Chapter 1: Select Rules for Retirement Plans

Corrections were made to this workbook through January of 2015. No subsequent modifications were made.

There are complex rules associated with traditional individual retirement arrangements (IRAs) that often result in errors or problems. For example, it is essential to understand how basis develops within an IRA, the potential advantages associated with basis in an IRA, and how to track basis. Proper attention to basis issues helps ensure that the taxpayer does not face double taxation on IRA funds and also ensures that any basis in the IRA is properly accounted for when the IRA is inherited by one or more beneficiaries. The basis in an inherited IRA remains with the IRA after the death of the account owner.

Distributions are generally reported on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts, etc.* Forms 1099-R are produced by financial institutions that frequently have limited or no tax information about the taxpayer holding the plan. This reporting procedure is also prone to errors and misreporting, especially if the plan had changes, excess contributions, inheritance issues, funding other than cash, or any other complications.

Note. Financial institutions are not responsible for tracking or reporting basis in IRAs.

This chapter provides essential details that should prove helpful in understanding common errors associated with IRAs, qualified plans, distributions, and the reporting of distributions.

BASIS IN A TRADITIONAL IRA

For 2014, the taxpayer's general contribution limit is the lesser of:

- $5,500[1] (plus an additional $1,000 for taxpayers who are age 50 or older before the end of the tax year),[2] or
- The amount of taxable compensation the taxpayer receives in the year.

No further contributions may be made to the taxpayer's IRA during and after the tax year in which the taxpayer attains age 70½. However, after age 70½, the taxpayer may qualify to make continued contributions to an IRA for a spouse who is under age 70½.[3]

Note. For further details on the IRA contribution rules, including use of spousal IRA accounts, see IRS Pub. 590, *Individual Retirement Arrangements (IRAs).*

1. IRS News Rel. IR-2013-86 (Oct. 31, 2013).
2. IRC §219(b)(5)(B).
3. IRC §219(c).

The taxpayer may make an IRA contribution up to the maximum amount allowable, but the actual amount of the contribution that can be deducted may be reduced. Whether there is a reduced deduction for the contribution depends on several factors, such as:

- The taxpayer's filing status,
- The taxpayer's modified adjusted gross income (MAGI), and
- Whether the taxpayer (or taxpayer's spouse, if applicable) is covered by a retirement plan at work at any time during that tax year.[4]

For 2013 and 2014, the table below shows the phaseout ranges of modified adjusted gross income (MAGI) that apply for traditional IRA contributions when one or more of the taxpayers is covered by another retirement plan.[5] These phaseout limits for contributions apply to the following taxpayers.

- Single, married filing separately (MFS), and head of household (HoH) filers participating in an employer retirement plan
- Married filing jointly (MFJ) filers when at least one spouse is covered by an employer retirement plan

For MFJ filers, the phaseout rules apply to both spouses even if only one of the spouses participates in an employer retirement plan. The phaseout ranges vary depending on whose IRA is being funded.

Filing Status	2013 MAGI Phaseout Ranges	2014 MAGI Phaseout Ranges
Single	$ 59,000– 69,000	$ 60,000– 70,000
MFJ (contributing spouse is covered by workplace retirement plan)	95,000–115,000	96,000–116,000
MFJ (contributing spouse is not covered by workplace retirement plan and other spouse is covered by workplace retirement plan)	178,000–188,000	181,000–191,000
HoH	59,000– 69,000	60,000– 70,000
MFS	0– 10,000	0– 10,000

The following general rules for these phaseout ranges apply to taxpayers who are covered by a retirement plan at work.

- Taxpayers with MAGI amounts **below** the ranges shown are entitled to deduct the full amount of their IRA contributions up to the $5,500 per-taxpayer maximum (plus the additional $1,000 that the taxpayer may contribute if age 50 or over).
- Taxpayers with MAGI amounts in the phaseout range are entitled to a reduced IRA deduction.
- Taxpayers with MAGI amounts in excess of the phaseout range cannot deduct any of the contributed amounts.

Taxpayers who do not qualify to make deductible IRA contributions may make nondeductible IRA contributions.[6] The amount of nondeductible contributions allowed each year is the general IRA limit for the taxpayer less the amount that the taxpayer deducts for the year.[7] The nondeductible contributions provide the taxpayer with **basis** in their IRA.

Example 1. Bruce is a 44-year-old single filer who participates in his employer's 401(k) plan. His 2014 MAGI is $72,400. He makes the maximum $5,500 IRA contribution. Because Bruce's MAGI is above the phaseout range for his filing status, he cannot deduct any portion of the $5,500. Bruce's $5,500 nondeductible contribution provides him with basis of $5,500 in his IRA.

4. IRS Pub. 590, *Individual Retirement Arrangements (IRAs)*.
5. IRS Notice 2013-73, 2013-49 IRB 598.
6. IRC §408(o).
7. IRC §408(o)(2)(B).

PRORATION OF WITHDRAWALS

Nondeductible IRA contributions are not taxable when distributed to the taxpayer or their heirs. If a distribution is made from an IRA that consists of deductible and nondeductible contributions, a formula determines the portion of the distribution that constitutes a nontaxable return of basis.[8] The formula is as follows.

$$\text{Nontaxable return of basis} = \frac{\text{Total nondeductible contributions} - \text{Amounts previously recovered}}{\text{Total end-of-year IRA balance} + \text{Distribution amount}} \times \text{Distribution amount}$$

Example 2. Barry has **one** IRA at Main Street Bank into which the following contributions were made.

Taxation Year	Deductible Contributions	Nondeductible Contributions
2004	$ 3,000	
2005	4,000	
2006	2,000	$ 2,000
2007	2,000	2,000
2008	5,000	
2009	1,000	4,000
2010	1,500	3,500
2011	4,000	1,000
2012	4,000	1,000
2013	3,500	2,000
Total	$30,000	$15,500

On May 31, 2014, Barry received a $5,000 distribution from his IRA. At the end of 2014, the IRA account balance was $45,000.

The amount of the $5,000 distribution that is considered a nontaxable return of basis is calculated as follows.

$$\text{Nontaxable return of basis} = \frac{\text{Total nondeductible contributions} - \text{Amounts previously recovered}}{\text{Total end-of-year IRA balance} + \text{Distribution amount}} \times \text{Distribution amount}$$

$$= \frac{\$15{,}500 - 0}{\$45{,}000 + \$5{,}000} \times \$5{,}000$$

$$= 0.31 \times \$5{,}000$$

$$= \$1{,}550$$

When the taxpayer with nondeductible contributions has more than one traditional IRA, the following rules apply when determining how much of a withdrawal is taxable.

- All existing traditional IRAs are treated as one account, including simplified pension (SEP) IRAs and savings incentive match plan for employees (SIMPLE) IRAs.[9]
- All distributions received during the tax year are added together and treated as one distribution.
- The values of all traditional IRAs as of the end of the tax year in which the distributions were made are added together for a total end-of-year IRA value.

