 30, 2011. The University of Illinois is considered a charity in this situation and, therefore, does not qualify as a DB. By paying the University of Illinois its one-half share gift before September 30 of the year following Tillie's death, the University is ignored for purposes of qualifying the trust as a DB.

The one-half share to the subtrust for child Alexis eventually passes to a charity. Normally, a charity named as a beneficiary of a trust disqualifies the trust as a DB because a charity is not an individual. However, the facts state the subtrust for Alexis is drafted to qualify as a conduit trust. A conduit trust is a safe harbor that automatically qualifies as a DB. A conduit trust can have a remainder beneficiary that is not an individual (the charity is United Way) and still qualify as a DB. Alexis' life expectancy is used to determine RMD.

> **Note**. The result would be different if the trust was not a conduit trust because the subtrust for Alexis would not satisfy the see-through trust rule requiring all beneficiaries to be individuals.

By cashing out the outright gift to the University of Illinois before September 30 of the year following the death of Tillie, the subtrust for Alexis qualifies as a DB.

Example 27. Tyra, age 60, dies in 2010 unmarried with a $1 million IRA. Tyra names a trust as her IRA beneficiary. The trust provides for **discretionary** distributions of income and principal to child Britt, age 35, for life. The trustee has the authority to accumulate income including RMDs at the trust level. Britt has a power of appointment to appoint the trust assets to her descendants or any charity Britt may choose upon her death. If the power of appointment is not exercised, the trust assets remaining on Britt's death are distributed to Britt's living natural descendants. The trust is valid and irrevocable. The proper documentation was furnished to the plan administrator.

In this trust, the income and principal distributions to Britt are discretionary. Britt is not required to receive all RMDs received by the trust. Accordingly, this trust is an accumulation trust and not a conduit trust. The trust must thus satisfy the see-through trust requirements to qualify as a DB. The issue is whether all potential trust beneficiaries are individuals. The power of appointment allows Britt to appoint charities as beneficiaries. A charity is not an individual and therefore does not qualify as a DB.

After Tyra's death, a potential solution is for Britt to sign a written disclaimer of the power of appointment in accordance with IRC §2518. A disclaimer of the power of appointment in essence renders the power of appointment null. Without the power of appointment, the trust qualifies as a see-through trust because all remaining beneficiaries, namely Britt's natural descendants, are individuals younger than Britt. After the disclaimer, Britt's life expectancy is used for RMD calculations.[63]

SPECIAL ISSUES

NONSPOUSAL BENEFICIARIES OF QUALIFIED PLANS

Before the enactment of the Pension Protection Act of 2006 (PPA 2006), for qualified retirement plans other than IRAs, only a surviving spouse was eligible to roll over a lump-sum distribution to the surviving spouse's own IRA. A nonspousal beneficiary had no right to stretch a distribution from a retirement plan. Moreover, many qualified retirement plans mandated lump-sum distributions to nonspousal beneficiaries. PPA 2006 changed the law to allow a nonspousal beneficiary the opportunity to transfer the qualified retirement plan account and take advantage of the RMD deferral rules applicable to inherited IRAs. Under IRC §402(c)(11), if the nonspousal beneficiary qualifies as a DB, the nonspousal beneficiary has the right to establish an inherited IRA in the name of the deceased participant and have the deceased participant's account transferred in a direct trustee-to-trustee transfer to an inherited IRA. It is important to note that this is **not** a rollover to a nonspouse's own IRA. A nonspousal beneficiary may not roll over money from the retirement plan to the nonspousal beneficiary's own IRA.

Under PPA 2006, there was a potential problem in that the qualified retirement plan document itself might not allow such a transfer to an inherited IRA. In other words, the qualified retirement plan could prohibit such a transfer under PPA 2006.[64] This rule was changed by the Worker, Retiree, and Employer Recovery Act of 2008. Effective in 2010, qualified retirement plans must be amended to allow the after-death transfer by a nonspousal beneficiary from a qualified retirement plan to an inherited IRA. An important requirement is that the IRA established to receive the transfer from the retirement account remain designated in the name of the deceased plan participant for the benefit of the beneficiary, with the beneficiary's social security number used for identification purposes. Additionally, there must be a direct transfer to the IRA custodian. The beneficiary **cannot** receive the proceeds and then redeposit the proceeds in the inherited IRA.[65]

63. Ltr. Rul. 200438044.

64. Notice 2007-7, IRB 2007-5 (Jan. 29, 2007).

65. IRC §402(c)(11).

SUCCESSOR BENEFICIARIES

Ltr. Rul. 200634068 provides a good road map for how various successor beneficiaries can receive beneficial ownership of an IRA without accelerating the recognition of income. Generally, the RMD life expectancy established at the time of the account owner's death establishes the life expectancy to use for all future successor beneficiaries. The death of the first beneficiary receiving the IRA after death does not change the calculation of RMD for future successor beneficiaries of the IRA. In essence, the death of the first beneficiary receiving the IRA is ignored for purposes of calculating future RMDs.

