Chapter 5: Retirement

Corrections were made to this material through January of 2012. No subsequent modifications were made.

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Tax professionals are frequently asked for advice about retirement strategies. Taxpayers at various stages of life have different questions and concerns. Those currently in the workforce have questions regarding the types of plans and contribution limitations. Those planning to change jobs have questions about the transferability of their retirement funds. Additionally, those thinking about transitioning out of the workforce have questions about accessing their retirement savings and the tax implications of doing so. This chapter provides tax professionals with information to help answer client questions, calculate required minimum distributions, and prepare tax returns that include retirement income.

TYPES OF RETIREMENT PLANS

Over the course of their working lives, taxpayers may participate in a variety of retirement plans. One employer may offer a defined benefit plan, another a defined contribution plan, and a third no plan at all. This section examines various types of retirement plans and their tax implications.

NONQUALIFIED RETIREMENT PLANS

Nonqualified retirement plans fall outside the guidelines of the Employee Retirement Income Security Act (ERISA). Generally, contributions to nonqualified plans are nondeductible by the employer. They are not taxable to the participant until received or available to the employee. These types of plans provide a "pay later" promise. They generally become deductible by the employer and become income to the participant at the time of payment. These types of plans include deferred compensation arrangements and employer-funded or employee-funded annuities. Nonqualified deferred compensation plans are governed by IRC §409A.

Nonqualified Deferred Compensation Plans (NQDC)

NQDC plans offer several opportunities that offset the initial disadvantage of being nondeductible by businesses in the year promised or funded. Primarily, NQDC plans allow:

- Selection of individual participants that does not require the universal coverage mandated by qualified plans (permitting disparity in contributions based on dollar amount, rate of contribution, payout timing, and age); and
- Contractual obligations to be tied to postemployment actions. (These can include noncompetition clauses or continued association with the former employer, which can lead to a competitive advantage.)

Note. See pages 417–427 in the 2010 *University of Illinois Federal Tax Workbook* for very detailed information about nonqualified deferred compensation plans. This can be found on the accompanying CD.

QUALIFIED RETIREMENT PLANS

Qualified retirement plans are those that meet IRS requirements for tax-favored status. IRC §410(a)(1) defines the minimum age and service requirements for a qualified retirement plan.

In general, a plan cannot require as a condition of participation that an employee complete a period of service with the employer extending beyond the later of:

- The date on which the employee attains age 21, or
- The date on which the employee completes one year of service.

IRC §410(a)(4) describes the rules governing when an eligible employee must begin participation. Under §410(a)(4), a plan is not qualified unless it provides that an employee who is otherwise eligible to participate under the terms of the plan commences participation no later than the earlier of:

- The first day of the first plan year beginning after the date on which the employee satisfies the §410(a)(1) minimum age and service requirements, or
- Six months after the date on which the employee satisfies the minimum age and service requirements.

There are two types of qualified retirement plans: defined benefit plans and defined contribution plans.

Defined Benefit Plans

Defined benefit plans are traditional pension plans that provide retirees with a specific amount of benefit at retirement. These plans are not as common as they were 30 years ago. The benefits provided under these plans are determined according to a formula, which is usually based on age at retirement, average compensation, and years of service.

For 2011, the maximum annual benefit for a participant in a defined benefit plan is the smaller of:

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

Benefits under a defined benefit plan generally can be paid only after retirement. They are usually provided in the form of an **annuity** for the life of the retired participant or the joint lives of the retired participant and spouse.

> **Note.** Additional information about annuities is found in the section entitled "Annuities" later in this chapter.

Defined-Benefit §401(k) Plan. Under the provisions of the Pension Protection Act of 2006,[1] employers with at least two and no more than 500 employees can establish a combined defined benefit/§401(k) plan (DB/K) for plan years beginning after December 31, 2009.

The assets of the DB/K must be held in a single trust and must be clearly identified and allocated to the defined benefit plan and the applicable defined contribution plan to the extent necessary for the separate application of the Code and ERISA.[2]

1. PL 109-280.
2. Treas. Reg. §1.408A-4, Q & A 12.

Defined Contribution Plans

Defined contribution plans are established by employers and allow discretionary contributions or contributions based on a formula provided in the plan document. There are three types of defined contribution plans.

1. **Money purchase plan.** The employer is required to contribute a specific percentage of the participant's annual compensation to an account in the participant's name.
2. **Target benefit purchase plan.** This plan is similar to a money purchase plan except the participant's age is taken into consideration in determining the contribution percentage.
3. **Profit sharing plan.** Unlike the prior two plans, there is no stated annual contribution percentage. Instead, the contribution is at the employer's discretion.

In defined contribution plans, the amount of retirement benefits is unknown until the employee actually begins receiving the benefits. This is the case because the benefit amount varies depending upon the annual contribution level of the employee and employer and the investments' performance.

Elective contributions to these plans are generally excluded from a participant's current income for the year. The contributions are considered pretax dollars for purposes of the individual's income tax. However, elective contribution amounts are not excluded from wages for purposes of FICA or OASDI taxes. Elective contributions are never forfeitable.

Each employee's elective contributions must be maintained in an individual account and accounted for separately from other types of contributions.[3] Employer contributions must be designated as originating from the employer.[4]

§401(k) Plans. A §401(k) plan is a defined contribution plan arrangement that permits employees to defer receiving part of their wages by contributing the funds to a retirement account. Employers may choose to make matching, nonelective, and/or profit-sharing contributions to employee accounts. Employer contributions to a qualified retirement plan are not includible in gross income of employees until those funds are distributed.

Example 1. Sally, an Illinois resident, is single and claims no withholding allowances. For 2011, she has a weekly gross salary of $1,000. As illustrated below, Sally's net pay is only reduced by $70, even though she elected to contribute $100 to her §401(k) plan.

	No Elective Contribution	$100 Elective Contribution
Gross pay	$1,000	$1,000
Elective contribution	0	(100)
Taxable income	$1,000	$ 900
Federal withholding	(167)	(142)
State withholding	(50)	(45)
FICA and OASDI	(57)	(57)
Net pay	$ 726	$ 656

Employees under age 50 may elect to contribute up to a maximum of $16,500 to their §401(k) account for 2011, and employees who are age 50 or older may elect to contribute up to an additional $5,500 "catch-up" contribution.

For 2011, the maximum compensation that can be factored into the equation used for figuring 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.

3. Treas. Reg. §1.401(k)-1(e)(3)(i).
4. Treas. Reg. §1.401(k)-1(a)(4)(ii).

For tax years beginning after December 31, 2001, the maximum deductible amount for employers is 25% of the total compensation of all eligible participants. If more than 25% of total compensation is contributed to the plan, the employer may carry over the excess and deduct it in subsequent years, always subject to the limit of 25% of the wages for that year.[5]

Section §401(k) plans must meet special nondiscrimination tests. These can be satisfied by complying with the actual-deferral-percentage (ADP) test, the ADP safe-harbor provisions, the automatic enrollment safe-harbor requirements, or the SIMPLE §401(k) provisions.[6]

§457 Plans. Employees of state or local government agencies may enter into a deferred compensation agreement with their employer to defer up to 100% of their compensation, subject to an annual limitation for 2011 of $16,500 for employees under age 50. 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 2.** Seth is employed by the state of Illinois and participates in a §457 plan as well as a §403(b) plan. Seth earns $50,000 per year. He may participate in a §457 plan and defer up to $16,500. Seth may also participate in a §403(b) plan and contribute up to $16,500 to that qualified retirement plan.

As long as the plan satisfies eligibility requirements, deferred compensation is not taxed to an employee until it is distributed. IRC §457 governs these types of plans.

Catch-Up Provision. There is also a catch-up provision for employees age 50 or older allowed under §457. The general catch-up provision is the statutory amount applicable to qualified plans, or $5,500 for 2011. However, 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 normal retirement age under the plan, the ceiling is an amount not in excess of 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 portions of plan ceilings for any prior years that have not been previously used.

> **Example 3.** Sam is age 61 and is employed by the state of Illinois. The state's plan specifies that normal retirement age is 65. He wants to defer as much as possible in 2011 under the §457 plan. He earns $50,000 per year. The maximum that he may defer is $22,000 (the $16,500 annual limit plus the $5,500 catch-up provision for employees over 50). He does not qualify for the special provision because his age is more than three years younger than the normal retirement age.

5. IRC §404(a)(3)(A).

6. IRC §401(k)(3)(C); Treas. Reg. §1.401(k)-1(b)(1)(ii).

Example 4. Luella is 64 in 2011. She is employed by the state of Illinois. Luella qualifies for the special catch-up provision for §457 plans. For 2011, she 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.

Luella made the following contributions during the last three years:

	2009	2010	2011
§457 plan ceiling	$16,500	$16,500	$16,500
Actual contribution	(15,000)	(500)	(16,500)
Unused limit	$ 1,500	$16,000	$ 0

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Luella's special catch-up contribution for 2011 is a maximum of $33,000 because the sum of the ceiling plus unused contribution limits for prior years equals $34,000 ($1,500 + $16,000 + $16,500). This is greater than the otherwise applicable maximum contribution amount of $22,000 available to employees over age 50 because she is in the last three years before normal retirement age.

Luella is not allowed an additional $5,500 catch-up amount for employees age 50 or older because of the coordination rules, which allow only the higher limitation amount.[7]

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 individual retirement arrangement (IRA).

§403(b) Plans. Public schools and certain tax-exempt organizations can use §403(b) plans to fund their employees' retirement. These types of plans have generally focused on tax-sheltered annuities (TSAs) that may be funded by various methods.

Annuity contracts must be purchased from a state-licensed insurance company, and the custodial accounts must be held by a bank or IRS-approved nonbank trustee/custodian.

The maximum contribution to a §403(b) plan for 2011 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 TSA Catch-Up for Certain Organizations. For tax years beginning after December 31, 2008, 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

7. IRC §§414(v)(6)(C) and 457(e)(18).

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 qualified employee by the qualified organization for prior years.[8]

When an employee is eligible for both an age 50 catch-up and the special TSA catch-up, the contributed amount is first attributed to the special TSA catch-up, and then to the age 50 catch-up.[9]

Designated §§401(k) or 403(b) Roth Accounts. Although Congress initiated the concept of designated Roth §§401(k) and §403(b) plans under EGTRRA in 2001, the option to contribute to these plans was made available for the first time starting January 1, 2006. Although designated Roth accounts were originally scheduled to sunset in 2010, these accounts were made permanent by the Pension Protection Act of 2006.[10]

Employer Issues. Employers have been slow to warm up to this new hybrid retirement savings vehicle that combines features of traditional §401(k) plans with attributes of Roth IRAs. Because employers must add a Roth option to their §§401(k) or 403(b) plan documents before designated Roth contributions can be made, many taxpayers will not be able to take advantage of this new savings option until the employer decides to make the option available.

Plans **cannot** be exclusively Roth. If a plan allows designated Roth contributions, it also must allow pretax contributions. New or amended plans must be adopted by the end of the plan year in which the amendment is to become effective. No retroactive designated Roth contributions are allowed. IRS Notice 2006-44 contains a sample plan amendment that sponsors can use to conform their plans to IRS requirements.

Although employers are not required to offer designated Roth accounts, those who choose to sponsor Roth plans must apply the decision universally to all plan participants. Plans that feature automatic employee enrollment must specify whether default contributions are considered pretax or designated Roth contributions. This is an important distinction because **designated Roth contributions — even those made by default — are irrevocable.**

Communicating the option to employees is one drawback to sponsoring a Roth account. This education process can be both difficult and time consuming.

Perhaps the largest drawback to sponsoring a designated Roth account is the **recordkeeping requirement**. Regulations[11] require that Roth contributions be kept segregated from pretax salary deferrals in individual employee accounts. **No amounts other than designated Roth contributions and qualified rollovers may be deposited into Roth accounts.** Employer-matching contributions, plan forfeitures, and any other employer contributions must be allocated to pretax accounts.

Designated Roth plan contributions, gains, and losses also must be accounted for separately. This requires plan fiduciaries to maintain two sets of records for participants who contribute to both pretax and designated Roth accounts. Sponsors must report contributions on each participating employee's Form W-2 and issue Forms 1099 to report any distributions from employee accounts.

8. Treas. Reg. §1.403(b)-4(c)(3)(i).
9. Treas. Reg. §1.403(b)-4)(c)(3)(iii).
10. PL 109-280.
11. Treas. Reg. §1.401(k)-1(f)(3).

In addition, sponsors must track an employee's basis in their designated Roth account, including recording the employee's beginning participation date to provide a base date for the 5-year participation rule. Because participants are allowed to take loans against their designated Roth accounts, maintaining basis records may be difficult. The effective date for reporting and recordkeeping requirements is the beginning of the 2007 taxable year.

Employer-withheld Roth contributions are subject to all applicable wage withholding requirements (i.e., federal, state, and local income taxes; FICA; and Medicare taxes). Contributions are also subject to the ADP test in the same manner as pretax §401(k) contributions. Pretax and Roth account balances can be considered separately for purposes of disregarding the requirement to offer a direct rollover option.[12] Sponsors are not required to offer participants a direct rollover option when an account balance is under $200.

Requirements. If an employer includes a designated Roth in its retirement options, an employee may elect to direct their §§401(k) or 403(b) contributions to a designated Roth account. These are elective contributions that, unlike pretax elective contributions, are currently includible in the employee's gross income. The following requirements must be met in order to make contributions to a Roth account.

- Separate accounting must be maintained for the designated Roth contributions and any gains or losses.
- Separate records must be kept for each account.
- Employees must be given the option of electing pretax contributions in addition to the designated Roth accounts.
- Only designated Roth and rollover contributions may be made to designated Roth accounts.

The plan administrator is responsible for accounting and maintaining the records for each employee's contributions.

Designated Roth **contributions are irrevocable** at the time the election is made. They cannot be moved to a traditional §§401(k) or 403(b) plan at a later date.

Designated Roth account earnings are exempt from income tax if held in an account until they are qualified for distribution. To be qualified, designated Roth contributions must be held until an employee has participated in the plan for five years and the participant:

- Attains age 59½,
- Becomes permanently or totally disabled, or
- Dies.

Like pretax §§401(k) or 403(b) plans, designated Roth plans can feature auto-enrollment options and offer participants the opportunity to **take loans** against their balances. Designated Roth participants are also allowed to change investment options as frequently as their plan documents allow. Plans must provide an election to change the designation of contributions at least once per year.

Designated Roth plans share IRC §402(g) contribution limitations with pretax §§401(k) or 403(b) plans, including the additional **catch-up contribution option** available to participants aged 50 and over. For 2011, these **contribution limitations are $16,500 and $5,500,** respectively. Designated Roth contributions are also **included when figuring the overall IRC §415 limitation** of $49,000 for aggregated annual employer and employee contributions.