8. IRS Notice 87-16, 1987-1 CB 446.

9. Ibid.

Example 3. Use the same facts as **Example 2,** except Barry also has an IRA at Anystreet Financial. The following contributions were made in addition to the Main Street Bank IRA.

Taxation Year	Deductible Contributions	Nondeductible Contributions
1999	$1,000	$0
2000	1,000	0
2001	1,000	0
2002	1,000	0
2003	2,000	0
Total	$6,000	$0

At the end of 2014, the Anystreet Financial IRA has a $12,000 balance due to growth on the contributions.

In order to calculate the portion of the $5,000 distribution that constitutes a nontaxable return of basis, Barry must treat both of his IRAs as a single account. The following table summarizes the relevant IRA amounts.

	Main Street Bank IRA	Anystreet Financial IRA	Total
Deductible contributions	$30,000	$ 6,000	$36,000
Nondeductible contributions	15,500	0	15,500
Balance, end of 2014	45,000	12,000	57,000

The nontaxable portion of the $5,000 distribution is calculated as follows.

$$\textbf{Nontaxable return of basis} = \frac{\textbf{Total nondeductible contributions} - \textbf{Amounts previously recovered}}{\textbf{Total end-of-year IRA balance} + \textbf{Distribution amount}} \times \textbf{Distribution amount}$$

$$= \frac{\$15{,}500 - 0}{\$57{,}000 + \$5{,}000} \times \$5{,}000$$

$$= 0.25 \times \$5{,}000$$

$$= \$1{,}250$$

Observation. Nondeductible contributions can be used to build basis in an IRA. Under the IRA rules, all the taxpayer's IRAs are aggregated and considered as one account and all distributions are treated as one distribution.[10] For retired spouses, a review of each spouse's IRA basis should be made to ensure that the spouse with the highest basis withdraws funds first to reduce income tax on the distributions.

The calculation to determine the nontaxable return of basis must be modified by amounts previously used to reduce the taxable portion of IRA distributions.

10. IRC §408(d)(2).

Example 4. Use the same facts as **Example 3,** which concluded that $1,250 of Barry's 2014 distribution was a nontaxable return of basis. In 2015, Barry withdraws $5,500 from his IRAs. The combined total value of his IRAs on December 31, 2015 is $52,000. The nontaxable portion of his 2015 distribution is calculated as follows.

$$\text{Nontaxable return of basis} = \frac{\text{Total nondeductible contributions} - \text{Amounts previously recovered}}{\text{Total end-of-year IRA balance} + \text{Distribution amount}} \times \text{Distribution amount}$$

$$= \frac{\$15{,}500 - \$1{,}250}{\$52{,}000 + \$5{,}500} \times \$5{,}500$$

$$= 0.248 \times \$5{,}500 \text{ (rounded to 3 decimal places in accordance with Form 8606)}$$

$$= \$1{,}364$$

TRACKING BASIS

It is important for the taxpayer to track basis in a traditional IRA in order to prevent paying tax on amounts that were not previously deducted as an IRA contribution and therefore were already taxed. Basis is tracked by determining whether the taxpayer has any nondeductible IRA contributions during the year and reporting those nondeductible contributions on Form 8606, *Nondeductible IRAs.*

Example 5. Conway and Carla filed a joint return for 2013. Both spouses are 33 years old. Conway, an architect, earned a 2013 salary of $65,000. Conway is covered by his employer's retirement plan. Carla, a civil engineer, earned a salary of $35,000 working part-time while attending college. Carla is not covered by a retirement plan. In October 2013, each spouse contributed $5,500 to their respective traditional IRAs.

Conway and Carla's tax preparer, Sandra, completed the 2013 return for the couple. Sandra learned that Conway paid $2,000 in tax-deductible student loan interest and Carla had a $3,800 tuition deduction for 2013.

Sandra calculated the spouses' MAGI for traditional IRA purposes, using IRS Pub. 590, *Individual Retirement Arrangements (IRAs),* Worksheet 1-1.

Worksheet 1-1. **Figuring Your Modified AGI** *Keep for Your Records*

Use this worksheet to figure your modified AGI for traditional IRA purposes.

1.	Enter your adjusted gross income (AGI) from Form 1040, line 38; Form 1040A, line 22; or Form 1040NR, line 37, figured without taking into account the amount from Form 1040, line 32; Form 1040A, line 17; or Form 1040NR, line 32	1.	94,200
2.	Enter any student loan interest deduction from Form 1040, line 33; Form 1040A, line 18; or Form 1040NR, line 33	2.	2,000
3.	Enter any tuition and fees deduction from Form 1040, line 34, or Form 1040A, line 19	3.	3,800
4.	Enter any domestic production activities deduction from Form 1040, line 35, or Form 1040NR, line 34	4.	
5.	Enter any foreign earned income exclusion and/or housing exclusion from Form 2555, line 45, or Form 2555-EZ, line 18	5.	
6.	Enter any foreign housing deduction from Form 2555, line 50	6.	
7.	Enter any excludable savings bond interest from Form 8815, line 14	7.	
8.	Enter any excluded employer-provided adoption benefits from Form 8839, line 28	8.	
9.	Add lines 1 through 8. This is your **Modified AGI** for traditional IRA purposes	9.	100,000

Sandra determined the deductible portion of each spouse's respective $5,500 IRA contribution separately.[11] Sandra noted that the $100,000 MAGI for Conway and Carla is not within the applicable MAGI phaseout range ($178,000–$188,000). This means Carla does not have any reduction in the deductibility of her $5,500 IRA contribution. Carla's full $5,500 IRA deduction is reported on Form 1040, line 32.

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

The $100,000 MAGI amount is within the applicable phaseout range ($95,000–$115,000) for Conway because he is covered by an employer retirement plan. Sandra calculated how much of Conway's $5,500 contribution is deductible. She calculated the deductible amount using the following Worksheet 1-2 from IRS Pub. 590.

Worksheet 1-2. **Figuring Your Reduced IRA Deduction for 2013**

Keep for Your Records

(Use only if you or your spouse is covered by an employer plan and your modified AGI falls between the two amounts shown below for your coverage situation and filing status.)

Note. If you were married and both you and your spouse contributed to IRAs, figure your deduction and your spouse's deduction separately.