Example 28. Taylor dies and leaves her $1 million IRA to child Abe. At Taylor's death, Abe has a life expectancy of 30 years. Abe dies 12 years later after naming his grandchild Zeke as the next successor beneficiary of the IRA. Abe's remaining life expectancy of 18 years at the time of his death (30 years less 12 years) remains the measuring life. Zeke is required to take minimum distributions in accordance with Abe's remaining 18-year life expectancy. Zeke's life expectancy is not used in any calculation of RMD.

Note. The same rules apply to a trust when the oldest beneficiary's life was used for RMD and there are transfers of the IRA among various successor trust beneficiaries.

ROTH IRA REQUIRED MINIMUM DISTRIBUTIONS

A distinctive feature of a Roth IRA is that the income earned by the IRA is not taxable. Nevertheless, there remains an incentive for stretch treatment for wealth accumulation within the Roth IRA.

During the account owner's life, there is **no** requirement for distributions from a Roth IRA. After the death of the account owner, the RMD rules apply to a Roth IRA. The post-death RMD rules under Treas. Reg. §1.408A-6, A-14(b) are applied "as though the Roth IRA owner died before attaining age 70½ regardless of when that owner actually dies." If the beneficiary qualifies as a DB, the Roth IRA can be distributed over the longer of the beneficiary's life expectancy or the deceased account owner's hypothetical life expectancy. If there is no DB, the Roth IRA must be distributed over five calendar years after the death of the account owner.[66]

USING AN IRA TO SATISFY A PECUNIARY GIFT

Sometimes gifts made under a will or trust are defined in terms of a specific dollar amount. Funding the gift of a pecuniary amount by transferring an interest in an IRA accelerates the recognition of income that could otherwise be deferred. This rule can be a pitfall for the unwary, particularly in funding pecuniary marital deduction formula gifts.[67]

Example 29. Leonard designates in his trust a gift of $50,000 to a particular beneficiary. If Leonard's IRA is assigned to satisfy that $50,000 gift, income tax on the IRA is immediately accelerated to the extent of $50,000. This is true regardless of whether the recipient of the gift qualifies as a DB. To avoid such accelerated recognition of income from an IRA, fractional gifts instead of pecuniary gifts should be used whenever an IRA is used to fund gifts.

TITLING IRA AFTER DEATH OF OWNER

The title registration of an inherited IRA is **critical** to avoid potential adverse tax consequences. A nonspousal beneficiary can never roll over a deceased account owner's IRA to the beneficiary's own IRA. Rather, the inherited IRA should be titled "IRA of deceased [account owner name], for benefit of [beneficiary name]." **No contribution should ever be made by a nonspousal beneficiary of the nonspouse's own funds to an inherited IRA.**

66. IRS Pub. 590, *Individual Retirement Arrangements.*

67. CCM 2006 – 44020; Choate, Natalie, *Life and Death Planning for Retirement Benefits,* Appendix 3 (Post-Publication Updates and Corrections, 9/1/07, 6th ed., Ataxplan Publications, 2006).

9

IMPORTANT AFTER-DEATH DEADLINES

September 30 of Year Following Death — "Cash Out" Rule[68]

The cash-out rule is the most important technique available to use to cure an ineligible beneficiary designation. If a beneficiary is cashed out by September 30 of the year following the year of death of the account holder, the cashed-out beneficiary can be ignored for purposes of determining DBs.

December 31 of Year Following Death — Division into Separate Accounts[69]

The separate accounts rule under Treas. Reg. §1.401(a)(9)-8, A-2(a)(2) is a useful technique to avoid the requirement that the oldest beneficiary's life expectancy must be used if multiple beneficiaries are named. If separate accounts are established by December 31 of the year following the year of death of the account owner, the life expectancy of the particular beneficiary of that separate account can be used for calculating RMD. This rule does not apply to trusts.

Nine Months after Death — Disclaimer[70]

A disclaimer under IRC §2518 is an effective after-death technique to restructure the beneficiary designation to qualify for stretch treatment. A disclaimer is a written refusal by a beneficiary to accept a benefit. The result of a disclaimer is that the disclaiming person is treated as having predeceased the account owner for purposes of the disclaimed right. Disclaimers must follow the strict requirements of §2518.