12. Treas. Reg. §1.401(a)(31)-1.

Taxation. The tax treatment of nonqualified distributions from a designated Roth account is different than those from a Roth IRA. Nonqualified distributions are actually treated more like traditional IRAs that contain nondeductible, after-tax contributions. The difference lies in the ordering rules for distributions. While Roth IRA distributions are considered to come first from contributions (basis), then from earnings, traditional IRA and designated Roth account distributions **are allocated between basis and earnings.**[13]

Designated Roth accounts also differ from other qualified plans, like traditional IRAs, because they are **available to high-income wage earners**. Designated Roth accounts have no income limitations.

Distributions. Although designated Roth contributions are made with after-tax dollars, participants cannot freely withdraw funds held in designated Roth accounts without tax consequences. Distributions are subject to the same RMD tules as traditional §§401(k) or 403(b) plans. **Hardship withdrawals** may be taken if a plan document allows, but any earnings on nonqualified distributions may be subject to tax.

The allocation is based on the following formula:

$$\text{Distribution} \times \frac{\text{Basis in account}}{\text{Account balance}} = \text{Nontaxable distribution}$$

Example 5. Millie, age 49, decided to take advantage of the designated Roth option her employer offered by electing to contribute her full $8,000 bonus to a designated Roth account in January 2010. Her investment did quite well, and her account balance grew to $12,000 by the end of the year. However, on December 31, 2010, Kay took a $10,000 hardship withdrawal from her account to pay for emergency medical expenses.

Because Millie did not participate in her designated Roth account for at least five years, her withdrawal is not qualified for tax exemption. Millie must allocate a portion of her distribution to earnings, which she then must include in her gross income. She determines the nontaxable portion of her distribution by multiplying the $10,000 total distribution by a fraction; the numerator of which is her $8,000 basis in the account, and the denominator of which is the $12,000 account balance.

$$\$10{,}000 \times \frac{\$8{,}000}{\$12{,}000} = \$6{,}667$$

Millie may exclude $6,667 of her $10,000 distribution, which represents the initial investment portion of her distribution. However, she must include the $3,333 ($10,000 – $6,667) investment earnings portion of her distribution in her 2010 gross income.

Millie may be subject to an early-distribution penalty of $333 ($3,333 × 10%) on the taxable portion of her distribution.

Rollovers. A Roth account may not accept any rollovers from a nonRoth account, and funds from a Roth account cannot be rolled over to a nonRoth account. However, funds from a Roth IRA and a designated Roth account can be commingled.

The tax treatment of recharacterizations, conversions, and rollovers from designated Roth accounts is different than that of Roth IRAs. (See the section on rollovers and conversions later in the chapter.) Unlike a Roth IRA contribution, there is no provision for a participant to recharacterize a pretax §§401(k) or 403(b) contribution into an after-tax contribution before the due date of the participant's return.

Likewise, the balance in a pretax deferred compensation account cannot be converted or rolled into a designated Roth account. Designated Roth funds may be rolled over only into another designated Roth §401(k) account or a Roth IRA. Designated Roth accounts cannot be rolled over into §403(b) accounts.

13. IRC §72(e)(8).

Advantages of Designated Roth Accounts. Designated Roth accounts generally benefit the following types of taxpayers.

- **Highly compensated workers.** The expanded eligibility requirements for designated Roth accounts make the Roth opportunity available to high-income taxpayers for the first time. Because highly compensated workers are more likely to be better prepared for retirement, they are also more likely to benefit from the Roth concept because they will presumably be in a high tax bracket in retirement. They also may be attracted to the concept of leaving a portion of their retirement income tax-free to heirs.

- **Younger workers.** Because younger workers are more likely to start out in a lower tax bracket, they may benefit more from the long-range tax benefits offered by Roth savings vehicles. They also benefit from the longer length of time they have to accumulate tax-free growth in their Roth accounts. Increasing their present loan eligibility may be an added benefit, because lenders sometimes reference an applicant's adjusted gross income.

- **Participants with adequate traditional retirement accounts.** The Roth option allows retirement savers to diversify their nest eggs and hedge their risks against tax rate uncertainty.

- **Participants who plan to continue working past their traditional retirement age.** Participants who plan to continue working after their normal retirement age will likely benefit from the flexibility of having a designated Roth account because they are more likely to be in a higher income tax bracket and face taxable social security benefits.

Individual Retirement Arrangements (IRAs)

Traditional IRAs. An IRA can be in the form of an individual retirement account or an individual retirement annuity. Most financial institutions — such as banks, brokerage houses, and mutual fund companies — offer individual retirement accounts. These funds can be placed in any type of investment, other than collectibles or property for the personal use of owners or their family. The choices, however, vary according to the type of institution that holds the IRA funds.

Each year, individuals under age 70½ can contribute up to the lesser of their compensation or the applicable annual dollar limit. IRA contributions must be made by the due date of the individual's income tax return (April 15), not including extensions. For 2011, the contribution limit is $5,000 per individual. In the case of a married filing jointly (MFJ) 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 income for the year.

Individuals who are at least 50 years old by the end of the year may make additional catch-up contributions. For 2011, the IRA catch-up contribution limit is an additional $1,000.

Contributions to traditional IRAs are fully deductible if the taxpayer and the taxpayer's spouse are not eligible to participate in an employer-sponsored retirement plan and are under age 70½ at the end of the tax year. The deductible contribution is reduced if the taxpayer is eligible to participate 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.

MAGI is calculated as **adjusted gross income plus** the following.

- Traditional IRA deduction
- Student loan interest deduction
- Tuition and fees deduction
- Domestic production activities deduction
- Foreign earned income exclusion and/or housing exclusion
- Foreign housing deduction
- Excludable qualified savings bond interest
- Excluded employer-provided adoption benefits

Taxpayer Covered by Employer's Plan	2011 MAGI Phaseout Range	Phaseout Span
MFJ or qualifying widow(er) (QW)	$90,000–110,000	$20,000
Single (S) or head of household (HoH)	56,000–66,000	10,000
MFS	0–10,000	10,000

If a married couple files jointly 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 $169,000.

Taxpayer Covered by Employer's Plan	2011 MAGI Phaseout Range	Phaseout Span
MFJ — one spouse not covered	$169,000–179,000	$10,000

If an active participant's MAGI exceeds the applicable dollar amount, the deductible contribution is calculated as follows.

Step 1. The lower amount of the MAGI phaseout range is subtracted from the taxpayer's MAGI. If the taxpayer's MAGI is equal to or more than the upper MAGI limit, the IRA contribution is not deductible.

Step 2. The result of Step 1 is divided by the total amount of the phaseout span.

Step 3. The IRA full-contribution limit is multiplied by the percentage calculated in Step 2.

Step 4. The result of Step 3 is subtracted from the IRA full contribution limit.

Example 6. Ted is age 45 and single. He earns $63,000 per year from his job. He has no other income on his return and is covered by his employer's retirement plan. He asks his tax professional to help him plan for his IRA contribution. Using the step-by-step calculation, his tax professional determines that Ted may contribute $5,000 to his IRA for 2011, but may only deduct $1,500.

Step 1. $63,000 MAGI – $56,000 MAGI phaseout lower amount = $7,000

Step 2. $7,000 ÷ $10,000 phaseout span (single) = 70%

Step 3. $5,000 contribution limit × 70% = $3,500

Step 4. $5,000 – $3,500 = $1,500 deductible contribution

Example 7. Reese is age 45 and married. He earns $170,000 per year from his job. Reese and his wife, Cynthia, have no other income on their joint return. They each contribute $5,000 to an IRA for 2011. Reese cannot deduct his contribution because he is an active participant in an employer's retirement plan and the couple's joint return MAGI exceeds the top end of the phaseout range ($110,000).

Cynthia can deduct $4,500, calculated as follows.

Step 1. $170,000 MAGI – $169,000 phaseout lower amount = $1,000

Step 2. $1,000 ÷ $10,000 phaseout span (MFJ one spouse not covered) = 10%

Step 3. $5,000 contribution limit × 10% = $500

Step 4. $5,000 – $500 = $4,500 deductible contribution

If a distribution is made from a traditional IRA with basis, the taxable amount is calculated as in the following example.

Example 8. Phyllis, age 60, made a $4,000 IRA contribution for the 2010 tax year, of which $500 was nondeductible. In 2011, Phyllis made a $5,000 contribution to an IRA, all of which was nondeductible. At the end of 2010, the balance in all her IRA accounts was $10,000. If she withdraws $1,000 in 2011, she will have to include $450 in gross income in 2011, computed as follows:

Nondeductible contribution/IRA balance	$5,500 ÷ $10,000 = 55%
Return of nondeductible portion	55% × $1,000 = $550
Taxable distribution	$1,000 − $550 = $450

Roth IRAs. The primary difference between a traditional IRA and a Roth IRA is that the tax treatment of the contributions and distributions is reversed. Contributions to a traditional IRA are deductible if the AGI limits are met. Contributions to a Roth IRA are never deductible. Distributions from a traditional IRA are taxable if contributions were deducted. Qualified distributions from a Roth IRA are not taxable.

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A Roth IRA must be established and contributions made by April 15 following the year in which the contribution applies. Unlike a traditional IRA, contributions to a Roth IRA can be made after an individual reaches age 70½, and balances can remain in a Roth IRA for the length of the account holder's life.

Contributions to a Roth IRA are based upon filing status and MAGI of the taxpayer, as shown in the following table for 2011:

	2011 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
S, HoH, or MFS (did not live with spouse)	Less than $107,000	At least $107,000 but less than $122,000	$122,000 or more
MFJ or QW	Less than $169,000	At least $169,000 but less than $179,000	$179,000 or more

If the MAGI is between the full-contribution MAGI limit and the maximum MAGI limit, the contribution is phased out over a $10,000 range for taxpayers in the MFJ, QW, and MFS (lived with spouse) categories. It is phased out over a $15,000 range for the S and HoH categories. The allowable Roth IRA contribution for taxpayers whose MAGI is in excess of the full-contribution MAGI limit and below the maximum MAGI limit is calculated as follows.

Step 1. The taxpayer's MAGI is subtracted from the applicable MAGI limit.

Step 2. The result of Step 1 is divided by the applicable phaseout range.

Step 3. The Roth IRA full-contribution limit is multiplied by the percentage calculated in Step 2 to determine the allowable Roth IRA contribution.

Example 9. Miguel is single, and his 2011 MAGI is $108,000. He may contribute $4,667 to his Roth IRA.

Step 1. $122,000 limitation – $108,000 MAGI = $14,000

Step 2. $14,000 ÷ $15,000 phaseout range= 93.33%

Step 3. $5,000 contribution limit × 93.33% = $4,667

Modified AGI. MAGI for Roth IRA purposes is defined as **AGI** with the following adjustments.

Minus

- Income resulting from the conversion of a traditional IRA to a Roth IRA or an RMD from an IRA (if figuring MAGI for conversion purposes)
- Income resulting from Roth IRA rollovers from qualified retirement plans

Plus

- Traditional IRA deduction
- Student loan interest deduction
- Tuition and fees deduction
- Domestic production activities deduction
- Foreign earned income exclusion and/or housing exclusion
- Foreign housing deduction
- Excludable qualified savings bond interest
- Excluded employer-provided adoption benefits

SIMPLE IRA. A SIMPLE (savings incentive match plans for employees) plan is a tax-favored retirement plan that may be established by an **employer with 100 or fewer employees.**[14]

Employees eligible to participate are those who have **earned at least $5,000** during any two years preceding the current calendar year, whether or not consecutive, and are expected to earn at least $5,000 during the year in which contributions are made. The employer can use less restrictive eligibility requirements in the plan by eliminating the prior year compensation requirements or current year compensation requirements. The employer must **allow all eligible employees to participate** in the SIMPLE plan. However, employees may be excluded from the plan if any of the following apply.

- The employees participate in a collective bargaining unit (union).
- The employees are nonresident aliens who earn no income within the United States.
- An acquisition, disposition, or similar transaction has happened and the employees would not be considered employees had the transaction not occurred.[15]

A SIMPLE plan can be established only if the employer maintains no other retirement plan. An exception to this rule exists for employers who maintain different plans for employees who are part of a collective bargaining unit (union).

A SIMPLE account can be part of a §401(k) plan or a plan that uses IRAs. A SIMPLE plan may not be established in a Roth IRA, although after an employee participates in a SIMPLE IRA for two years, the account can be converted to a Roth IRA or rolled over to any other IRA. Prior to the 2-year period, rollovers to other types of IRAs are not permitted and any transfer to an account that is not a SIMPLE IRA is considered a taxable distribution and is subject to applicable early distribution penalties.[16]

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14. IRC §408(p); IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE and Qualified Plans).*
15. IRS Notice 98-4, 1998-1 CB 269.
16. IRS Notice 98-4, 1998-1 CB 269, Q & A I-3 and I-4.

SIMPLE plans must be maintained on a calendar-year basis. The plan must be established between January 1 and October 1 during the year in which contributions will begin. The only exception to this rule is for an employer whose business commences operations after October 1. These new employers are allowed to create a SIMPLE IRA as soon as it is administratively feasible.

SIMPLE plans are started by completing Form 5304-SIMPLE or Form 5305-SIMPLE. Form 5304 is used when the **employee** chooses the financial institution that will maintain the SIMPLE IRA, and Form 5305 is used when the **employer** designates the financial institution that will be used.

A SIMPLE plan allows **eligible employees** to direct the employer to reduce their salary in exchange for contributing the reduction to their retirement plan. These contributions must go to a SIMPLE IRA, not to the employee's traditional IRA. In addition to salary reduction contributions, the employer must make either matching contributions or nonelective contributions to the plan. Employees may not opt out of a SIMPLE plan. However, they may choose not to make contributions for the year. In this case, the only contribution would be the employer's nonelective contribution, if the plan provides for such contributions for the year. Employees can stop their contributions at any time during the year. If they do so, they may not be able to resume contributions until the beginning of the next calendar year.

The SIMPLE plan is advantageous to both the employee and the employer. The employee can make larger contributions to the SIMPLE plan than to a traditional IRA. However, employee contributions are subject to limitations. In 2011, the maximum contribution to a SIMPLE plan is $11,500. If the employee is at least age 50, an additional $2,500 contribution is permitted. If the employee's salary is under these amounts, then 100% of salary can be contributed. Employees who participate in other retirement plans are limited to $16,500 total (2011) annual contributions. Employers are not responsible for monitoring compliance with either of these limitations.[17]

The **advantage to the employer** is that it can provide a retirement benefit to the employee without the paperwork required for traditional types of retirement plans.[18] Employers can avoid the burdens of the top-heavy rules required by other plans. The employer may deduct all contributions made to its employees' SIMPLE IRA. Employers can also claim a tax credit for part of the ordinary and necessary costs of starting the plan. The credit equals 50% of the cost to establish, administer, and educate employees about the plan, up to a maximum of $500 per year for each of the first three years of the plan. The first year that the credit can be taken is the year prior to the year the plan becomes effective. The credit is claimed on Form 8881, *Credit for Small Employer Pension Plan Startup Costs.*

Employer Contributions. The employer is generally required to match each employee's salary reduction contribution on a dollar-for-dollar basis up to 3% of the employee's compensation. If the employer chooses, it may instead make nonelective contributions of 2% of the employee's compensation. When determining the nonelective contribution, the compensation limit amount is $245,000 for 2011. Therefore, the maximum nonelective employer contribution is $4,900 ($245,000 × 2%). If the employer chooses to make nonelective contributions, it must make them for all eligible employees whether or not they make salary reduction contributions. The employer may choose to restrict the nonelective contributions to eligible employees who make $5,000 or more in the year, if the plan document so provides.