IF you ...	AND your filing status is ...	AND your modified AGI is over ...	THEN enter on line 1 below ...
are **covered** by an employer plan	single or head of household	$59,000	$69,000
	married filing jointly or qualifying widow(er)	$95,000	$115,000
	married filing separately	$0	$10,000
are **not covered** by an employer plan, but your spouse is **covered**	married filing jointly	$178,000	$188,000
	married filing separately	$0	$10,000

1. Enter applicable amount from table above	1.	115,000
2. Enter your ***modified AGI*** (that of both spouses, if married filing jointly)	2.	100,000
Note. If line 2 is equal to or more than the amount on line 1, **stop here.** Your IRA contributions are not deductible. See *Nondeductible Contributions*, earlier.		
3. Subtract line 2 from line 1. **If line 3 is $10,000 or more ($20,000 or more if married filing jointly or qualifying widow(er) and you are covered by an employer plan), stop here.** You can take a full IRA deduction for contributions of up to $5,500 ($6,500 if you are age 50 or older) or 100% of your (and if married filing jointly, your spouse's) compensation, whichever is less	3.	15,000
4. Multiply line 3 by the percentage below that applies to you. If the result is not a multiple of $10, round it to the next highest multiple of $10. (For example, $611.40 is rounded to $620.) However, if the result is less than $200, enter $200. • Married filing jointly or qualifying widow(er) **and** you are covered by an employer plan, multiply line 3 by 27.5% (.275) (by 32.5% (.325) if you are age 50 or older). • All others, multiply line 3 by 55% (.55) (by 65% (.65) if you are age 50 or older).	4.	4,125
5. Enter your compensation minus any deductions on Form 1040 or Form 1040NR, line 27 (deductible part of self-employment tax) and line 28 (self-employed SEP, SIMPLE, and qualified plans). If you are filing a joint return and your compensation is less than your spouse's, include your spouse's compensation reduced by his or her traditional IRA and Roth IRA contributions for this year. If you file Form 1040 or Form 1040NR, do not reduce your compensation by any losses from self-employment	5.	65,000
6. Enter contributions made, or to be made, to your IRA for 2013, but **do not** enter more than $5,500 ($6,500 if you are age 50 or older). If contributions are more than $5,500 ($6,500 if you are age 50 or older), see *Excess Contributions*, later.	6.	5,500
7. **IRA deduction.** Compare lines 4, 5, and 6. Enter the smallest amount (or a smaller amount if you choose) here and on the Form 1040, 1040A, or 1040NR line for your IRA, whichever applies. If line 6 is more than line 7 and you want to make a nondeductible contribution, go to line 8	7.	4,125
8. **Nondeductible contribution.** Subtract line 7 from line 5 or 6, whichever is smaller. Enter the result here and on line 1 of your Form 8606	8.	1,375

Conway may deduct $4,125 of his $5,500 IRA contribution for 2013. The remaining $1,375 constitutes a nondeductible contribution. Conway had the option to withdraw the nondeductible $1,375 contribution from the IRA before the due date for his 2013 tax return or leave that amount in the IRA and report it on his 2013 tax return as a nondeductible IRA contribution using Form 8606. Conway decided to leave the $1,375 in the IRA and Sandra prepared the Form 8606 that accompanied the 2013 joint tax return for Conway and Carla.

Sandra is aware that Conway already has nondeductible contributions of $1,000 from 2011 and $1,530 from 2012 (for a total of $2,530 in nondeductible contributions that must be carried forward to 2013 and shown on the Form 8606). The first page of the 2013 Form 8606 follows.

Form **8606**
Department of the Treasury
Internal Revenue Service (99)

Nondeductible IRAs

▶ Information about Form 8606 and its separate instructions is at *www.irs.gov/form8606*.

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

OMB No. 1545-0074
2013
Attachment Sequence No. **48**

Name. If married, file a separate form for each spouse required to file Form 8606. See instructions.	Your social security number
Conway and Carla Clayton	999-99-9999

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

Home address (number and street, or P.O. box if mail is not delivered to your home)		Apt. no.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete the spaces below (see instructions).		
Foreign country name	Foreign province/state/county	Foreign postal code

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

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

- You made nondeductible contributions to a traditional IRA for 2013.
- You took distributions from a traditional, SEP, or SIMPLE IRA in 2013 **and** you made nondeductible contributions to a traditional IRA in 2013 or an earlier year. For this purpose, a distribution does not include a rollover, qualified charitable distributions, one-time distribution to fund an HSA, conversion, recharacterization, or return of certain contributions.
- You converted part, but not all, of your traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2013 (excluding any portion you recharacterized) **and** you made nondeductible contributions to a traditional IRA in 2013 or an earlier year.

1	Enter your nondeductible contributions to traditional IRAs for 2013, including those made for 2013 from January 1, 2014, through April 15, 2014 (see instructions)	1	1,375
2	Enter your total basis in traditional IRAs (see instructions)	2	2,530
3	Add lines 1 and 2	3	3,905
	In 2013, did you take a distribution ... — No ▶ Enter the amount from line 3 on line 14.		
13	Add lines 11 a... is the non... portion of all your distribution...	13	
14	Subtract line 13 from line 3. This is **your total basis in traditional IRAs for 2013 and earlier years**	14	3,905
15	**Taxable amount.** Subtract line 12 from line 7. If more than zero, also include this amount on Form 1040, line 15b; Form 1040A, line 11b; or Form 1040NR, line 16b	15	
	Note. You may be subject to an additional 10% tax on the amount on line 15 if you were under age 59½ at the time of the distribution (see instructions).		

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63966F Form **8606** (2013)

Observations for **Example 5:**

1. The 2013 MAGI phaseout range for Roth IRAs was $178,000–188,000 for taxpayers filing MFJ.
2. Instead of adding the nondeductible portion of his 2013 traditional IRA contribution to his basis, Conway could have recharacterized the $1,375 as a Roth IRA contribution if he did so before his tax filing deadline (including extensions).

Note. Basis is tracked by disclosing nondeductible IRA contributions on Form 8606. Generally, Form 8606 is filed with the taxpayer's return. However, a taxpayer who is not required to file a return is still required to disclose a nondeductible IRA contribution on Form 8606. In this case, the taxpayer's identifying information is indicated on Form 8606, which must be filed with the IRS by the normal tax return due date.[12]

Note. A Form 8606 is required for each year in which a nondeductible contribution is made and recommended for each year thereafter. If the nondeductible contribution is not reported on Form 8606, it is not included in basis when calculating subsequent distributions from the IRA. There is a $50 penalty for each required Form 8606 that is not timely filed.[13] In addition, there is a $100 penalty for overstating the nondeductible contribution amount on Form 8606.[14] These penalties may be waived when there is reasonable cause.

12. Instructions for Form 8606.
13. IRC §6693(b)(2).
14. IRC §6693(b)(1).

COMMON FORM 1099-R PROBLEMS AND CORRECTIVE ACTIONS

The instructions for Form 1099-R regarding the box 2a "taxable amount" state "Generally, you must enter the taxable amount in box 2a. However, if you are unable to reasonably obtain the data needed to compute the taxable amount, leave this box blank." For box 2b, the instructions state that the issuer should enter an "X" in the box "taxable amount not determined" only if the issuer is unable to reasonably obtain the data needed to compute the taxable amount. If this box is checked, box 2a should be blank.[15]

Issuers often do not follow these instructions and indicate amounts in box 2a that do not reflect the amount of the distribution that is actually taxable to the taxpayer (either with or without an "X" in box 2b). Taxable amounts in box 2a may be more of an issue for taxpayers who have multiple accounts, because the issuer of the Form 1099-R for the account from which the distribution was made does not have knowledge of the taxpayer's IRAs at other financial institutions (but may still enter an amount in box 2a as the "taxable amount").