NET UNREALIZED APPRECIATION ON EMPLOYER STOCK

If an employer's stock is part of a qualified retirement plan, that employer's stock can be eligible for special favorable tax treatment when distributed to the employee.[71] If the retirement plan beneficiary receives a lump-sum distribution from a retirement plan that includes the employer's stock, the participant is not taxed on the net unrealized appreciation of that stock until the employer's stock is sold. When the employer's stock is sold, the stock is entitled to capital gains treatment.[72] This favorable tax treatment is also available to a beneficiary of a deceased employee's retirement account if a lump-sum distribution is received by the beneficiary.[73]

While a participant is alive, rolling over a retirement plan that holds appreciated employer stock to an IRA causes the unrealized capital gain advantage to be lost. IRA distributions cannot qualify for net unrealized appreciation treatment.[74]

IRC §691(c) INCOME TAX DEDUCTION FOR ESTATE TAXES

Under IRC §691(c), a beneficiary who receives income in respect of a decedent (IRD) is entitled to a miscellaneous itemized deduction (not subject to the 2% AGI floor) on Schedule A for the federal estate tax attributable to inclusion of the IRD as an asset for estate-tax purposes. Since an IRA is generally IRD, this itemized deduction should be taken by the beneficiary if the account owner's estate involves sufficient assets to generate federal estate tax.

---

68. Treas. Reg. §1.401(a)9-4(A-4)(a).
69. Treas. Reg. §1.401(a)(9)-8, A-2(a)(2).
70. IRC §2518.
71. IRC §402(e)(4)(A).
72. Treas. Reg. §1.402(a)-1(b)(1)(i).
73. Rev. Rul. 69-297, 1969-1 CB 131.
74. Treas. Reg. §1.401(c)-2, A-13(a).

COMMON PLAN BENEFICIARIES — SUMMARY

The account owner has the right to name the beneficiary receiving the IRA at death. The choice of beneficiary depends in large part on how much "dead-hand" control the account owner wishes to exert over the beneficiary. For income tax planning purposes, individuals named as beneficiaries clearly qualify as DBs eligible for maximum deferral.

INDIVIDUALS AS BENEFICIARIES

Surviving Spouse — Super Beneficiary

As discussed previously, the surviving spouse is the best choice of plan beneficiary for RMD deferral purposes. The surviving spouse is the only plan beneficiary who can roll over the IRA to the surviving spouse's own IRA or treat the IRA as the surviving spouse's own IRA. Alternatively, the surviving spouse may take withdrawals from the existing IRA using special favorable life expectancy calculations. As an additional bonus, a gift of an IRA to the surviving spouse qualifies for the marital deduction for estate-tax purposes.

Children, Grandchildren, and Other Nonspouse Individuals

Individuals qualify as DBs eligible for maximum RMD deferral. Naming individuals as outright beneficiaries simplifies eligibility for maximum stretch treatment.

TRUST AS BENEFICIARY

Many account owners want to exercise more control over the IRA balance than outright transfers allow. A trust is often the legal entity created to obtain the desired control. Unfortunately for RMD stretch purposes, a trust is not generally eligible to be a DB. Only if the strict requirements provided in the regulations for a see-through trust or conduit trust are satisfied will a trust named as an IRA beneficiary be eligible for stretch treatment.

These strict eligibility requirements apply to all types of trusts receiving IRA benefits, including:

- Testamentary trusts (trusts established under will),
- Lifetime trusts passing property after the death of the account owner,
- Bypass trusts/credit shelter trusts,
- Special needs trusts,
- Minor trusts, and
- Marital QTIP trusts.

In addition to the necessity to qualify either as a see-through trust or conduit trust, a marital qualified terminable interest property (QTIP) trust must satisfy the requirements for the estate-tax marital deduction. The surviving spouse must receive all trust income. In addition, all the IRA income earned annually after the death of the account owner must be either:

- Distributed to the surviving spouse, or
- Accessible to the surviving spouse.[75]

75. Rev. Rul. 2006-26, IRB 2006-22 (May 30, 2006).

REVOCABLE TRUST

A revocable trust must satisfy all the requirements of either a see-through trust or a conduit trust. A revocable trust often has the additional burden of paying whatever estate tax is owed. If estate taxes are paid by the revocable trust, the trust arguably has a nonindividual beneficiary. This may disqualify the trust as a DB. This problem may be addressed by paying all estate taxes before September 30 following the year of death.[76]

CHARITY

A charity as an outright IRA beneficiary can receive IRA benefits free of income taxation and estate taxation. Unfortunately, naming both a charity and individuals as beneficiaries of a trust receiving an IRA causes potential problems for the individuals because the charity is not an eligible DB. Using a separate IRA for the charitable gift is a simple way to avoid this problem.

ESTATE

An estate is generally ineligible to be a DB. Expressly naming an estate as the plan beneficiary should be avoided for RMD purposes. Allowing the estate to be the default beneficiary should also be avoided. Any time an estate becomes the beneficiary of an IRA, the account owner has failed to properly plan. This normally occurs when the account owner fails to properly name primary and secondary beneficiaries on the IRA beneficiary designation form.[77]

---

76. Ltr. Rul. 200610026.

77. Ltr. Rul. 200849019.