> **Example 10.** Groups to Go, Inc., has 20 employees who are eligible to participate in its SIMPLE IRA plan. In 2011, the company chose the matching election for its contributions to the plan. Therefore, only the employees who participate in the plan and contribute to their SIMPLE IRA receive employer contributions up to 3% of compensation.
>
> Darla has a yearly salary of $65,000 and decides to contribute 5% of her salary to her SIMPLE IRA. Her yearly contribution is $3,250. Groups to Go matches Darla's contribution up to 3% of her salary or $1,950. Darla's total contribution to her SIMPLE IRA is $5,200 ($3,250 + $1,950). The financial institution that is trustee for the SIMPLE IRA offers several investment choices and Darla is free to select which investment option suits her best.

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17. Ibid, Q & A C-3.

18. IRS Pub. 590, *Individual Retirement Arrangements (IRAs).*

Contributions must be made for every employee who performed personal services during the year — even those who died or were terminated.

Example 11. Pot Holes Away, Inc., has 50 employees who are eligible to participate in its SIMPLE IRA plan. The company chose to make a 2% nonelective contribution for each of its employees in 2011. Under this option, even if an eligible employee does not contribute to their SIMPLE IRA, the employee still receives an employer nonelective contribution of 2% of salary.

Tommie has an annual salary of $30,000. He decided that he cannot afford to contribute to his SIMPLE IRA this year. Even though he does not contribute, Pot Holes Away must make a nonelective contribution of $600 ($30,000 × 2%) to Tommie's SIMPLE IRA.

Each year, the employer can choose the same or a different method for the next year's contribution. A summary description of the plan must be provided to employees at least 60 days before they are eligible to participate in the plan, and prior to the employee election period for each year the employer maintains the plan (usually November 2 prior to each calendar year). Information that must be contained in this communication includes:

- Details concerning the employee's opportunity to make or change a salary reduction,
- A description of the method of contribution that the employer will make for the following calendar year (either a matching or nonelective contribution), and
- A summary provided by the financial institution where the SIMPLE IRA is maintained.[19]

There are timing requirements for employers making contributions under a SIMPLE IRA plan. **Employee contributions** must be deposited in the financial institution serving as trustee for the plan within 30 days after the end of the month in which the amounts would otherwise have been payable to the employee in cash. The **employer contribution** must be made by the due date, including extensions, for filing the business tax return for the year. All amounts deposited into an employee's SIMPLE IRA are nonforfeitable.

Note. It is recommended that employee deferrals be remitted at the same time as payroll tax deposits. If an employer fails to make required contributions according to its plan, the tax-favored treatment of the SIMPLE IRA plan is lost for the employer and all plan participants. An employer can correct certain SIMPLE IRA plan failures under the IRS's employee plans compliance resolution system. The IRS has a SIMPLE IRA Plan Fix-It Guide on its website.[20]

Information Reporting. There is no requirement for the employer to submit annual financial reports to the IRS for SIMPLE IRAs. The financial institutions holding the SIMPLE IRAs annually provide information on Form 5498, *IRA Contribution Information,* to all participants and to the IRS. Distributions from a SIMPLE IRA are reported on Form 1099-R, *Distributions from Pensions, Annuitites, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts, etc.* SIMPLE IRA contributions **are not** included in the "wages, tips, other compensation" box on Form W-2. However, salary deferrals are included in the boxes for social security and Medicare wages.

Distributions. Plan participants cannot take loans against their SIMPLE IRAs. Distributions can be taken as a lump sum or rolled over to another IRA or employer retirement plan. Rollovers to other SIMPLE IRAs are tax free. Rollovers to other types of IRAs are tax free as long as the account has been held for at least two years. SIMPLE IRAs are treated the same as traditional IRAs for distribution and estate tax purposes.[21]

Note. For distributions made before two years, the penalty is 25% of the distribution.

19. IRS Notice 98-4, 1998-1 CB 269, Q & A G-1.

20. [www.irs.gov/pub/irs-tege/simple__checklist.pdf] Accessed on Aug. 18, 2011.

21. IRS Pub. 4334, *SIMPLE IRA Plans for Small Businesses.*

SEP IRA. Any employer is eligible to establish a SEP (simplified employee pension) IRA. However, there are certain requirements to keep the plan qualified. Employers must contribute to the accounts of each employee who meets the following criteria, even for those employees who die or are terminated from employment during the year.

1. The employee has reached age 21 by the end of the plan year.
2. The employee has worked for the employer in at least three of the five immediately preceding years.
3. The employee has received at least $550 in compensation from the employer during 2011.[22]

Employers may use less restrictive participant requirements than those listed above. The employer may exclude employees who are covered by a collective bargaining agreement and nonresident aliens.

Advantages. SEP IRAs offer the following advantages.

1. A SEP IRA does not have the start-up and operating costs of a conventional retirement plan and it allows for a contribution of up to 25% of each employee's salary.
2. Contributions to a SEP IRA are tax deductible to the employer.
3. The employer is not required to make contributions each year because contribution decisions can change annually.
4. There are generally no information documents for the employer to file with the IRS annually.
5. A tax credit of up to $500 per year is available to cover startup costs for the first three years of the plan.

Establishing a SEP IRA. A SEP IRA may be established prior to the due date, including extensions, of the employer's tax return. To establish a SEP IRA, an employer must prepare a written agreement, provide employees with notice of the plan, and create an account for each eligible employee. The plan document sets forth the participation requirements and the allocation formula for employer contributions.

The employer can establish a SEP IRA by adopting Form 5305-SEP, a SEP prototype, or a customized document. Using Form 5305-SEP (shown on the following page) to establish the plan does not require prior IRS approval or a determination letter. If the employer wishes to use a prototype SEP IRA, the prototype plan must first be approved by the IRS. Prototype plans are usually available through a mutual fund company, insurance company, or other qualified institution. If the employer uses a customized document, the employer must obtain a ruling from the IRS to ensure that the plan meets all applicable requirements.

The following employers cannot use Form 5305-SEP to establish a SEP IRA.

- Those who maintain any other qualified retirement plan (except another SEP)
- Those who use leased employees
- Those who want a plan year to be other than a calendar year
- Those who want an allocation formula that takes into account social security contributions made by the employer

The employer must notify all eligible employees of their program rights under the plan, a list of the eligibility requirements, how contributions are allocated, and the name of a person to contact for further information. If the employer has chosen to use Form 5305-SEP, the employer must also provide a copy of this completed form to each eligible employee, along with a copy of the 5305 instructions.

22. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE and Qualified Plans).*

Form **5305-SEP** (Rev. December 2004) Department of the Treasury Internal Revenue Service

Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement

(Under section 408(k) of the Internal Revenue Code)

OMB No. 1545-0499

Do not file with the Internal Revenue Service

______________________________ (Name of employer) makes the following agreement under section 408(k) of the Internal Revenue Code and the instructions to this form.

Article I—Eligibility Requirements (check applicable boxes—see instructions)

The employer agrees to provide discretionary contributions in each calendar year to the individual retirement account or individual retirement annuity (IRA) of all employees who are at least ________ years old (not to exceed 21 years old) and have performed services for the employer in at least ________ years (not to exceed 3 years) of the immediately preceding 5 years. This simplified employee pension (SEP) ☐ includes ☐ **does not** include employees covered under a collective bargaining agreement, ☐ includes ☐ **does not** include certain nonresident aliens, and ☐ includes ☐ **does not** include employees whose total compensation during the year is less than $450*.

Article II—SEP Requirements (see instructions)

The employer agrees that contributions made on behalf of each eligible employee will be:

A. Based only on the first $205,000* of compensation.

B. The same percentage of compensation for every employee.

C. Limited annually to the smaller of $41,000* or 25% of compensation.

D. Paid to the employee's IRA trustee, custodian, or insurance company (for an annuity contract).

______________________________ Employer's signature and date

______________________________ Name and title

Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

Form 5305-SEP (Model SEP) is used by an employer to make an agreement to provide benefits to all eligible employees under a simplified employee pension (SEP) described in section 408(k).

Do not file Form 5305-SEP with the IRS. Instead, keep it with your records.

For more information on SEPs and IRAs, see Pub. 560, Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans), and Pub. 590, Individual Retirement Arrangements (IRAs).

Instructions to the Employer

Simplified employee pension. A SEP is a written arrangement (a plan) that provides you with an easy way to make contributions toward your employees' retirement income. Under a SEP, you can contribute to an employee's traditional individual retirement account or annuity (traditional IRA). You make contributions directly to an IRA set up by or for each employee with a bank, insurance company, or other qualified financial institution. When using Form 5305-SEP to establish a SEP, the IRA must be a Model traditional IRA established on an IRS form or a master or prototype traditional IRA for which the IRS has issued a favorable opinion letter. You may not make SEP contributions to a Roth IRA or a SIMPLE IRA. Making the agreement on Form 5305-SEP does not establish an employer IRA described in section 408(c).

When not to use Form 5305-SEP. Do not use this form if you:

1. Currently maintain any other qualified retirement plan. This does not prevent you from maintaining another SEP.

2. Have any eligible employees for whom IRAs have not been established.

3. Use the services of leased employees (described in section 414(n)).

4. Are a member of an affiliated service group (described in section 414(m)), a controlled group of corporations (described in section 414(b)), or trades or businesses under common control (described in sections 414(c) and 414(o)), unless all eligible employees of all the members of such groups, trades, or businesses participate in the SEP.

5. Will not pay the cost of the SEP contributions. Do not use Form 5305-SEP for a SEP that provides for elective employee contributions even if the contributions are made under a salary reduction agreement. Use Form 5305A-SEP, or a nonmodel SEP.

Note. *SEPs permitting elective deferrals cannot be established after 1996.*

Eligible employees. All eligible employees must be allowed to participate in the SEP. An eligible employee is any employee who: (1) is at least 21 years old, and (2) has performed "service" for you in at least 3 of the immediately preceding 5 years. You can establish less restrictive eligibility requirements, but not more restrictive ones.

Service is any work performed for you for any period of time, however short. If you are a member of an affiliated service group, a controlled group of corporations, or trades or businesses under common control, service includes any work performed for any period of time for any other member of such group, trades, or businesses.

Excludable employees. The following employees do not have to be covered by the SEP: (1) employees covered by a collective bargaining agreement whose retirement benefits were bargained for in good faith by you and their union, (2) nonresident alien employees who did not earn U.S. source income from you, and (3) employees who received less than $450* in compensation during the year.

Contribution limits. You may make an annual contribution of up to 25% of the employee's compensation or $41,000*, whichever is less. Compensation, for this purpose, does not include employer contributions to the SEP or the employee's compensation in excess of $205,000*. If you also maintain a salary reduction SEP, contributions to the two SEPs together may not exceed the smaller of $41,000* or 25% of compensation for any employee.

You are not required to make contributions every year, but when you do, you must contribute to the SEP-IRAs of all eligible employees who actually performed services during the year of the contribution. This includes eligible employees who die or quit working before the contribution is made.

Contributions cannot discriminate in favor of highly compensated employees. Also, you may not integrate your SEP contributions with, or offset them by, contributions made under the Federal Insurance Contributions Act (FICA).

If this SEP is intended to meet the top-heavy minimum contribution rules of section 416, but it does not cover all your employees who participate in your salary reduction SEP, then you must make minimum contributions to IRAs established on behalf of those employees.

Deducting contributions. You may deduct contributions to a SEP subject to the limits of section 404(h). This SEP is maintained on a calendar year basis and contributions to the

* *For 2005 and later years, this amount is subject to annual cost-of-living adjustments. The IRS announces the increase, if any, in a news release, in the Internal Revenue Bulletin, and on the IRS website at www.irs.gov.*

For Paperwork Reduction Act Notice, see page 2. Cat. No. 11825J Form **5305-SEP** (Rev. 12-2004)

SEP are deductible for your tax year with or within which the calendar year ends. Contributions made for a particular tax year must be made by the due date of your income tax return (including extensions) for that tax year.

Completing the agreement. This agreement is considered adopted when:

- IRAs have been established for all your eligible employees;
- You have completed all blanks on the agreement form without modification; and
- You have given all your eligible employees the following information:

1. A copy of Form 5305-SEP.

2. A statement that traditional IRAs other than the traditional IRAs into which employer SEP contributions will be made may provide different rates of return and different terms concerning, among other things, transfers and withdrawals of funds from the IRAs.

3. A statement that, in addition to the information provided to an employee at the time the employee becomes eligible to participate, the administrator of the SEP must furnish each participant within 30 days of the effective date of any amendment to the SEP, a copy of the amendment and a written explanation of its effects.

4. A statement that the administrator will give written notification to each participant of any employer contributions made under the SEP to that participant's IRA by the later of January 31 of the year following the year for which a contribution is made or 30 days after the contribution is made.

Employers who have established a SEP using Form 5305-SEP and have furnished each eligible employee with a copy of the completed Form 5305-SEP and provided the other documents and disclosures described in *Instructions to the Employer* and *Information for the Employee,* are not required to file the annual information returns, Forms 5500 or 5500-EZ for the SEP. However, under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), this relief from the annual reporting requirements may not be available to an employer who selects, recommends, or influences its employees to choose IRAs into which contributions will be made under the SEP, if those IRAs are subject to provisions that impose any limits on a participant's ability to withdraw funds (other than restrictions imposed by the Code that apply to all IRAs). For additional information on Title I requirements, see the Department of Labor regulation at 29 CFR 2520.104-48.

Information for the Employee

The information below explains what a SEP is, how contributions are made, and how to treat your employer's contributions for tax purposes. For more information, see Pub. 590.

Simplified employee pension. A SEP is a written arrangement (a plan) that allows an employer to make contributions toward your retirement. Contributions are made to a traditional individual retirement account/annuity (traditional IRA). Contributions must be made to either a Model traditional IRA executed on an IRS form or a master or prototype traditional IRA for which the IRS has issued a favorable opinion letter.