If the taxpayer receives a Form 1099-R that is incorrect, the following steps should be taken.

- Request a corrected Form 1099-R from the issuer (with box 2b for "taxable amount not determined" checked and box 2a blank, as indicated in the instructions).
- If a corrected Form 1099-R cannot be obtained before the deadline for filing the taxpayer's tax return, Form 4852, *Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* should be completed and used instead.

Example 6. Use the same facts as **Example 3.** Barry received the following Form 1099-R from Anystreet Financial showing his 2014 withdrawal.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, and ZIP or foreign postal code **Anystreet Financial Corp. 123 Anystreet Chicago, IL 60647**		1 Gross distribution $ **5000.00** 2a Taxable amount $ **5000.00**	OMB No. 1545-0119 **2014** Form **1099-R**	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
		2b Taxable amount not determined ☐	Total distribution ☐	**Copy B Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.**
PAYER'S federal identification number **37-6000522**	RECIPIENT'S identification number **123-45-6789**	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $ **0.00**	
RECIPIENT'S name **Barry Brooks**		5 Employee contributions /Designated Roth contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	
Street address (including apt. no.) **34 West Schubert Avenue**		7 Distribution code(s) **1** — IRA/SEP/SIMPLE ☒	8 Other $ %	This information is being furnished to the Internal Revenue Service.
City or town, state or province, country, and ZIP or foreign postal code **Chicago, IL 60647**		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) **000-00100100**		15 Local tax withheld $ $	16 Name of locality	17 Local distribution $ $

Form **1099-R** www.irs.gov/form1099r Department of the Treasury - Internal Revenue Service

15. Instructions for Form 1099-R.

Anystreet Financial should not have included an amount in box 2a because they did not have data sufficient to make that determination. Not all of Barry's $5,000 distribution is taxable because $1,250 of that distribution represents a nontaxable return of basis from his IRA. He mentions this to his tax preparer, Sigmund, who contacts Anystreet Financial to correct the Form 1099-R. Unfortunately, Sigmund is unable to obtain a corrected Form 1099-R from Anystreet Financial before the filing deadline for Barry's tax return. Sigmund completes the following Form 4852 for Barry.

Form **4852**
(Rev. August 2013)
Department of the Treasury
Internal Revenue Service

Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

► Attach to Form 1040, 1040A, 1040-EZ, or 1040X.
► Information about Form 4852 is available at *www.irs.gov/form4852*.

OMB No. 1545-0074

1 Name(s) shown on return	2 Your social security number
Barry Brooks	**123-45-6789**

3 Address
34 West Schubert Avenue, Chicago, IL 60647

4 **Enter year in space provided and check one box.** For the tax year ending December 31, **2014** ,
I have been unable to obtain (or have received an incorrect) ☐ Form W-2 **OR** ☒ Form 1099-R.
I have notified the IRS of this fact. The amounts shown on line 7 or line 8 are my best estimates for all wages or payments made to me and tax withheld by my employer or payer named on line 5.

5 Employer's or payer's name, address, and ZIP code	6 Employer's or payer's identification number (if known)
Anystreet Financial Corp., 123 Anystreet, Chicago, IL 60647	**37-6000522**

7 Form W-2. Enter wages, tips, other compensation, and taxes withheld.

a Wages, tips, and other compensation		g State income tax withheld		
b Social security wages		(Name of state)		
c Medicare wages and tips		h Local income tax withheld		
d Advance EIC payment		(Name of locality)		
e Social security tips		i Social security tax withheld		
f Federal income tax withheld		j Medicare tax withheld		

8 Form 1099-R. Enter distributions from pensions, annuities, retirement/profit-sharing plans, IRAs, insurance contracts, etc.

a Gross distribution	**$5,000**	f Federal income tax withheld	
b Taxable amount		g State income tax withheld	
c Taxable amount not determined	☒	h Local income tax withheld	
d Total distribution	☐	i Employee contributions	
e Capital gain (included in line 8b)		j Distribution codes	**1**

9 How did you determine the amounts on lines 7 and 8 above?
Box 2a of the 1099-R received from Anystreet Financial Corp. should be blank and Box 2b should be marked Taxable amount not determined. The taxpayer has basis in his IRAs from nondeductible contributions made in earlier years.

10 Explain your efforts to obtain Form W-2, Form 1099-R, or Form W-2c, Corrected Wage and Tax Statement.
Sent written request by ordinary mail to issuer March 12, 2015.

Sign Here
Under penalties of perjury, I declare that I have examined this statement, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ► Date ►

Note. According to the Form 4852 instructions, an attempt should always be made to obtain a corrected Form 1099-R before using Form 4852 to correct the error.

EXCESS CONTRIBUTIONS

An excess contribution is a contribution that is in excess of the taxpayer's general IRA limit for the year. The rules regarding excess contributions apply to both traditional and Roth IRAs.

Example 7. Josie is a single filer and is 44 years old. She receives 2014 employment income of $34,000. She contributes $6,500 to a traditional IRA for 2014. Josie's IRA contribution for the year is subject to a general limit of $5,500. Therefore, the additional amount she contributed ($1,000) is an excess contribution.

Example 8. Use the same facts as **Example 7,** except Josie's 2014 MAGI is $73,000 and she participates in a retirement plan at work. Therefore, her income is high enough to preclude any IRA deduction for the year because it exceeds the phaseout range that applies to her filing status for the tax year. Josie can still make a nondeductible IRA contribution up to the applicable general limit ($5,500). The additional $1,000 contribution over the $5,500 general limit constitutes an excess contribution.

Example 9. Use the same facts as **Example 7,** except Josie's employment income is $3,100. Because a taxpayer's IRA contribution cannot exceed their compensation, the applicable general limit for her 2014 IRA contribution is $3,100. Of the $6,500 IRA contribution she makes, $3,400 ($6,500 − $3,100) is considered an excess contribution.

To avoid a penalty, an excess contribution generally must be withdrawn by the due date (including extensions) of the taxpayer's return for the year in which the excess contribution was made. If the amount is not withdrawn by that date, a 6% excess contribution tax applies.[16] It continues to apply each year on any amount of excess contributions that remain in an IRA at the end of the tax year. This excess contributions tax is reported on Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.*

The amount of the excess contribution is generally not included in income for the year because it was not previously deducted by the taxpayer. However, if an excess contribution is withdrawn, any income earned on the excess contribution must also be withdrawn. These earnings are included in the taxpayer's gross income for the year and are subject to income tax and the 10% penalty on early withdrawals.[17]

Note. The 10% penalty on early withdrawals is discussed in the next section of this chapter.