An employer is not required to make SEP contributions. If a contribution is made, however, it must be allocated to all eligible employees according to the SEP agreement. The Model SEP (Form 5305-SEP) specifies that the contribution for each eligible employee will be the same percentage of compensation (excluding compensation greater than $205,000*) for all employees.

Your employer will provide you with a copy of the agreement containing participation rules and a description of how employer contributions may be made to your IRA. Your employer must also provide you with a copy of the completed Form 5305-SEP and a yearly statement showing any contributions to your IRA.

All amounts contributed to your IRA by your employer belong to you even after you stop working for that employer.

Contribution limits. Your employer will determine the amount to be contributed to your IRA each year. However, the amount for any year is limited to the smaller of $41,000* or 25% of your compensation for that year. Compensation does not include any amount that is contributed by your employer to your IRA under the SEP. Your employer is not required to make contributions every year or to maintain a particular level of contributions.

Tax treatment of contributions. Employer contributions to your SEP-IRA are excluded from your income unless there are contributions in excess of the applicable limit. Employer contributions within these limits will not be included on your Form W-2.

Employee contributions. You may make regular IRA contributions to an IRA. However, the amount you can deduct may be reduced or eliminated because, as a participant in a SEP, you are covered by an employer retirement plan.

SEP participation. If your employer does not require you to participate in a SEP as a condition of employment, and you elect not to participate, all other employees of your employer may be prohibited from participating. If one or more eligible employees do not participate and the employer tries to establish a SEP for the remaining employees, it could cause adverse tax consequences for the participating employees.

An employer may not adopt this IRS Model SEP if the employer maintains another qualified retirement plan. This does not prevent your employer from adopting this IRS Model SEP and also maintaining an IRS Model Salary Reduction SEP or other SEP. However, if you work for several employers, you may be covered by a SEP of one employer and a different SEP or pension or profit-sharing plan of another employer.

SEP-IRA amounts—rollover or transfer to another IRA. You can withdraw or receive funds from your SEP-IRA if, within 60 days of receipt, you place those funds in the same or another IRA. This is called a "rollover" and can be done without penalty only once in any 1-year period. However, there are no restrictions on the number of times you may make "transfers" if you arrange to have these funds transferred between the trustees or the custodians so that you never have possession of the funds.

Withdrawals. You may withdraw your employer's contribution at any time, but any amount withdrawn is includible in your income unless rolled over. Also, if withdrawals occur before you reach age 59½, you may be subject to a tax on early withdrawal.

Excess SEP contributions. Contributions exceeding the yearly limitations may be withdrawn without penalty by the due date (plus extensions) for filing your tax return (normally April 15), but are includible in your gross income. Excess contributions left in your SEP-IRA after that time may have adverse tax consequences. Withdrawals of those contributions may be taxed as premature withdrawals.

Financial institution requirements. The financial institution where your IRA is maintained must provide you with a disclosure statement that contains the following information in plain, nontechnical language:

1. The law that relates to your IRA.

2. The tax consequences of various options concerning your IRA.

3. Participation eligibility rules, and rules on the deductibility of retirement savings.

4. Situations and procedures for revoking your IRA, including the name, address, and telephone number of the person designated to receive notice of revocation. This information must be clearly displayed at the beginning of the disclosure statement.

5. A discussion of the penalties that may be assessed because of prohibited activities concerning your IRA.

6. Financial disclosure that provides the following information:

a. Projects value growth rates of your IRA under various contribution and retirement schedules, or describes the method of determining annual earnings and charges that may be assessed.

b. Describes whether, and for when, the growth projections are guaranteed, or a statement of the earnings rate and the terms on which the projections are based.

c. States the sales commission for each year expressed as a percentage of $1,000.

In addition, the financial institution must provide you with a financial statement each year. You may want to keep these statements to evaluate your IRA's investment performance.

Paperwork Reduction Act Notice. You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	1 hr., 40 min.
Learning about the law or the form	1 hr., 35 min.
Preparing the form	1 hr., 41 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, Washington, DC 20224. Do not send this form to this address. Instead, keep it with your records.

Contributions. Only the employer can make contributions to SEP IRAs. Self-employed taxpayers who establish a SEP IRA can contribute to their own SEP IRAs. Contributions must be in the form of cash, check, or money order. Property cannot be contributed; however, participants can rollover certain property from one retirement account to another. The employer does not incur trustee or administrative fees because each employee controls their own SEP IRA account.

The maximum contribution to a SEP IRA for 2011 is the **lesser** of:

- 25% of compensation, or
- $49,000.

Contributions must be deposited into employee accounts on or before the due date (including extensions) for filing the employer's federal tax return for the year. Contributions made to all employees must be calculated on the same percentage of compensation. In addition, the employer is not required to make contributions each year because contribution decisions can change each year.

> **Example 12.** Bling Mining Company mines for semi-precious stones in the southwestern desert region of the country. Some years are very profitable and others are less so. Bling Mining decides to establish a SEP IRA for its employees. In 2010, the company's plan made a 10% contribution of employee compensation to all eligible employees. In 2011, the company had a wildly successful year and it revised its plan to increase the contribution level to 18%.

Information to Employees. Employers must annually provide each eligible employee with a written statement indicating the amount of the employer contributions made to the employee's SEP IRA. This statement must be provided to the employee by the **later of:**

- 30 days after the contribution, or
- January 31 following the calendar year for which the contribution was made.

Employers do not include SEP contributions in gross income reported on their employees' Form W-2. SEP-IRA contributions are not subject to income tax, social security, or Medicare taxes. However, in box 13 on the Form W-2, "Retirement Plan" is checked.

Deduction Limit for the Self-Employed. The self-employed taxpayer who contributes to a SEP IRA must make a special calculation to determine the maximum deduction. Compensation for these purposes is net earnings from self-employment (SE), which takes into account **both of the following.**

- The deduction for half of SE tax
- The deduction for contributions to a SEP IRA

Because the deduction for contributions to the SEP IRA and net earnings are mutually dependent, the deduction for contributions to the SEP IRA is calculated indirectly by reducing the contribution rate specified in the plan. This can be computed by taking the contribution percentage and dividing it by one plus the allowable percentage.

1. Plan contribution rate as a decimal (for example, 25% = .25)
2. Rate in line 1 plus 1 (.25 + 1 = 1.25)
3. Line 1 divided by line 2 is the SE rate as a decimal (.25 ÷ 1.25 = .20)

To arrive at the allowable contribution to a SEP IRA, the percentage just computed is multiplied by the profit of the business minus half of the SE tax **before** deducting the SEP contribution.

Nondiscrimination Rules. The plan must not discriminate in favor of any of the following.

- Highly compensated employees
- Officers
- 10% or greater shareholders
- Self-employed individuals

An employee is considered a highly compensated employee if they are a 5% owner or receive compensation in the prior year exceeding $110,000 (in 2010 or 2011).[23]

Employer contributions are automatically deemed discriminatory in favor of highly compensated employees unless the contributions bear a uniform relationship to each eligible employee's compensation.[24] A rate of contribution that decreases as compensation increases is considered uniform.[25]

> **Example 13.** Dokie Corporation makes SEP contributions of 10% of each eligible employee's first $30,000 of compensation. It contributes 2% for all compensation above $30,000. Dokie's SEP is not considered discriminatory because the rate of contribution decreases as its employees' compensation increases.

Permitted Disparity. The nondiscrimination rules permit a level of disparity in certain circumstances. A SEP plan that is integrated with social security benefits may provide for additional contributions when an employee's income exceeds a certain level.[26] The level at which the contribution increases is called the integration level. The integration level generally means compensation up to the social security wage base.

> **Example 14.** Dates for Duds provides a SEP plan to all its eligible employees. It contributes 3% of each employee's compensation up to the social security wage base. It also contributes 5% of the employee's compensation in excess of the social security wage base. This plan provides for a permitted disparity.

Top-Heavy Plans. A SEP plan that is top heavy must meet minimum contribution requirements for non-key employees.[27] A plan is considered top heavy if the aggregate accounts of key employees exceed 60% of the aggregate accounts of all employees. However, under SEP plans, employers may choose to use contributions rather than account balances to determine whether they fall under the top-heavy rules.[28]

If subject to the top-heavy rules, the employer must make minimum contributions for the non-key employees equal to the **lesser** of:

- 3% of each non-key employee's compensation, or
- The percentage at which contributions are made for the key employee with the highest percentage for the year.

SEP Plan Year. If the employer's tax year is not a calendar year, a SEP plan may be based on either the employer's tax year or the calendar year. Employer contributions made during a calendar year are deductible for the tax year of the employer within which the calendar year ends. Therefore, if the employer's tax year is a calendar year, the employer deducts the contributions made during the tax year/calendar year. If its tax year is not a calendar year but its SEP plan year is, the deduction is taken in the tax year containing the end of the calendar year for which the contributions were made.

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23. IRS News Release IR-2010-108 (Oct. 28, 2010).
24. IRC §408(k)(3)(c).
25. Prop. Treas. Reg. §1.408-8(c)(1).
26. Treas. Reg. §1.401(l)-1.
27. IRC §408(k)(1)(B).
28. IRC §416(i)(6)(B).

Example 15. Skillful Plumbing Company has a SEP IRA plan that is based on a calendar year. Skillful's tax year ends June 30. The contributions it made during the 2010 calendar year are deductible in its tax year ending June 30, 2011.

SARSEP Plans. SARSEP plans are a type of SEP. No new SARSEP (salary reduction simplification employee pension) plans have been established since December 31, 1996. However, employers can continue to maintain SARSEP plans established prior to that date. Employees hired after December 31, 1996, are still allowed to participate in existing SARSEP plans.

Employers operating a SARSEP plan must meet the following requirements on an annual basis for all eligible employees.

- At least 50% of employees eligible to participate must choose to make elective deferrals for the year.
- There can be no more than 25 employees eligible to participate in a SARSEP plan at any time during the preceding year.
- The elective deferrals of highly compensated employees must meet the SARSEP ADP test.[29]

In an IRS sample of examined SARSEP plans, the following common mistakes were found.

- Failure of deferral percentage test
- Failure to make the required top-heavy contribution
- Violation of the no-more-than-25-eligible-employees rule
- Violation of the 50% rule
- Violation of deductible employer contribution limit
- Failure to timely amend plan document[30]

Caution. Employers must be particularly vigilant about maintaining SARSEP plans in accordance with all applicable regulations. An employer can correct certain SARSEP plan failures under the IRS's employee plans compliance resolution system. The IRS has a SARSEP Plan Fix-It Guide on its website.[31]

29. IRS Pub. 4407, *SARSEP*.

30. Ibid.

31. [www.irs.gov/pub/irs-tege/sarsep_checklist.pdf] Accessed on Aug. 18, 2011.

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Plan Comparisons

	Designated Roth §401(k) or §403(b) Plans	Roth IRA	Traditional §§401(k) or 403(b) Plans
Income eligibility limitations for full contribution	No limits	MFJ: $168,999 Single/HoH: $106,999 MFS (apart): $106,999 [a] MFS (together): N/A [a]	No limits
Age/minimum service limitations	Qualified plan must offer participation to employees age 21+ or who have more than one year of service.	No age restrictions	Qualified plan must offer participation to employees age 21+ or who have more than one year of service.
Contributions	After-tax	After-tax	Pre-tax
Maximum contribution limit [b]	$16,500 (under age 50) $22,000 (age 50+)	$5,000 (under age 50) $6,000 (age 50+)	$16,500 (under age 50) $22,000 (age 50+)
Deadline for employee contributions	December 31	Due date of return, without extensions	December 31
Earnings	Tax-exempt [c]	Tax-exempt [c]	Tax-deferred
Qualified distributions	Tax free	Tax free	Taxable
Loans allowed	Yes, if plan allows	No	Yes, if plan allows
Hardship withdrawals allowed	Yes, if plan allows	N/A	Yes, if plan allows
Required minimum distributions	Employees: **later** of age 70½ or retirement Self-employed and 5% owners: age 70½	No requirement to take distributions during owner's lifetime	Employees: **later** of age 70½ or retirement Self-employed and 5% owners: age 70½
Qualified distributions	Owner participation in the account for at least **five years** and funds withdrawn after: • Age 59½ • Disability • Death	Owner participation in the account for at least **five years** and funds withdrawn after: • Age 59½ • Disability • Death • First-time home purchase (lifetime limit of $10,000)	Funds withdrawn after: • Age 59½ • Disability • Death

[a] If MFS but spouses did **not** live together at any time during the year, the contribution is limited for AGIs that are at least $107,000, but less than $122,000. If MFS but spouses lived together, a partial contribution is allowed if the AGI is less than $10,000.

[b] Other limitations may apply, such as earnings limits, plan limits, and combined employer/employee elective deferral limits.

[c] Earnings withdrawn with nonqualified distributions may be subject to tax and penalty.

Plan Comparisons (continued)

	Designated Roth 401(k) or 403(b) Plans	Roth IRA	Traditional 401(k) or 403(b) Plans
Early withdrawal penalties	10% penalty on nonqualified early withdrawals that are required to be included in income	Contributions (basis): none Earnings: 10% penalty on nonqualified early withdrawals	10% penalty on nonqualified early withdrawals of both contributions and earnings
Common exceptions to early withdrawal penalties	Unknown	• Equal lifetime payments • Used to pay medical expenses over 7.5% of AGI • Used to pay health insurance premiums for unemployed • College expenses	• Equal lifetime payments • Used to pay medical expenses over 7.5% of AGI • Age 55+ and separated from service
Recharacterization of contributions	Not allowed; Roth contribution designation is irrevocable	Allowed by due date of return	No statutory provision
Rollovers/conversions	May be rolled over to Roth IRA or another designated Roth 401(k) account	• Roth IRA to Roth IRA • Nondeductible IRA to Roth IRA • Traditional IRA to Roth IRA	Pre-tax contributions can be rolled over to: • Traditional IRA • SEP • §403(b) plan • §457 plan • Qualified plan After-tax contributions can be transferred to a traditional IRA by direct transfer only Pre-tax contributions cannot be converted to designated Roth account

5

DISTRIBUTIONS BEFORE AGE 59½

Withdrawals (distributions) from retirement plans may occur at any time. Generally, distributions taken before age 59½ are subject to a penalty.[32] The penalty applies to the part of the distribution that is included in gross income. This is in addition to any regular income tax due on the amount.

There are exceptions to this rule.[33] The penalty is not assessed when the following distributions are made.

1. Distributions to a **beneficiary after the owner's death**
2. Distributions because the owner is **disabled**
3. Distributions made as a series of **substantially equal periodic payments** (annuity)
4. Distributions from **employer plans** if the employee separated from the employer's service during or after the year the employee **attained age 55** (This does not apply to self-employed individuals or IRAs.)

Example 16. Mitch retires from All County Insurance at age 56. He takes a $30,000 distribution from his company retirement account during the year he retires. He is not subject to the 10% early-withdrawal penalty because he separated from service after age 55.

Example 17. Use the same facts as **Example 16,** except Mitch rolls his company retirement account over to an IRA. If he withdraws anything from his IRA prior to reaching age 59½, he will be subject to the 10% early-withdrawal penalty.

5. Distributions to pay for **deductible medical expenses** in excess of 7.5% of gross income
6. Distributions to pay the **cost of medical insurance** for the individual, spouse, or dependents if the individual lost their job, received unemployment compensation for 12 consecutive weeks, and the distribution was received no later than 60 days after being re-employed (IRA only)
7. Distributions to pay for **qualified higher education expenses** (IRA only)
8. Distributions to **buy, build, or rebuild a first home** (limited to $10,000 distribution) (IRA only)
9. Distributions to **satisfy an IRS levy** of the qualified plan
10. Distributions to a **qualified reservist**
11. Distributions from qualified employer plans to an alternate payee under a **qualified domestic relations order**

Generally, distributions are taxable in the year they are received. Exceptions exist for rollovers, qualified charitable distributions, tax-free withdrawals of contributions, and the return of nondeductible contributions.

Distributions from traditional IRAs are taxed as ordinary income. Distributions from pensions and annuity accounts are taxed as ordinary income based on the amount exceeding the net cost that is distributed.[34]

32. IRC §72(t).

33. IRS Pub. 575, *Pension and Annuity Income.*

34. IRS Pub. 939, *General Rule for Pensions and Annuities,* and IRS Pub. 575, *Pension and Annuity Income.*

REQUIRED MINIMUM DISTRIBUTIONS (RMD)

Funds invested in tax-deferred retirement accounts cannot be held indefinitely. Generally, distributions from retirement accounts must begin by April 1 of the year following the year the taxpayer turns age 70½. An exception to this general rule applies to individuals who participate in qualified pension, profit sharing, and stock bonus plans (qualified plans) and who continue to work past age 70½, as long as these individuals are not owners of the company that employs them. For these individuals, distributions from qualified plans (not including IRAs) must begin the year they actually retire.[35] Individuals who own traditional IRAs must begin RMDs at age 70½ regardless of whether they continue to be employed. Waiting until April 1 to take the initial distribution requires the individual to actually take two distributions in one year. 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 turned 70½ on August 8, 2010. He must take an RMD by April 1, 2011, based on his December 31, 2009 retirement account balance or he will incur an excise-tax penalty of 50%. He must also take an additional distribution by December 31, 2011, based on his December 31, 2010 balance.

The RMD is calculated by using the qualified retirement account balance at the close of business on December 31 of the preceding year and dividing it by the applicable distribution period or life expectancy identified in a table found in IRS Pub. 590, *Individual Retirement Arrangements*. If additional contributions are made to the retirement account during the year, they do not affect the RMD for that year because the RMD amount is determined based on the balance at the end of the prior year.

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[36] — Table III (most often used), and
2. The Joint Life and Last Survivor Table[37] — Table II (only used when the spouse is named sole beneficiary and is more than 10 years younger than the account owner).

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

Example 19. On December 31, 2009, the balance in Bill's IRA was $335,000. Bill is unmarried. He turned 70½ in October 2010, which requires him to withdraw his first RMD by April 1, 2011. He uses Table III to calculate the amount of his RMD. His divisor is 27.4 because he is 70 at the end of 2010. By April 1, 2011, he must withdraw $12,226 ($335,000 ÷ 27.4) from his account. His divisor for 2011 will be 26.5.

Uniform Lifetime (Table III)

Age	Distribution Period
70	$\boxed{27.4}$
71	26.5
72	25.6
73	24.7

35. IRC §401(a)(9)(C)(i)(II).

36. Treas. Reg. §1.401(a)(9)-9, A-2.

37. Treas. Reg. §1.401(a)(9)-9, A-3.

For married account owners whose spouse is more than 10 years younger and is the sole beneficiary, the RMD is calculated using the Joint Life and Last Survivor Table (Table II). This table reduces the RMD compared to the amount calculated with Table III.

Example 20. Bill from **Example 19** plans to marry Juliette, a woman who is 11 years younger. They are planning a wedding in February 2011. When Bill calculates his RMD for 2011, he may use Table II. His IRA balance at the end of 2010 is $323,000. His divisor is 27.2 because he is age 71 and his new bride is age 60. Therefore, his 2011 RMD will be $11,875 ($323,000 ÷ 27.2). This is his second RMD in 2011. The first RMD was based on his December 31, 2009 balance and the second RMD was based on his December 31, 2010 balance.

Joint Life and Last Survivor (Table II)

Age	60	61	62	63
70	27.4	26.7	26.1	25.4
71	$\boxed{27.2}$	26.5	25.8	25.2
72	27.0	26.3	25.6	24.9

Distributions from tax-deferred retirement accounts are included in the payee's gross income under the annuity rules.[38] In applying these regulations, there are three special requirements that must be considered.

1. All tax-deferred retirement accounts are treated as one contract.
2. All distributions during one year are treated as one distribution. For traditional IRAs, the RMD amount can be satisfied by withdrawing funds from any or all accounts.
3. The value of the contract, income on the contract, and investment in the contract are computed as of the end of the calendar year in which the tax year begins.[39]

RMD RULES FOR INHERITED IRAs

Stretch Planning for Inherited IRAs

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 RMD rules. The goal of the stretch period is to obtain maximum wealth accumulation on the retirement account. Proper naming of the beneficiary who receives the IRA proceeds at the account owner's death controls whether the maximum stretch period is obtained.

An inherited IRA or inherited retirement account simply means any retirement account that is payable after the death of an account owner. Some tax authorities 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.

Wealth Accumulation Advantages. During the stretch period of time, 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. 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 income taxation in the future.

38. IRC §§408(d)(1) and 72.

39. IRC §408(d)(2).

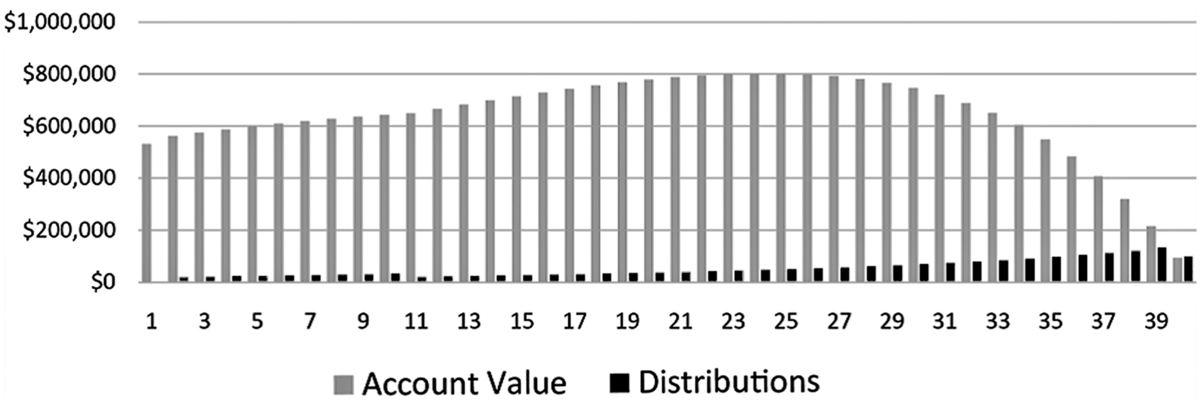
The following example illustrates how effective use of RMD rules can result in significant wealth accumulation.

Example 21. Jenni dies at age 78. Her IRA's value is $500,000. She named her surviving spouse, Mitchell, as her sole beneficiary. Mitchell is age 67 when Jenni dies. He elects to roll over Jenni's IRA into his own IRA. Mitchell names his 44-year-old daughter, Louise, as his beneficiary. At age 70½, Mitchell begins taking RMDs over the period determined by the Uniform Lifetime Table. Mitchell recalculates his life expectancy each year.

When Mitchell is age 79, he dies. Louise (age 55) begins taking RMDs over her life expectancy (29.6 years, which is fixed in the year Mitchell dies). Louise names her 30-year-old son, Wally, as her successor beneficiary.

Louise dies when she is 70 years old after receiving payments from Mitchell's IRA for 16 years. Wally continues to receive RMDs over Louise's remaining life expectancy (13.6 years). A summary of payments follows.[40]

Year 1	Mitchell becomes owner of Jenni's IRA.
Year 3	Mitchell begins taking RMDs at age 70½ using his life expectancy.
Year 12	Louise begins taking RMDs the year after Mitchell's death using her life expectancy.
Year 28	Wally begins taking RMDs the year after Louise's death using her remaining life expectancy.
Year 40	Jenni's IRA fund balance reaches zero.



This scenario assumes a fixed 6% annual rate of return is earned, all earnings are reinvested, all distributions are taken at yearend, and no tax law changes related to RMDs occur. Using these assumptions, over $2 million is distributed over 40 years to three generations.

DESIGNATED BENEFICIARIES

A retirement account owner can name any person or entity (charity, estate, or trust) as the beneficiary of the account. However, unless the beneficiary meets the definition of "designated" beneficiary at the time of the account owner's death, the beneficiary's time to delay recognition of income on the retirement account balance is limited.

A **designated beneficiary** must be a natural person. A natural person is defined as an individual, or "natural person" can also apply to certain qualifying trusts. A charity, corporation, estate, or nonqualifying trust may be named as a beneficiary, but they are never considered "designated" beneficiaries. A designated beneficiary is not required to be specified by name in the plan, or by the owner as long as the beneficiary is identifiable.[41] For example, the term "children" could be used as beneficiaries in the plan rather than specifically naming each child.

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40. This example was derived from "Stretch IRAs" by James Walsh, JD. Copyright 2011, Broadridge Investor Communication Solutions, Inc. Used with permission.

41. Treas. Reg. §1.401(a)(9)-4, A-1.

In order to be considered "designated," the individual must be identified by September 30 of the year following the year of the account owner's death.[42] This permits proper identification of designated beneficiaries.

There are specific rules pertaining to RMDs when an account owner dies and the tax-deferred retirement account is inherited by a designated beneficiary.

> **Note.** A beneficiary named through an estate, either under the owner's will or by state law, is not a designated beneficiary for RMD purposes.

Example 22. Kathleen dies on March 14, 2010. The beneficiaries of her retirement account are her two sons, Christopher, age 27, and Paul, age 31. Paul is always in money trouble and currently is in danger of losing his house. He doesn't want to wait to receive an annual distribution. He wants his money now. The value of Kathleen's account is determined and Paul gets his half of the account's value in cash on May 1, 2010. Because he received the cash before September 30, 2011, he is no longer a designated beneficiary. The RMD for this account is now based on Christopher's age.

Example 23. Juanita never saw any need to name a beneficiary for her retirement account. She didn't have any close relatives and never made an effort to know any of her distant family members. When she died, the state determined that the beneficiary of her estate was her second cousin, Ellian. For purposes of determining the RMD period, there is no designated beneficiary for Juanita.

A **surviving spouse** qualifies as a designated beneficiary. The surviving spouse also holds a unique position as a "super beneficiary" if they are the sole beneficiary. This occurs because there are several choices that can be made that affect distribution amounts after the spouse's death. The surviving spouse may delay recognition of the IRA amount in the following ways.

1. **Rollover.** The surviving spouse can roll over all or only a portion of the deceased's account balance to the surviving spouse's own IRA.[43]
2. **Alternative Treatment.** The surviving spouse can elect to treat the deceased's account as the surviving spouse's account. This can be accomplished in the following ways.
    a. **Using account owner's life expectancy.** The surviving spouse can continue to receive payments over the deceased account owner's life expectancy using the Single Life Expectancy Table (Table I) if the deceased owner was over age 70½. If the deceased account owner died before reaching age 70½, the surviving spouse can wait to begin distributions until the deceased account owner would have reached age 70½.[44]
    b. **Using surviving spouse life expectancy.** The surviving spouse can receive benefits over the surviving spouse's life expectancy using the Single Life Expectancy Table (Table I), with the life expectancy calculated annually.[45]

    No other beneficiary has these rights.[46]

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42. Treas. Reg. §1.401(a)(9)-4, A-4.
43. Treas. Reg. §1.408-8, A-5(a).
44. Treas. Reg. §1.401(a)(9)-3, A-3(b); IRS Pub. 590, *Individual Retirement Arrangements (IRAs)*.
45. Treas. Reg. §1.401 (a)(9)-5, A-5(c)(2).
46. Ibid.

Example 24. In 2010, Nevel is age 65 and his wife, Penelope, is age 72. On December 10, 2011, Penelope dies unexpectedly. While alive, Penelope named Nevel as her retirement account sole designated beneficiary. She took her RMD in 2010. Nevel can do one of the following.

- Nevel can roll over Penelope's account into his own retirement account or retitle the IRA in his own name.
- Nevel can continue to receive RMDs using Penelope's hypothetical life expectancy (Table I).
- Nevel can receive RMDs over his own life expectancy using Table I.

An **individual other than a spouse** can be named as a designated beneficiary. The RMD period in this situation is the longer of the beneficiary's life expectancy, or the deceased account owner's hypothetical life expectancy.[47] The Single Life Expectancy Table (Table I) is used for calculating the applicable factor. Table I is the only table used for determining factors for **after-death RMDs**.

Example 25. Josh dies at age 50 on May 1, 2010. He has $300,000 in his retirement account on his date of death. He named his daughter, Rachel, as his beneficiary. Because Rachel is an individual, she is considered a designated beneficiary.

Rachel is age 25 when Josh dies. The RMD rules permit Rachel to use her life expectancy for determining the RMD. Her age the year after Josh's death is 26. Her 2011 life expectancy from Table I is 57.2. The balance in Josh's account on December 31, 2010, is $302,588. Rachel takes this balance and divides it by the factor from Table I. The RMD in 2011 for Rachel is $5,290 ($302,588 ÷ 57.2). Thereafter, she subtracts one from 57.2 for each year after Josh's death.

Single Life Expectancy (Table I)

Age	Life Expectancy
25	58.2
26	$\boxed{57.2}$
27	56.2

Multiple Designated Beneficiaries

If **more than one beneficiary** is named by the retirement account owner, special RMD rules apply. If there is more than one beneficiary as of September 30 of the year following the year of the account owner's death, the beneficiary with the shortest life expectancy (the oldest person) is used as the "designated" beneficiary if both of the following apply.

1. All beneficiaries are individuals.
2. The account was not divided into separate accounts or shares for each beneficiary.

Example 26. When Langley established his retirement account, he knew he wanted to leave something to his sister's children, so he designated them as his beneficiaries. At the time he established the account, there were three children. However, a fourth child was born several years later. "Children" is considered an expandable class, and the new child is included as Langley's designated beneficiary.