Example 10. Lawson, who is single and 56 years old, made an excess contribution of $3,000 during 2013. He withdrew the $3,000 excess contribution by April 15, 2014 (the due date of his 2013 tax return). He also withdrew the $100 of income that the $3,000 excess contribution earned while it was in the IRA. The $3,000 excess contribution is not included in Lawson's income for the year, and this amount is not subject to the 6% excess contributions tax because Lawson withdrew it from the IRA before the required deadline.

However, the $100 of income is included in Lawson's gross income for the year and is subject to income tax and a 10% penalty (or $10) under IRC §72(t).

16. IRC §4973.

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

Example 11. Use the same facts as **Example 10,** except Lawson does not withdraw the $3,000 excess contribution by the due date of his tax return. Consequently, the $3,000 is subject to the 6% penalty. Lawson must calculate the penalty and add this amount to his tax liability for 2013. This $180 ($3,000 × 6%) excess contributions tax is reported on Form 5329. The relevant portion of page 1 of Lawson's Form 5329, which accompanied his 2013 tax return, follows.

14	Prior year exc... line 9. If zero or less, enter -0-	14	
15	Excess contributions for 2013 (see instructions)	15	3,000
16	Total excess contributions. Add lines 14 and 15	16	3,000
17	**Additional tax.** Enter 6% (.06) of the **smaller** of line 16 **or** the value of your traditional IRAs on December 31, 2013 (including 2013 contributions made in 2014). Include this amount on Form 1040, line 58, or Form 1040NR, line 56 .	17	180

Part IV Additional Tax on Excess Contributions to Roth IRAs

Although a taxpayer can eliminate excess contributions by withdrawing them, an excess contribution may also be eliminated by treating it as an additional allowable contribution in a later tax year.[18] In that later tax year, the taxpayer can deduct the amount of excess contribution that is the lesser of:

- The taxpayer's maximum allowable deduction for the year less the amount contributed for the year, or
- The total amount of excess contributions at the beginning of the year.

Example 12. Stella, age 45, has $30,000 of employment income in 2012 and in 2013. Her maximum allowable IRA deductions for 2012 and 2013 are $5,000 and $5,500, respectively. In 2012, Stella contributes $6,100 to an IRA; in 2013, she contributes $4,500. At the end of 2012, Stella has an excess contribution of $1,100 ($6,100 − $5,000). This $1,100 excess contribution exposes Stella to an excess contribution penalty of $66 (6% × $1,100). Stella has the option of eliminating the excess contribution and related penalty by withdrawing the excess contribution from her IRA before April 15, 2013 (the due date for her 2012 tax return). She also has the option of treating some of the excess contribution as her 2013 contribution. The amount of excess contribution she may deduct in 2013 is calculated as follows.

	Maximum IRA deduction for 2013	$5,500
	Less: IRA contributions made for 2013	(4,500)
A	Difference	$1,000
B	Amount of excess contributions at the beginning of 2013	$1,100
	Stella's deductible excess contribution (lesser of A or B)	$1,000

As part of her total $5,500 IRA deduction for 2013, Stella may deduct $1,000 of her $1,100 excess contribution. However, the total $1,100 excess contribution for 2012 still triggers the $66 penalty for 2012 because it was not withdrawn before the due date for her 2012 return. In addition, although using $1,000 of the $1,100 excess contribution as part of her 2013 IRA deduction eliminated $1,000 of excess contributions for 2013, there is a $100 excess contribution remaining for 2013. This $100 of excess contributions triggers a $6 (6% × $100) penalty for 2013.

Note. For further details about the treatment of excess contributions, see IRS Pub. 590, *Individual Retirement Arrangements (IRAs).*

18. IRC §219(f)(6); and IRS Pub. 590, *Individual Retirement Arrangements (IRAs).*

EARLY WITHDRAWAL PENALTY

As a general rule, distributions from a qualified plan or IRA that are received by the account owner before attaining age 59½ are:

- Subject to income tax, and
- Subject to a 10% penalty tax **in addition to** the income tax.[19]

> **Note.** The 10% penalty is increased to a 25% penalty when the taxpayer is under age 59½ and has a distribution from a SIMPLE IRA within a 2-year period from the date they first participated in a SIMPLE plan (or other qualified salary reduction arrangement).[20]

Example 13. Charles is age 49 and has an IRA with Elm Street Bank & Trust. He received an IRA distribution during 2013 in order to pay for a 2-week vacation in the Bahamas. Charles receives the following Form 1099-R reporting the distribution.

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city or town, province or state, country, and ZIP or foreign postal code **Elm Street Bank & Trust** **1458 Elm Street** **Elmwood, NH 03031**		1 Gross distribution $ **15000.00** 2a Taxable amount $	OMB No. 1545-0119 **2013** Form **1099-R**	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
		2b Taxable amount not determined ☒	Total distribution ☐	**Copy 1 For State, City, or Local Tax Department**
PAYER'S federal identification number **37-5060877**	RECIPIENT'S identification number **456-78-1313**	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $ **1500.00**	
RECIPIENT'S name **Charles Seguin**		5 Employee contributions /Designated Roth contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	
Street address (including apt. no.) **1258 Maple Street**		7 Distribution code(s) **1** — IRA/ SEP/ SIMPLE ☑	8 Other $ %	
City or town, province or state, country, and ZIP or foreign postal code **Elmwood, NH 03031**		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) **789-101112**		15 Local tax withheld $ $	16 Name of locality	17 Local distribution $ $

Form **1099-R** www.irs.gov/form1099r Department of the Treasury - Internal Revenue Service

> **Note.** A nonperiodic distribution is generally subject to 10% federal tax withholding. However, the individual may make an election to opt out of any tax withholding using Form W-4P, *Withholding Certificate for Pension or Annuity Payments.* For further details, see IRC §3405(b) and the instructions for Form W-4P.

Charles's distribution is subject to income tax and potentially the 10% penalty tax. The $15,000 distribution is included in his gross income for the year.

19. IRC §72(t).
20. IRC §72(t)(6).

The penalty amount is entered on Charles's Form 1040, line 58 (shown below). Also, the word "No" is entered to the left of line 58 to indicate that Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts,* is not required. **The 10% penalty is in addition to any other income tax liability Charles has for 2013.**

Other Taxes	56	Self-employment tax. Attach Schedule SE	56	
	57	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919	57	
	58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required NO	58	1,500
	59a	Household employment taxes from Schedule H	59a	
	b	First-time homebuyer credit repayment. Attach Form 5405 if required	59b	
	60	Taxes from: a ☐ Form 8959 b ☐ Form 8960 c ☐ Instructions; enter code(s)	60	

IRC §72(t) provides several exceptions to the 10% penalty on early distributions, as shown in the following table.