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

Separate accounts for separate beneficiaries can be established at any time, either before or after the owner's RMD beginning date. Separate accounts are not combined for RMD purposes until the year after the accounts are established or, if later, the date of death. Generally, the RMD rules apply separately to each account. However, the distribution period for an account is separately determined (disregarding beneficiaries of the other account(s)) only if the account was established by December 31 following the year of the owner's death.[48]

Example 27. Jules dies at age 79 in 2011 with a $1 million IRA. He names his sons, Albert (age 50), Ben (age 40), and Chuck (age 38) as beneficiaries. By December 31 of the year following Jules' death, the IRA is titled in three subaccounts for the benefit of each son. Each separate account uses the life expectancy of the son owning the account. The accounts are titled "IRA of Jules, deceased, for benefit of [son's name]," using the son's social security number for identification purposes.

If the IRA were not separated and titled into three accounts, the RMD would be calculated using the oldest son's (Albert) life expectancy.

When a beneficiary chooses to **cash out** their portion of the retirement account by September 30 following the year of the account owner's death, this beneficiary is then **not** counted in determining the account owner's designated beneficiaries. This strategy removes a beneficiary who would otherwise jeopardize qualification as a designated beneficiary (such as a charity) for other beneficiaries in the group.

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

> *. . . Consequently, except as provided in §1.401(a)(9)-6, any person who was a beneficiary as of the date of the employee's death, but is not a beneficiary as of that September 30 (e.g., because the person receives the entire benefit to which the person is entitled before that date), is not taken into account in determining the employee's designated beneficiary for purposes of determining the distribution period for required minimum distributions after the employee's death.*

Disclaiming the Benefit. A beneficiary may choose to **disclaim** their portion of the retirement account. A disclaimer must follow the strict requirements of IRC §2518 in order to be considered valid. When a beneficiary disclaims entitlement to the IRA, this beneficiary is not taken into account when determining designated beneficiaries.

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

> *. . . Accordingly, if a person disclaims entitlement to the employee's benefit, pursuant to a disclaimer that satisfies section 2518 by that September 30 thereby allowing other beneficiaries to receive the benefit in lieu of that person, the disclaiming person is not taken into account in determining the employee's designated beneficiary.*

Example 28. Waylan dies on December 2, 2010. The beneficiaries of his retirement account are his children, Margo, Lance, Elvis, and Donna. Donna is a WBA star, earning in excess of $5 million per year. Her siblings never amounted to much. Donna formally disclaims the inheritance in January 2011, leaving her siblings as the only designated beneficiaries. Because Donna disclaimed her inheritance before September 30, 2011, the RMD of Waylan's account will be calculated using the age of the oldest remaining designated beneficiary if they have not separated the accounts. Donna will be treated as if she predeceased Waylan.

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48. Treas. Reg. §1.401(a)(9)-8, A-2(a)(2).

Trust as Beneficiary. Generally, a **trust** does not qualify as a designated beneficiary even when it is named the beneficiary. However, the **oldest beneficiary** of the trust is treated as the designated beneficiary if all the following are true.

1. The trust is a valid trust under state law or would be but for the fact that there is no corpus.
2. The trust is irrevocable or becomes irrevocable upon the owner's death.
3. The trust beneficiaries are identifiable from the trust instrument.
4. The retirement account trustee, custodian, or issuer was provided with a copy of the trust document with the agreement that, if the trust document is amended, the administrator will provide a copy of the amended document, or:
   a. A list of all trust beneficiaries, including contingent and remainder beneficiaries, with a description of the conditions of their entitlement;
   b. Certification that the list is correct and complete;
   c. An agreement that the owner will provide any amendments to the document to the trustee, custodian, or issuer within a reasonable amount of time; and
   d. Agreement to provide the trustee, custodian, or issuer a copy of the agreement when requested.

The deadline to provide beneficiary documentation to the trustee, custodian, or issuer is October 31 of the year following the year of the account owner's death.

> **Note.** See the 2009 *University of Illinois Federal Tax Workbook,* pages 357–360 for more information on a trust as beneficiary of an IRA. This can be found on the accompanying CD.

RMD DEFAULT RULES

The RMD default rules apply when a **beneficiary does not qualify as a designated beneficiary.** The RMD time period depends upon whether the deceased account owner died before or after reaching age 70½.

When an IRA account **owner dies before reaching age 70½** and there is no designated beneficiary, the IRA must be distributed within five calendar years after the date of the account owner's death. There is no requirement to withdraw installments during the 5-year period. Unequal withdrawals can be made at any time during the 5-year period. There is no 10% early-withdrawal penalty even when the recipient of the IRA is under age 59½.[49]

Example 29. Gertie dies at age 50 in August 2011. She was unmarried and had a $250,000 IRA. Gertie did not have any relatives or friends that she wanted to assign as the beneficiary of her IRA. Her estate becomes the beneficiary of her retirement account. Under Gertie's will, her estate passes outright to her two estranged children, Lomax (age 27) and Bertha (age 25). Her estate does not qualify as a designated beneficiary. Because Gertie died before her first RMD, the maximum time period used for distributing the IRA amount is five calendar years after August 2011. Lomax and Bertha must each withdraw their portion of the IRA amount by December 2016.

When an IRA account **owner dies on or after age 70½** and there is no designated beneficiary, the account balance at the end of the year prior to the year of death is used to calculate the RMD. The Single Life Expectancy Table (Table I) is used for the decedent's life expectancy using the decedent's age upon death minus one. For each year thereafter, the life expectancy is reduced by one for each year after the year of death.[50]

49. IRS Pub. 590, *Individual Retirement Arrangements (IRAs)*.

50. Ibid.

Example 30. Stephan dies in 2011 at age 80 without naming a designated beneficiary. His estate becomes the beneficiary of his retirement account. His only living relative is a nephew who lives thousands of miles away. On December 31, 2011, Stephan's account balance was $100,000. Table I shows a life expectancy at age 80 of 10.2. The figure used in the calculation for the RMD is 9.2 (10.2 – 1). In 2012, the RMD for his account is $10,870 ($100,000 ÷ 9.2). In the following year, the figure used in the calculation will be 8.2. This process continues until all amounts in the account are distributed to Stephan's nephew.

Single Life Expectancy (Table I)

Age	Life Expectancy
79	10.8
80	$\boxed{10.2}$
81	9.7

INSUFFICIENT WITHDRAWALS

If distributions are less than the RMD for the year, the account owner must pay a 50% excise tax on the amount not distributed as required.

If the excess accumulation is due to a reasonable error and the account owner is taking steps to remedy the insufficient distribution, the excise tax may be waived. To request a waiver of the excise tax, a statement of explanation is attached to Form 5329, *Additional Tax on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*.[51]

QUALIFIED CHARITABLE DISTRIBUTIONS

With the passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,[52] the provision for IRA owners who are at least age 70½ to make a direct charitable contribution of up to $100,000 from their IRA was extended through December 31, 2011.

A distribution made directly by an IRA trustee (other than a SEP or SIMPLE IRA) to an eligible charitable organization is considered a qualified charitable distribution (QCD) and is nontaxable. The IRA owner must be at least age 70½ when the distribution is made. The charitable organization must provide the same type of contribution acknowledgement that is required to claim a Schedule A charitable contribution deduction.[53]

For couples who file MFJ, each spouse may exclude up to $100,000 annually. Any QCD in excess of the $100,000 maximum annual exclusion limit is included in income, and reported like any other IRA distribution. The QCD amount is limited to the distribution amount that would otherwise be included in income. If the IRA includes nondeductible contributions, the QCD is first considered paid out of otherwise taxable income.

Example 31. Alice, age 75, has an IRA with a total value of $30,000. It consists of $20,000 deductible contributions and earnings, and $10,000 nondeductible contributions (basis). After all the devastating tornadoes in the spring of 2011, Alice instructed the trustee of her IRA to directly make a $25,000 distribution to the American Red Cross on May 1, 2011. The American Red Cross acknowledged her contribution via a letter and Alice files this with her important 2011 documents.

Because Alice is at least age 70½ and the distribution is made directly by the trustee to a qualified organization, the part of the distribution that would otherwise be includible in Alice's income ($20,000) is a QCD. A portion of Alice's distribution was attributed to her nondeductible IRA contributions ($5,000). Therefore, she must file Form 8606, *Nondeductible IRAs,* with her return.

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51. IRS Pub. 590, *Individual Retirement Arrangements (IRAs).*

52. PL 111-312.

53. IRS Pub. 526, *Charitable Contributions.*

Alice includes the total distribution ($25,000) on line 15a of Form 1040. She completes Form 8606 to determine the amount to enter on line 15b of Form 1040 and the remaining basis in her IRA. Alice enters "0" on line 15b. This is Alice's only IRA and she took no other distributions in 2011. She also enters "QCD" next to line 15b to indicate a qualified charitable distribution.

After the distribution, her basis in her IRA is $5,000. If Alice itemizes her deductions and files Schedule A with Form 1040, the $5,000 portion of the distribution attributable to the nondeductible contributions can be deducted as a charitable contribution, subject to AGI limits. She cannot take a charitable contribution deduction for the $20,000 portion of the distribution that was not included in her income.[54]

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code **Frugal Group IRA Trustees** **4321 Savalot Circle** **Goldville, MD 21200**	1 Gross distribution $ **25000** 2a Taxable amount $ **20000**	OMB No. 1545-0119 **2011** Form **1099-R**	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
	2b Taxable amount not determined ☐	Total distribution ☐	**Copy B**
PAYER'S federal identification number **65-0000000** / RECIPIENT'S identification number **333-44-5555**	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $	**Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.**
RECIPIENT'S name **Alice Cooper**	5 Employee contributions /Designated Roth contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	
Street address (including apt. no.) **1234 Rock Road**	7 Distribution code(s) **7** / IRA/SEP/SIMPLE ☒	8 Other $ %	This information is being furnished to the Internal Revenue Service.
City, state, and ZIP code **Anywhere, IL 60606**	9a Your percentage of total distribution %	9b Total employee contributions $	
10 Amount allocable to IRR within 5 years $ / 11 1st year of desig. Roth contrib.	12 State tax withheld $ $	13 State/Payer's state no.	14 State distribution $ $
Account number (see instructions)	15 Local tax withheld $ $	16 Name of locality	17 Local distribution $ $

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

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return **2011** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2011, or other tax year beginning , 2011, ending , 20		See separate instructions.
Your first name and initial **Alice**	Last name **Cooper**	**Your social security number** **3 3 3 4 4 5 5 5 5**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions. **1234 Rock Road**	Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). **Anywhere, IL 60606**		**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking ... change your ...
Foreign country name	Foreign province/county	Foreign postal code

If you did not get a W-2, see instructions.	14 Other gains or (losses). Attach Form 4797			14	
	15a IRA distributions	15a	25,000	b Taxable amount QCD 15b	0
	16a Pensions and annuities	16a		b Taxable amount 16b	

54. IRS Pub. 590, *Individual Retirement Arrangements (IRAs)*.

FUND TRANSFERS AND ROLLOVERS

Taxpayers participating in qualified retirement plans or who own IRAs may make tax-free transfers of assets from one retirement program to another retirement program. Transfers can be made from one trustee to another trustee, be incident to divorce, or be made via rollovers.

TRUSTEE-TO-TRUSTEE TRANSFERS

Transfers made between trustees, either requested by the taxpayer or at the trustee's request, are not considered rollovers. Because this transaction is not considered a rollover, it is not affected by the 1-year waiting period (discussed later in this chapter.)

TRANSFERS INCIDENT TO DIVORCE

When a couple divorces and either spouse owns a retirement account, the division of property may include one spouse receiving a portion of the other spouse's retirement account. **The transfer of funds is not taxable to either spouse if it is made under a divorce decree or separation agreement.** In order to ensure the transfer is not taxable, the transfer must be made either from trustee to trustee, or the IRA must be renamed for the spouse receiving the asset. The IRA can be split into separate IRAs and one of the accounts established with the ex-spouse as owner, or the entire IRA can be renamed with the ex-spouse as owner.

If money is withdrawn from an IRA by the account owner in order to pay the settlement amount, the distribution is treated as if it were received in a taxable distribution. If the IRA owner is under age 59½, the 10% early-withdrawal penalty applies in addition to the regular tax applied to the withdrawal amount.

Two court cases demonstrate the hazard of withdrawing money from an IRA rather than rolling it over. In *Bunney v. Comm'r,*[55] Mr. Bunney and his wife divorced and the property settlement required Mr. Bunney to split the value of his retirement account with his ex-wife. Mr. Bunney withdrew money from his IRA account, deposited it in a money market account, and gave a substantial portion of the money to his ex-wife. He only claimed the remaining portion of his IRA withdrawal on his tax return. The court found that the entire distribution was taxable; the 10% early-withdrawal penalty was applied and the substantial-underpayment-of-tax penalty was applied.

In *Jones v. Comm'r,*[56] Mr. Jones and his wife divorced. The property settlement required Mr. Jones to transfer his interest in his IRA to his ex-wife. Mr. Jones withdrew the funds from his IRA and later endorsed the distribution check over to his ex-wife. His ex-wife did not deposit the check into another IRA. Mr. Jones failed to timely file his tax return for that year. Consequently, the court found that the entire distribution was taxable; the 10% early-withdrawal penalty was applied; and the failure-to-timely-file penalty was applied.

Qualified Domestic Relations Order

A qualified domestic relations order (QDRO) is a judgment, decree, or court order which creates or recognizes the existence of an alternate payee's right to receive, or assigns to an alternate payee the right to receive, all or part of the benefits of a qualified plan.

The QDRO may require that the payment be made at any time. If the payee is a spouse or former spouse of the plan participant, the alternate payee is taxed as if they were the distributee of the plan. If the alternate payee is a child or other dependent of the participant, the distribution is deemed a distribution to the plan participant and is taxed to the plan participant.

The 10% early-distribution penalty does not apply to any distribution to an alternate payee under a QDRO regardless of the alternate payee's age at the time of the distribution.

55. *Bunney v. Comm'r,* 114 TC 259 (Apr. 10, 2000).

56. *Jones v. Comm'r,* TC Memo 2000-219 (Jul. 20, 2000).

The alternate payee may be eligible to roll over, or timely transfer to an IRA, all or a portion of a distribution under a QDRO. However, a trustee-to-trustee transfer is necessary to avoid the 20% withholding on the transfer.[57]

Example 32. Ben and Geri get divorced. Geri has an IRA of $60,000. A QDRO is issued naming their only child as the "alternate payee" and ordering payments of $500 per month. Because the alternate payee is Geri's child, the monthly payment of $500 from Geri's IRA is taxable to Geri (not the child). Geri will also be subject to the 10% penalty unless she meets one of the exceptions.[58]

Example 33. Ben and Geri get divorced. A QDRO is issued awarding $30,000 of the IRA to Ben. Because Ben is now the alternate payee, he may roll over the $30,000 into his own IRA or take a distribution. A distribution will be subject to taxation and a 10% penalty on Ben's return unless he meets one of the exceptions under IRC §72(t).