Exception	Code Reference	Applies to Qualified Plan	Applies to IRA
Distributions after age 59½	§72(t)(2)(A)(i)	Yes	Yes
Distributions after death	§72(t)(2)(A)(ii)	Yes	Yes
Disability	§72(t)(2)(A)(iii)	Yes	Yes
Educational expense	§72(t)(2)(E)	No	Yes
Substantially equal periodic payments (SEPP)	§72(t)(2)(A)(iv)	Yes	Yes
Separation from employer after age 55	§72(t)(2)(A)(v)	Yes	No
Medical expense	§72(t)(2)(B) and (D)	Yes	Yes
ESOP dividend exemption	§72(t)(2)(A)(vi)	Yes	No
Qualified domestic relations order (QDRO)	§72(t)(2)(C)	Yes	No
IRS plan levies	§72(t)(2)(A)(vii)	Yes	Yes
First-time homebuyer distributions	§72(t)(2)(F)	No	Yes
Qualified reservist distributions	§72(t)(2)(G)(iii)(II)	Yes	Yes
Federal employee retirements	§72(t)(2)(A)(viii)	Yes	No

A Form 1099-R may be issued showing that a distribution is subject to the early withdrawal penalty even though one of these exceptions applies to the taxpayer. Form 5329 is used to notify the IRS which exception applies and to show the amount of the distribution qualifying for the exception. (**Example 29** at the end of this chapter includes a completed form.)

> **Observation.** The part of a distribution that is considered the return of basis in connection with nondeductible contributions (discussed previously) is not subject to the 10% penalty.[21] However, the 10% penalty **applies to any income earned** that was required to be reported.[22] In addition, excess contributions returned to the taxpayer before the due date of the taxpayer's income tax return for the year (discussed previously) are not subject to the 10% penalty.

21. IRC §408(d)(4), (5); and *Robert A. Hall, et al. v. Comm'r*, 76 TC Memo 1998-336 (Sep. 28, 1998).

22. *Robert A. Hall, et al. v. Comm'r*, 76 TC Memo 1998-336 (Sep. 28, 1998).

DISTRIBUTIONS AFTER AGE 59½

A distribution that is received after the taxpayer attains age 59½ is generally not subject to the 10% penalty.[23] Under these rules, a taxpayer attains age 59½ on the date that is six months after the taxpayer's 59th birthday.

Example 14. Susanna's birth date is June 30, 1955. She attains age 59 on June 30, 2014. Susanna reaches age 59½ on December 30, 2014. Therefore, December 30, 2014, is the earliest date on which she may receive a penalty-free distribution (assuming she does not qualify for another exception prior to attaining age 59½).

Example 15. Stefano's birth date is July 3, 1955. He attains age 59 on July 3, 2014. Stefano reaches age 59½ on January 3, 2015. Accordingly, January 3, 2015, is the earliest date on which he may receive a penalty-free distribution (assuming he does not qualify for any other exception before reaching age 59½).

Note. If the taxpayer receives a distribution after reaching age 59½, the appropriate distribution code for box 7 of Form 1099-R is "7," which denotes a "normal distribution."[24]

DISTRIBUTIONS AFTER DEATH

A distribution from a taxpayer's qualified retirement plan or IRA that is made to the taxpayer's estate or beneficiary on or after the taxpayer's death is exempt from the 10% penalty.[25] Accordingly, if a spouse dies and the surviving spouse begins receiving the deceased spouse's distributions prior to age 59½, the distributions are not subject to the 10% penalty.[26] The surviving spouse can also direct that funds from the deceased spouse's qualified plan be transferred into an IRA of which the surviving spouse is the designated beneficiary.[27]

However, if the surviving spouse rolls over the deceased spouse's IRA funds into an IRA in the surviving spouse's name, distributions from the surviving spouse's IRA are subject to the 10% penalty if made prior to age 59½. The penalty applies because the surviving spouse changed the character of the funds with the rollover. The funds are considered to come from the surviving spouse's own account and not from the account of the decedent.

Example 16. Oscar owned a traditional IRA when he died. After his death, his surviving spouse, Tricia, rolled over a distribution from Oscar's IRA into a separate IRA of her own. She received a distribution from this separate IRA in her name before she attained age 59½. The distribution is subject to the 10% penalty because the transfer of the funds into her own IRA changed the character of the funds and the funds became hers. The distribution is treated as a distribution from her own IRA funds, not those of her deceased spouse that she received in the capacity of beneficiary. Once she rolled the funds over into her own IRA, the funds no longer qualified for exemption from the 10% tax.[28]

Caution. Tax preparers should advise clients to contact them prior to making changes to their IRAs.

23. IRC §72(t)(2)(A)(i).
24. Instructions for Form 1099-R.
25. IRC §72(t)(2)(A)(ii).
26. This example is based on Ltr. Rul. 200450057 (Sep. 13, 2004).
27. Ibid.
28. This example is based on *Charlotte and Charles T. Gee v. Comm'r,* 127 TC 1 (2006). See also *Sears v. Comm'r,* TC Memo 2010-146 (Jul. 6, 2010).

DISABILITY EXCEPTION

Distributions taken due to a taxpayer's disability are exempt from the 10% penalty.[29] For purposes of this rule, the disability must be of a nature that precludes the taxpayer from engaging in any **substantial gainful activity** because of a physical or mental impairment that is medically determinable and can be **expected to result in death or continue indefinitely.**[30] "Substantial gainful activity" means the activity or a comparable activity that the individual customarily engaged in before the impairment (or before retirement if the impairment arises during the taxpayer's retirement).[31]

The taxpayer must be able to substantiate the disability if the IRS requests documentation.[32] To determine whether a sufficient disability exists for purposes of this rule, the nature and severity of the impairment are the primary considerations. All the facts are considered in making this determination,[33] including the taxpayer's education, training, and work experience.

Examples of impairment that may be sufficient to constitute a disability for purposes of this penalty exemption include the following.[34]

- Loss of two limbs
- Progressive diseases, such as diabetes or multiple sclerosis, that have resulted in physical loss or atrophy of a limb
- A heart, lung, or blood vessel disease that has resulted in a major loss of heart or lung capacity and leads to fatigue, breathlessness, or pain upon slight exertion (such as walking several blocks, using public transportation, or doing small chores) despite medical treatment
- Inoperable and progressive cancer
- Brain damage or abnormality that has caused severe loss of judgment, intellect, orientation, or memory
- Mental diseases that require the taxpayer to be institutionalized or constantly supervised
- Loss of vision, such that the taxpayer has no better than 20/200 vision in their best eye after correction, or a limitation in the field of vision, such that the widest diameter of the taxpayer's visual field is no greater than 20 degrees
- Permanent and total loss of speech
- Total deafness not correctible by hearing aid

29. IRC §72(t)(2)(A)(iii).
30. IRC §72(m)(7).
31. Treas. Reg. §1.72-17A(f)(1).
32. Ibid.
33. Treas. Reg. §1.72-17A(f)(2).
34. Ibid.

Example 17. Brian worked as a commercial equipment leasing manager. Because he was dissatisfied with his compensation, he became a life insurance agent. However, after working as a life insurance agent for several months, he failed to meet the necessary sales quota and lost his insurance agent position. As a result, he suffered a mental breakdown because of his inability to support his family.

Due to financial hardship, he withdrew $54,000 from his IRA at the age of 52. His doctor diagnosed him with depression, anxiety, and panic disorder. He receives ongoing treatment for these disorders, including medication. The doctor indicated that it was unclear how long the condition of depression would last. His psychologist stated that Brian's depression impaired his decision-making ability and made him take much longer than usual to complete any task.

Brian's mental disability does not qualify for an exemption from the 10% penalty on the $54,000 IRA withdrawal because it is not a mental disease that requires continued institutionalization or constant supervision as specified in Treas. Reg. §1.72-17A(f) and IRC §72(m)(7).[35]

Note. For mental diseases, periodic consultation with a mental health professional does not constitute the "constant supervision" required by Treas. Reg. §1.72-17A(f)(2).[36]

A taxpayer who is disabled for purposes of social security[37] or who receives disability payments from an insurance company[38] is not necessarily disabled under the rules for the penalty exemption.

Example 18. Charles is employed as a boiler mechanic with an electric utility company. His work requires lifting large, very heavy pieces of metal and welding while kneeling. Over the years of his employment, he sustained a back injury that required surgery, developed painful bursitis in his shoulder that required medication, and then had a work-related injury to his left knee that required surgery. After the knee surgery, Charles had a full range of motion with his knee, but it caused him pain when he lifted heavy items.

Due to inactivity after the knee injury, Charles gained 40 pounds. Eventually, Charles was diagnosed with knee arthritis, obesity, and a rotator cuff injury in his shoulder. He went on a leave of absence from work and was required to attend physical therapy and engage in a home exercise program. His physician indicated that he was "temporarily totally disabled" for a 4-year period. The injury precluded his gainful activity, including comparable work activity, which would require lifting heavy objects.

While on the leave of absence, he received a lump sum from his employment pension plan when he was under age 59½. At the time he received the pension plan distribution, there was no reasonable indication that he would be able to return to work. Despite Charles's injuries being labelled "temporary," the injuries were indefinite in duration. The injury constitutes a "disability" and qualifies for the exception from the 10% penalty on the pension plan distribution.

Observation. Example 18, based on the facts of *Rideaux v. Comm'r,*[39] indicates that the requirement that the impairment result in death or be of "indefinite" duration may be met if it appears that the injury is of indefinite duration at the time the taxpayer receives the distribution, even if it is later determined that the injury was not, in fact, of an indefinite nature.

35. The facts of this example are based on *Keeley v. Comm'r*, TC Summ. Op. 2003-53 (May 15, 2003).

36. *Dwyer v. Comm'r*, 106 TC 337 (1996).

37. *Stipe v. Comm'r,* TC Memo 2011-92 (Apr. 25, 2011).

38. *Kowsh v. Comm'r*, TC Memo 2008-204 (Aug. 28, 2008).

39. *Rideaux v. Comm'r*, TC Summ. Op. 2006-74 (May 3, 2006).

Example 19. Mary, a postal worker in a supervisory position, was hospitalized for depression. She began treatment with a clinical psychologist, who determined that her condition was, at least in part, work-related. About a year after her hospitalization, Mary attempted to return to work at the post office in a lower stress position that did not involve supervisory duties. However, after working for a short time, her condition worsened and she was unable to continue in that position. Mary was again hospitalized for depression after leaving employment.

She received compensation payments for the next year, during which she also received a distribution from a qualified plan. Because there was no evidence that her condition changed during the time she did not work and because she was unable to continue in a comparable position, her depression rendered her unable to engage in any substantial gainful activity. At the time of the distribution, her depression was indefinite because there was no reasonable indication of when she might be able to return to work. Her depression constitutes a disability that qualifies for the exemption from the 10% penalty.[40]

Note. For a disability to qualify for the disability exception, it must preclude working at any substantial gainful activity. The disability, however, does **not** need to be work-related.

EDUCATIONAL EXPENSE EXCEPTION

Distributions from an IRA (including a Roth IRA and SEP IRA) are exempt from the 10% penalty to the extent that the distributions made during the year do not exceed the amount of **qualified educational expenses** paid by the taxpayer in that year.[41]

"Qualified educational expenses" include tuition, fees, books, supplies, and equipment that are necessary for enrollment or attendance at an eligible educational institution.[42] An "eligible educational institution" is defined as any college, university, vocational school, or other post-secondary educational institution that is eligible to participate in a student aid program administered by the U.S. Department of Education.

Note. For further details on which educational institutions qualify as "eligible educational institutions" (including a link to the list of accredited schools from the Department of Education's website), see **www.irs.gov/Individuals/Eligible-Educational-Inst.**

The qualified educational expenses may be paid for the taxpayer who owns the IRA, the taxpayer's spouse, or the child or grandchild of either the taxpayer or taxpayer's spouse.[43] This is true even if the individual is not a dependent.

40. The facts of this example are based on *Coleman-Stephens v. Comm'r*, TC Summ. Op. 2003-91 (Jul. 16, 2003).

41. IRC §72(t)(2)(E).

42. IRC §529(e)(3).

43. IRC §72(t)(7)(A).

The amount of qualified higher education expenses must be reduced by any amounts received as an excludable scholarship, educational assistance allowance, or other excludable payment for educational expenses or in connection with enrollment.[44] A distribution from an IRA does not constitute a distribution for qualified educational expenses if it is made to the taxpayer after the taxpayer has attained age 59½ or if the distribution qualifies for another exception because it is made under one of the following circumstances.[45]

- To the taxpayer's beneficiary or estate after the taxpayer's death
- Because of the taxpayer's disability
- As part of a series of SEPPs
- In connection with the taxpayer's separation from the employer's service at or after age 55
- As an ESOP dividend distribution
- Because of an IRS levy on the taxpayer's retirement plan
- To an alternate payee under the terms of a QDRO
- To an unemployed taxpayer in connection with the payment of health premiums
- To the taxpayer in connection with medical expenses

Note. A Roth IRA distribution is usually subject to a 10% penalty if it is made before the taxpayer attains age 59½ or before the end of the 5-year period commencing with the time at which the taxpayer's first Roth IRA was funded. The educational expense exception eliminates the 10% penalty for both of these situations.