ROLLOVERS

Generally, a rollover is a tax-free distribution from one retirement account to another. Rollovers to or from a traditional IRA can originate from a variety of sources. These include transferring to or from any of the following.

- Another traditional IRA
- An employer's qualified retirement plan
- A deferred compensation plan of a state or local government (§457 plan)
- A tax-sheltered annuity plan (§403(b) plan)

The following chart illustrates which types of retirement accounts can be rolled from or rolled to another type of retirement account. The chart can be found on the IRS website at **www.irs.gov/pub/irs-tege/rollover_chart.pdf.**

ROLLOVER CHART

6/7/2011

Roll From	Roll To: Roth IRA	IRA (traditional)	SIMPLE IRA	SEP-IRA	457(b) (government)	Qualified Plan[1] (pre-tax)	403(b) (pre-tax)	Designated Roth Account (401(k), 403(b) or 457(b)[2])
Roth IRA	YES	NO	NO	NO	NO	NO	NO	NO
IRA (traditional)	YES[3]	YES	NO	YES	YES[4]	YES	YES	NO
SIMPLE IRA	YES,[3] after two years	YES, after two years	YES	YES, after two years	YES,[4] after two years	YES, after two years	YES, after two years	NO
SEP-IRA	YES[3]	YES	NO	YES	YES[4]	YES	YES	NO
457(b) (government)	YES[3]	YES	NO	YES	YES	YES	YES	YES,[3,5] after 12/31/10
Qualified Plan[1] (pre-tax)	YES[3]	YES	NO	YES	YES[4]	YES	YES	YES,[3,5] after 9/27/10
403(b) (pre-tax)	YES[3]	YES	NO	YES	YES[4]	YES	YES	YES,[3,5] after 9/27/10
Designated Roth Account (401(k), 403(b) or 457(b)[2])	YES	NO	NO	NO	NO	NO	NO	Yes, if a direct trustee to trustee transfer

[1]Qualified plans include, for example, profit-sharing, 401(k), money purchase, and defined benefit plans
[2]Governmental 457(b) plans, after December 31, 2010
[3]Must include in income
[4]Must have separate accounts
[5]Must be an in-plan rollover
For more information regarding retirement plans and rollovers, visit Tax Information for Retirement Plans Community.

57. IRC §402(e)(1)(B).
58. IRC §72(t)(3).

There is a 60-day time limit for making a rollover contribution. The 60-day requirement may be waived in the event of casualty, disaster, or other event beyond the taxpayer's reasonable control. If a distribution is not rolled over within the 60-day period, the transaction is considered taxable. The 60-day rollover requirement is waived automatically when all the following apply.

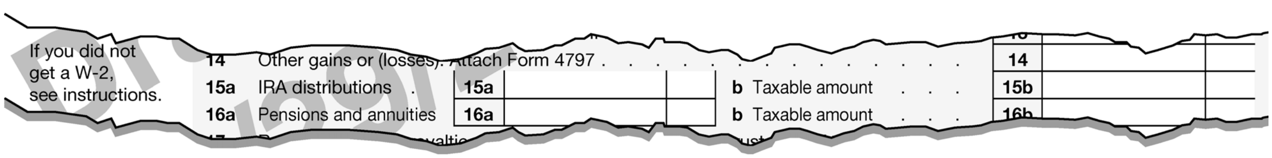
- The financial institution received the funds on the taxpayer's behalf before the end of the 60-day period.
- All rules established by the financial institution for depositing funds into an eligible retirement plan within the 60-day period were followed.
- The funds were not deposited within the 60-day period because of an error on the part of the financial institution.
- The funds are eventually deposited into an eligible retirement plan within one year of the rollover transaction.
- The transaction would have been a valid rollover if the financial institution had deposited the funds as instructed.

There is generally a 1-year rollover waiting period for an IRA if funds were distributed to be rolled over into another retirement plan or if the funds from one retirement plan were rolled in.

Example 34. Rae has two IRAs; Bank IRA and Mutual Fund IRA. Rae wants to create a new IRA — Credit Union IRA — and she withdraws funds from her Bank IRA to roll over into her Credit Union IRA. Once the rollover transaction occurs, she cannot make a tax-free rollover to or from either her Bank IRA or her Credit Union IRA for one year.

Reporting

Rollover amounts are reported on Form 1040, lines 15a and 15b. The distribution is reported on line 15a and if the total distribution was a rollover, zero is entered on line 15b. If only a portion of the distribution was rolled over, the taxable portion is entered on line 15b.


If you did not get a W-2, see instructions.

14	Other gains or (losses). Attach Form 4797			14	
15a	IRA distributions	15a	b Taxable amount	15b	
16a	Pensions and annuities	16a	b Taxable amount	16b	

FUND CONVERSIONS

Effective January 1, 2008, distributions from tax-qualified retirement plans, tax-sheltered annuities, and §457 plans can be rolled over directly to a Roth IRA, subject to the restrictions that currently apply to rollovers from a traditional IRA into a Roth IRA.

ROTH VERSUS TRADITIONAL IRA

The ability to eventually take tax-free withdrawals from a Roth IRA makes the conversion of a traditional IRA to a Roth seem attractive. However, this is a decision that has no "one size fits all" answer. Each taxpayer should analyze the options based on their individual circumstances. The conversion depends on a number of factors, including current tax rates versus future tax rates, how the taxes on the conversion will be paid, the size of the estate, plans for the estate, and who the beneficiaries are for the IRA.

Example 35. Leon, 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 but hold back some of the money in order to pay the applicable taxes.

Leon 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, Leon needs $8,333 ($7,500 ÷ .90). He can convert the balance of $41,667 to a Roth IRA.

If Leon 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 Leon 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 Leon had used nonIRA 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 $663,384.

Pros and Cons of Converting an IRA to a Roth 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 do they prefer to pass the investments to heirs?** With a Roth, there is no requirement to take mandatory distributions. 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?** For those who have seen their investments' value drop significantly, the decision about whether to convert from a traditional IRA to a Roth is simplified. 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 nonIRA funds to pay the taxes due after conversion?** If not, the conversion may end up costing the taxpayer money.

CONVERTING TRADITIONAL IRAs TO ROTH IRAs

In tax years beginning after December 31, 2009, taxpayers can convert (roll over) a traditional IRA to a Roth IRA regardless of the taxpayer's AGI and filing status.

If the taxpayer took a distribution from a Roth IRA after a conversion and made the election to include the income ratably over 2011 and 2012, 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 includible in income as a result of the conversion, or
- The remaining portion of the amount includible in income that was not already included in income.

Example 36. Mary has a traditional IRA with a value of $25,000. It contains only deductible contributions and earnings. She converts the traditional IRA to a Roth IRA in 2010.

If Mary takes a $5,000 distribution from a Roth IRA in 2010 after the conversion, she must include the $5,000 in income in 2010 under the accelerated rule. In 2011, she will include $12,500 (the lesser of half the income from the conversion or the remaining untaxed income from the conversion). In 2012, Mary will have $7,500 to include in income (the remaining untaxed portion of the conversion).

In addition to the special treatment afforded to Roth IRAs converted in 2010, 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. There is no sunset on this repeal.

Planning Tip. Taxpayers who were previously unable to contribute to Roth IRAs because their AGI was too high and have not been contributing to traditional IRAs because they are covered under a qualified employer plan may wish to start making nondeductible contributions to a traditional IRA. These taxpayers can now convert the traditional IRAs to Roth IRAs. See instructions for Form 8606, *Nondeductible IRAs,* for the proper reporting of these transactions.

To avoid creating excessive taxable income, an option is to have the taxpayer roll over all **deductible** IRAs, including earnings, into a §401(k) plan (if the plan permits this). Then only nondeductible funds plus earnings remain in the IRA(s). The taxpayer can convert the nondeductible funds into a Roth IRA, and the only amount taxable will be the earnings accumulated from the time of the rollover until the time of conversion.

Example 37. Lori has $250,000 in her traditional IRA. She earns $200,000 each year and is covered under her employer's qualified retirement plan.

She makes a nondeductible contribution of $5,000 per year for 2009, 2010, and 2011. Her basis in the traditional IRA is $15,000. The FMV of her IRA is $300,000 in 2011 when she converts it to a Roth IRA. In this situation, she owes tax on $285,000 ($300,000 – $15,000).

Example 38. Use the same facts as **Example 37,** except the qualified plan of Lori's employer allows for rollovers from IRAs. In 2011, she rolls over $285,000, pays no tax on the rollover, and then converts the remaining $15,000 from her IRA to a Roth IRA. Because her basis is $15,000, she pays no tax on the conversion to the Roth IRA. Each year, she can continue to make a nondeductible contribution to her traditional IRA and then convert that amount into a Roth IRA. This strategy effectively bypasses the AGI limits for contributing to Roth IRAs.

RECHARACTERIZATION

Another factor in favor of converting a traditional IRA to a Roth IRA is the ability to recharacterize the conversion if the taxpayer changes their 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 39. Jamal converted his traditional IRA to a Roth in January 2010. At that time, the value of the IRA was $85,000. At the end of 2010, the IRA had a value of $70,000. Jamal recharacterizes the Roth IRA back to a traditional IRA in March 2011 so that he doesn't have to pay tax on $15,000 of nonexistent income when he files his 2010 tax return.

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

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 40. Tia is single and covered by a retirement plan. She contributed $4,000 to a new traditional IRA on May 27, 2010. On February 24, 2011, Tia learns that her 2010 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. 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, 2010; recharacterized $3,000 of that contribution on February 24, 2011, 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 either of her 2010 or 2011 Forms 1040.[59]

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59. Instructions for Form 8606.

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 41. Logan is single and contributed $4,000 to a new Roth IRA on June 16, 2010. On December 29, 2010, Logan determines that his 2010 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, 2010; recharacterized that contribution on December 29, 2010, 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 2010 Form 1040, line 15a, and enters zero on line 15b.[60]

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.

RECONVERSION

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 includible 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.

60. Ibid.

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.[61]

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 the 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.[62]

> **Note.** An explanation of the process used to request a letter ruling is covered in Chapter 3, IRS Update.

ANNUITIES

An annuity is a series of payments made at regular intervals over a period of more than one year. However, the term **annuity** is also often used to describe a contract between an investor and an issuer whereby the investor gives the issuer a sum of money in exchange for a promise to be paid a certain amount of money periodically beginning after some date in the future.

Annuities can be qualified or nonqualified, and different rules apply to each. A **qualified annuity** is fully taxable when withdrawn, **unless nondeductible contributions** were made, such as a nondeductible IRA. If certain requirements are satisfied, contributions made to qualified annuities may be wholly or partially deductible from the taxable income of the individual or employer making the contributions. Like IRAs, qualified annuities are bound by the same RMD rules.[63]

Annuities may be funded with IRA contributions or pension funds. Investment regulatory agencies discourage placing IRA contributions into annuities because the tax-deferred character of IRAs negates the advantage of annuities and the higher servicing costs of annuities erode growth of the investment.

Example 42. Mika, an unmarried participant in a defined benefit plan, turns 70½ in 2010. The plan provides a monthly annuity payment of $2,500 for life with a 10-year period certain. In order to meet the requirements, Mika must begin drawing payments on or before April 1, 2011, and continue to receive $2,500 each month for the rest of her life. If she dies before March 2021, her beneficiary would receive the payments for the remainder of the 10 years.

Example 43. Alex participated in a profit sharing plan during his career. When he turned 70½, Alex calculated and took timely RMDs. At age 75, Alex decides to transfer his entire account balance to an annuity so he won't have to deal with the annual calculations. If Alex purchases the annuity on June 1, 2011, he can use any date between January 1 and June 1 as the starting date for his payment intervals.

> **Caution.** If Alex selects the annual option for his annuity and does not receive the annual RMD for the current year, he must calculate and take his RMD for the prior year under the profit sharing plan. Transferring the account to an annuity is not a method for skipping an RMD.

61. IRS Pub. 590, *Individual Retirement Arrangements (IRAs)*.
62. Treas. Reg. §301.9100-3.
63. IRC §403.

Nonqualified annuities are funded with nondeductible retirement funds. Therefore, they are exempt from the RMD rules that apply to retirement funds after a taxpayer reaches age 70½.[64]

A new law allows partial annuitization of a nonqualified annuity contract. Holders of nonqualified annuities (annuity contracts held outside of a tax-qualified retirement plan or IRA) may elect to receive a portion of the contract in the form of a stream of annuity contracts, leaving the remainder of the contract to accumulate income on a tax-deferred basis. A portion of an annuity, endowment, or life insurance contract may be annuitized while the balance is not annuitized. The annuitization period must be for 10 years or more, or for the lives of one or more individuals. The partial annuitization provision is effective for amounts received in tax years beginning after December 31, 2010.

ANNUITY PHASES

Annuities have two phases: the accumulation phase and the annuitization phase. In the **accumulation phase**, a person invests money with an insurance or investment company over a period of time or in a lump sum. The investment then produces income. Funds withdrawn during the accumulation phase are termed withdrawals and receive less favored tax treatment. In the **annuitization phase**, the annuity owner, annuitant, or beneficiary withdraws regular periodic payments from the contract until death or until a certain time period has elapsed.

An **immediate annuity** is one which is purchased with a single premium and requires distributions to begin within one year of the date the annuity is purchased. A **deferred annuity** does not have a predetermined date for payment distributions to begin. Tax rules governing annuities in the annuitization phase are more favorable.

PARTIES TO AN ANNUITY CONTRACT

There are three parties to an annuity contract: the owner, the annuitant, and the beneficiary. In many cases, the owner and annuitant are the same individual. These three parties are specified in the annuity contract or in related documents, such as employment agreements.

The owner is usually the purchaser of the annuity and has all the rights under the contract, except for the rights of any irrevocable beneficiary. The owner is responsible for income taxes on payments made from the annuity. If applicable, premature distribution penalties are based on the owner's age. If the owner dies during the accumulation phase, there is a mandatory distribution of the death benefit for contracts issued after January 18, 1985. The distribution can take the form of:

1. An immediate lump-sum payment,
2. A complete withdrawal within five years of the date of death,[65] or
3. Payments spanning the life of the beneficiary if there is a designated beneficiary and payments begin within one year of the owner's death.[66]

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64. IRC §4974.
65. IRC §72(s)(1)(B).
66. IRC §72(s)(2)(C).

The sole exception is that a spouse may elect to continue the contract.[67] If an owner dies after annuitization, payments continue to the beneficiary based on the annuitant's life and the chosen payment plan.[68] An annuity owner may be a natural person or a person who is not a natural person (e.g., corporations, partnerships, and trusts). With some exceptions, an annuity contract owned by a person who is not a natural person does not receive tax-deferred treatment and is taxed annually as ordinary income received or accrued by the owner.[69] Exceptions include:

- A trust or other entity holding the annuity as an agent for a natural person,[70]
- Immediate annuities,
- Annuities acquired by an estate upon the death of the owner, and
- Employers who are nominal owners of annuities that are part of a nonqualified deferred-compensation plan.

If the owner of an annuity is a grantor trust, the death of the grantor triggers mandatory distribution.

5

The annuitant and beneficiary are named by the owner of the annuity contract. The **annuitant** must be a natural person because the annuitant serves as the basis for measuring the life for purposes of determining the amount and duration of payments made by the insurance company under the contract.

The **beneficiary**, most often the spouse of the owner or annuitant, must be named in the contract. If the beneficiary is not named, a will or intestacy laws govern. The beneficiary designation may be revocable or irrevocable, with the revocability being lost if the owner dies. The beneficiary receives any residual contract value upon the death of the annuitant. Annuities provide varying payments based on the age of the owner and beneficiary and any term-certain survivorship established by the contract.

ANNUITY DISTRIBUTION REQUIREMENTS

Annuity distributions must be paid in periodic payments at intervals not longer than one year. They can be paid over a single life or over a joint life expectancy. Once the distribution period is established, it cannot be lengthened. The dollar amount of payments can only be increased for the following reasons.[71]

1. A percentage increase in a specified and generally acceptable cost-of-living index
2. A reduction in the employee payment to provide for a survivor benefit upon death, but only if the beneficiary whose life is being used to determine the period described in IRC §401(a)(9)(A)(ii) dies or is no longer the employee's beneficiary under a qualified domestic relations order (QDRO)[72]
3. A cash refund of employee contributions upon the employee's death
4. An increase in benefits under the plan

Distributions can be made under either a life annuity or joint and survivor annuity. Annuity payments must begin on or before the employee's required beginning date and must match the stated intervals for payment. If the interval is annual, there is only one required payment per year. However, payments can be monthly, bimonthly, quarterly, or semiannually. If the annuity contract is purchased after the required beginning date, the first payment interval must begin on or before the purchase date.

67. IRC §72(s)(3).
68. IRC §72(s)(1(A).
69. IRC §72(u)(1).
70. Ibid.
71. Prop. Treas. Reg. §1.401(a)(9)-6.
72. IRC §414(p).

THREE COMMON VARIETIES OF ANNUITIES

There are **three types** of annuities. Each type differs in how money in the contract is invested.

1. **Fixed annuities.** Fixed annuity payments are fixed for the entire life of the contract. In this regard, there is no risk to the owner. However, the payment amounts never increase.

2. **Variable annuities.** While payments are guaranteed in variable annuities, the amount of the payment is not guaranteed. Payments vary depending on the rise or fall of the stock market. The money is placed in investment options known as subaccounts, which are similar to mutual funds. Each subaccount has its own degree of risk, ranging from aggressive growth funds to bond funds. Therefore, the annuity holder has the opportunity to make substantial gains, depending on the performance of the investment. However, the annuity holder can lose money if the investments perform poorly. If the owner decides to transfer the money between subaccounts, there may be an associated fee. When annuitized, payments fluctuate depending on the performance of the investments. Some variable annuities allow **fixed annuitization,** in which the annuity holders receive fixed payments. The insurance or investment company recalculates payments each year based on the performance of the investments.

3. **Equity-indexed annuities**. In this type of annuity, the money is invested in a fixed account, with a stated guaranteed return, and the investor may earn an additional return based on the performance of a particular stock index, such as the Standard and Poor's 500 Index, the Dow Jones Industrial Average, the NASDAQ Composite Index, or the Russell 2000 Index. Therefore, the owner receives both the opportunity to earn money based on stock performance and the stability of a fixed account. However, the investment is essentially a fixed annuity, and the gains made in the contract due to the performance of the stock index are fairly small. When annuitized, payments are fixed.

OTHER ANNUITY FEATURES

Annuity contracts can include riders. Riders are additional options available to investors of annuities. Riders usually have an additional charge associated with them.

For example, an annuity has a death benefit, although it is not like one found in a life insurance policy. If the annuity holder dies before the contract annuitizes, the beneficiary receives either the current value of the annuity or the amount paid into it, whichever is greater. If the annuity holder dies when the investments are performing poorly and the account value is less than what was contributed, the beneficiary receives the amount the annuity holder contributed.

Once an annuity holder begins to receive monthly payments, the death benefit no longer exists on the contract. For example, if the annuity holder begins receiving annuity payments at age 65 and dies at age 67, the insurance company retains the money held in the contract. However, one can buy **term-certain annuities,** which guarantee that either the annuity holder or the beneficiary will receive payments for a certain period of time, such as 10 to 15 years. For example, if the annuity owner died three years after beginning to receive payments from a 10-year term-certain annuity, the beneficiary would still receive payments for the next seven years. As the term-certain period increases, payments made under the contract decrease.

The money in an annuity grows tax deferred, which means the money is not taxable until payments begin. Gains are taxed at ordinary income tax rates, a key disadvantage compared to investments whose gains are taxed at capital gain rates. If the annuity holder dies before payments begin, the beneficiary pays taxes on the gain from the death benefit. In either case, the person who receives the money (the annuity owner or beneficiary) is taxed at the ordinary income tax rate.

> **Note.** See the 2010 *University of Illinois Federal Tax Workbook,* pages 495–507, for a comprehensive discussion of annuities. This can be found on the accompanying CD.

SOCIAL SECURITY INCOME TAXATION

As a result of the 1983 Social Security Reform Act, social security income becomes taxable when half of the worker's social security income plus all other "provisional income" exceeds $25,000 (S) or $32,000 (MFJ). "Provisional income" includes municipal bond interest and similar nontaxable income, with all income reported on line 22 of Form 1040.

Example 44. Heather, who is single, received Form SSA-1099 reporting $12,000 of social security benefits she received in 2010 in box 5. She also had taxable interest income in 2010 of $24,000 and tax-exempt interest income of $1,000. She had no other income and no adjustments in arriving at AGI. Her taxable social security benefits are $3,000, as shown on the following worksheet.

2010 Form 1040—Lines 20a and 20b

Social Security Benefits Worksheet—Lines 20a and 20b *Keep for Your Records*

1.	Enter the total amount from **box 5** of **all** your **Forms SSA-1099** and **Forms RRB-1099.** Also, enter this amount on Form 1040, line 20a **1.** 12,000		
2.	Enter one-half of line 1	**2.**	6,000
3.	Combine the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21	**3.**	24,000
4.	Enter the amount, if any, from Form 1040, line 8b	**4.**	1,000
5.	Combine lines 2, 3, and 4	**5.**	31,000
6.	Enter the total of the amounts from Form 1040, lines 23 through 32, plus any write-in adjustments you entered on the dotted line next to line 36	**6.**	0
7.	Is the amount on line 6 less than the amount on line 5? ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. ☒ **Yes.** Subtract line 6 from line 5	**7.**	31,000
8.	If you are: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2010, enter $25,000 • Married filing separately and you lived with your spouse at any time in 2010, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17	**8.**	25,000
9.	Is the amount on line 8 less than the amount on line 7? ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. If you are married filing separately and you **lived apart** from your spouse for all of 2010, be sure you entered "D" to the right of the word "benefits" on line 20a. ☒ **Yes.** Subtract line 8 from line 7	**9.**	6,000
10.	Enter: $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2010	**10.**	9,000
11.	Subtract line 10 from line 9. If zero or less, enter -0-	**11.**	0
12.	Enter the **smaller** of line 9 or line 10	**12.**	6,000
13.	Enter one-half of line 12	**13.**	3,000
14.	Enter the **smaller** of line 2 or line 13	**14.**	3,000
15.	Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	**15.**	0
16.	Add lines 14 and 15	**16.**	3,000
17.	Multiply line 1 by 85% (.85)	**17.**	10,200
18.	**Taxable social security benefits.** Enter the **smaller** of line 16 or line 17. Also enter this amount on Form 1040, line 20b	**18.**	3,000

TIP *If any of your benefits are taxable for 2010* ***and*** *they include a lump-sum benefit payment that was for an earlier year, you may be able to reduce the taxable amount. See Pub. 915 for details.*

Example 45. Holly, who is single, received Form SSA-1099 reporting $12,000 of social security benefits she received in 2010 in box 5. She also had taxable interest income in 2010 of $34,000 and tax-exempt interest income of $1,000. She had no other income and no adjustments in arriving at AGI. Her taxable social security benefits are $10,200, as shown on the following worksheet.

2010 Form 1040—Lines 20a and 20b

Social Security Benefits Worksheet—Lines 20a and 20b *Keep for Your Records*

Before you begin:
- √ Complete Form 1040, lines 21 and 23 through 32, if they apply to you.
- √ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 33).
- √ If you are married filing separately and you lived apart from your spouse for all of 2010, enter "D" to the right of the word "benefits" on line 20a. If you do not, you may get a math error notice from the IRS.
- √ Be sure you have read the **Exception** on page 25 to see if you can use this worksheet instead of a publication to find out if any of your benefits are taxable.

1. Enter the total amount from **box 5** of **all** your **Forms SSA-1099** and **Forms RRB-1099.** Also, enter this amount on Form 1040, line 20a **1.** 12,000

2. Enter one-half of line 1 . . . **2.** 6,000

3. Combine the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21 . . . **3.** 34,000

4. Enter the amount, if any, from Form 1040, line 8b . . . **4.** 1,000

5. Combine lines 2, 3, and 4 . . . **5.** 41,000

6. Enter the total of the amounts from Form 1040, lines 23 through 32, plus any write-in adjustments you entered on the dotted line next to line 36 . . . **6.** 0

7. Is the amount on line 6 less than the amount on line 5?

☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b.

☒ **Yes.** Subtract line 6 from line 5 . . . **7.** 41,000

8. If you are:
- Married filing jointly, enter $32,000
- Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2010, enter $25,000
- Married filing separately and you lived with your spouse at any time in 2010, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17

. . . **8.** 25,000

9. Is the amount on line 8 less than the amount on line 7?

☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. If you are married filing separately and you **lived apart** from your spouse for all of 2010, be sure you entered "D" to the right of the word "benefits" on line 20a.

☒ **Yes.** Subtract line 8 from line 7 . . . **9.** 16,000

10. Enter: $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2010 . . **10.** 9,000

11. Subtract line 10 from line 9. If zero or less, enter -0- . . . **11.** 7,000

12. Enter the **smaller** of line 9 or line 10 . . . **12.** 9,000

13. Enter one-half of line 12 . . . **13.** 4,500

14. Enter the **smaller** of line 2 or line 13 . . . **14.** 4,500

15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0- . . . **15.** 5,950

16. Add lines 14 and 15 . . . **16.** 10,450

17. Multiply line 1 by 85% (.85) . . . **17.** 10,200

18. **Taxable social security benefits.** Enter the **smaller** of line 16 or line 17. Also enter this amount on Form 1040, line 20b . . . **18.** 10,200

TIP *If any of your benefits are taxable for 2010* ***and*** *they include a lump-sum benefit payment that was for an earlier year, you may be able to reduce the taxable amount. See Pub. 915 for details.*

As of January 2010, 14 states also tax social security benefits at some level. They include Colorado, Connecticut, Iowa (only until 2014), Kansas, Minnesota, Missouri (only until 2012), Montana, Nebraska, New Mexico, North Dakota, Rhode Island, Utah, Vermont, and West Virginia.[73]

Social security taxability has become a burden for many retirees. The $32,000 income threshold, established in 1983, has shrunk to near poverty levels in today's dollars. This threshold is especially burdensome when that income includes half of an individual's social security benefits. For retirees of middle class means or better, taxation of their social security benefits is essentially automatic. However, for some, this may be an area of personal taxation that merits attention. Those with the ability to manage their income downward will see a double benefit. Lowering income to a level where social security benefits are not taxed also saves tax dollars on the income that has been managed downward.

MANAGING INCOME DOWNWARD

A basic goal to decrease taxability of benefits is lowering adjusted gross income (AGI) for social security recipients. This may be accomplished by any normal means of tax planning for taxpayers who have a degree of control. Taxpayers who still own a business may be able to shift taxable income to nontaxable forms, or may be able to adjust the mix of dollars used for their income needs. Here are some options for taxpayers to consider.

For Those in Business

To manage income downward, business owners might consider the following.

- Bunching income and deductions in order to alternate high and low years
- Taking all available deductions (This involves closely tracking expenses and mileage, and using a home office if allowable.)
- Paying a wage to a spouse involved in the business and starting an IRC §105 plan to deduct all medical expenses for both spouses
- Establishing a health savings account for the owner and spouse (if employed)
- Forming an entity to manage taxes and provide fringe benefits, especially for single taxpayers for whom a spousal IRC §105 plan is not an option
- Using IRC §179 on purchases, such as vehicles with a gross vehicle weight over 6,000 lbs
- When selling a business, structuring the sale to minimize taxes by using favorable allocations and lower monthly payments through installment sales
- Using pension options such as an individual §401(k), which, as a qualified plan, allows contributions after age 70½; IRAs; as well as pension contributions if income is below the threshold for deductibility

For Wage Earners

To manage income downward, individual wage earners might consider the following.

- Maximizing use of pretax medical spending account options
- Using health savings accounts, if available
- Using deferred compensation plans, if available
- Using traditional IRAs, if AGI and age allow them to be deductible (This option is especially effective if AGI falls below $56,500 for MFJ or $28,250 for single taxpayers. At these levels, the saver's credit is an added bonus, producing tax savings of over 50% of contributions in some cases.)
- Using elective pension plans such as SIMPLE, §§401(k), 403(b), or 457 plans

73. [Retirementliving.com/RLtaxes.html] Accessed on Dec. 13, 2010.

Other Options

Options for lowering income include the following.

- Taking investment losses by selling after-tax investments to trigger recognition (Losses can erase capital gains income and provide a net capital loss of $3,000 per year to offset other income.)
- Drawing down nonretirement plan investments
- For the first year of distributions only, delaying the distribution for one year and bunching the distributions (assuming taxpayer is 70½)
- Choosing after-tax investments with high tax efficiency, such as mutual funds with low turnover ratios or stocks that do not pay dividends
- Prior to drawing social security benefits, converting traditional IRAs to Roth IRAs so withdrawals during retirement do not raise income and increase social security taxability (In some cases, the conversions may not produce added tax because credits or business losses may offset the recognition of income.)
- Evaluating whether to contribute to a tax-deferred retirement account or a Roth IRA (A close look at the Roth §401(k) option is merited.)

As a practicality, these moves only work for those with very moderate levels of income. Some will not fit certain taxpayers because of unique circumstances. Taxpayers whose AGI is higher may be able to lower the taxable percentage of their social security benefits from 85% to 50% by some of these strategies. For those with higher incomes, these strategies are still worth considering because they may make excellent tax sense independent of the social security issue.