SUBSTANTIALLY EQUAL PERIODIC PAYMENTS

A distribution is exempt from the 10% penalty if that distribution is one of a series of substantially equal periodic payments (SEPPs) that are based on the life expectancy of the taxpayer or the joint life expectancy of the taxpayer and the designated beneficiary.[46]

This exception does not apply to distributions from qualified plans (or from annuities purchased using funds from a qualified plan) unless the SEPPs begin after the taxpayer separates from service with the employer maintaining the plan.[47] However, the IRS has indicated that the SEPP exception is available for IRA distributions; in this situation, whether the taxpayer has ceased employment is irrelevant because an IRA is not a qualified plan.[48]

44. IRC §§72(t)(7)(B) and 25A(g)(2).
45. IRC §72(t)(2)(E).
46. IRC §72(t)(2)(A)(iv).
47. IRC §72(t)(3)(B).
48. Ltr. Rul. 8923053 (Mar. 16, 1989).

There are three safe harbors available for structuring distributions so that they meet the requirements of the SEPP exception.[49] The safe harbors are as follows.

1. **The RMD method.** Distributions under the RMD method are calculated by taking the account balance on December 31 of the preceding year and dividing that balance by the life expectancy factor applicable to the taxpayer from one of the three IRS life expectancy tables.

Note. The life expectancy tables are found in IRS Pub. 590, *Individual Retirement Arrangements (IRAs)*. There are three tables: the single life table, the uniform lifetime table, and the joint and survivor table. For guidance on the use of these tables, see IRS Pub. 590 and the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Advanced Individual Issues.

Under this method, payments are recalculated for each subsequent year after the first year of payments.

2. **The fixed amortization method.** This method involves calculating a level annual payment amount by using either the single life expectancy table or the joint and survivor expectancy table plus an interest rate. The interest rate used must not be more than 120% of the applicable federal mid-term rate for either of the two months immediately preceding the month in which the first distribution is made.[50] The resulting payments remain the same each year and are not recalculated.

Note. "Applicable federal rates" (AFR) are used for various tax calculations. They are published in the form of a monthly revenue ruling. For more information on AFRs, see the 2012 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 8: Investment Income.

3. **The fixed annuitization method.** This method calculates the annual payment by dividing the account balance by an appropriate annuity factor. The annuity factor must be based on an appropriate interest rate and on the life expectancy of the taxpayer or joint life expectancies of the taxpayer and spouse, if applicable. The annual payment is the same each year and is not recalculated.

Note. The account balance is determined using any reasonable method based on all the facts and circumstances. There are also limitations on the interest rate used in the fixed annuitization method. See Rev. Rul. 2002-62 for further details.

Observation. If the taxpayer wants to receive their SEPP on a monthly basis, the annual amount calculated using the RMD method is divided by 12. However, under the **other two methods,** special calculations must be made to provide for monthly rather than annual payments.

49. IRS Notice 89-25, 1989-1 CB 662, modified by Rev. Rul. 2002-62, 2002-42 IRB 710.

50. Rev. Rul. 2002-62, 2002-42 IRB 710.

Example 20. Julie attains age 50 in 2013 and is single. To avoid the 10% penalty, she wants to receive distributions from her IRA in 2013 using the SEPP exception. On December 31, 2012, her IRA had a balance of $220,000. The single life expectancy table Julie used for her calculation follows.

Appendix C. Life Expectancy Tables

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

Age	Life Expectancy	Age	Life Expectancy
0	82.4	28	55.3
1	81.6	29	54.3
2	80.6	30	53.3
3	79.7	31	52.4
4	78.7	32	51.4
5	77.7	33	50.4
6	76.7	34	49.4
7	75.8	35	48.5
8	74.8	36	47.5
9	73.8	37	46.5
10	72.8	38	45.6
11	71.8	39	44.6
12	70.8	40	43.6
13	69.9	41	42.7
14	68.9	42	41.7
15	67.9	43	40.7
16	66.9	44	39.8
17	66.0	45	38.8
18	65.0	46	37.9
19	64.0	47	37.0
20	63.0	48	36.0
21	62.1	49	35.1
22	61.1	50	34.2
23	60.1	51	33.3
24	59.1	52	32.3
25	58.2	53	31.4
26	57.2	54	30.5
27	56.2	55	29.6

Julie calculates her 2013 distribution using the RMD method as follows.

$$\text{Julie's 2013 distribution} = \frac{\text{December 31, 2012 account balance}}{\text{Single life expectancy factor for age 50}}$$

$$= \frac{\$220{,}000}{34.2}$$

$$= \$6{,}433$$

Example 21. Use the same facts as **Example 20.** Julie received her 2013 distribution and now wants to calculate her SEPP distribution for 2014. Her IRA continued to grow throughout 2013. On December 31, 2013, the IRA balance is $224,730. Julie's 2014 SEPP is calculated as follows, using the factor from the single life expectancy table for age 51 (because she attains age 51 in 2014).

$$\text{Julie's 2014 distribution} = \frac{\text{December 31, 2013 account balance}}{\text{Single life expectancy factor for age 51}} = \frac{\$224{,}730}{33.3} = \$6{,}749$$

Julie's SEPP from her IRA for 2014 is $6,749. Although this amount is different than the 2013 distribution, this change does not constitute a modification that would result in a forfeiture of the SEPP exemption (discussed in the next section). Julie adhered to the RMD method and the redetermination of the appropriate amount each year does not constitute a modification of the SEPPs (discussed in the next section).

Note. Because the RMD method takes into account an updated yearend balance for each subsequent year's SEPP calculation, income, gains, and losses within an IRA or qualified plan influence the amount of the SEPP. This is not true when the other two safe harbor methods are used.

Forfeiting the Exemption and Recapture Tax

Once the taxpayer uses SEPPs as an exemption from the 10% penalty, the taxpayer is obligated to continue receiving SEPPs without changing them in a manner that constitutes a **modification** of those payments for a period of time. The exemption is forfeited if the payments are modified (for reasons other than disability or death) before the **later** of:

- The end of the 5-year period that begins on the date that the first SEPP was made, or
- The date on which the taxpayer attains age 59½.[51]

The 5-year period ends on the fifth anniversary date of the first distribution.[52] The clearest guidance on whether a modification of SEPPs has occurred exists in various letter rulings. Generally, a modification to the SEPPs occurs if, after such payments begin, there is either:

- An addition to the account balance other than gains or losses occurring within the account,
- A transfer of the account balance to another retirement plan, or
- A rollover of the distribution received by the taxpayer that results in the distribution being nontaxable.[53]

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51. IRC §72(t)(4)(A).
52. *R.C. Arnold v. Comm'r,* 111 TC 250 (1998).
53. Ltr. Rul. 201051025 (Sep. 30, 2010).

The various letter rulings providing guidance on SEPP changes that constitute a modification include the following.

Adding a 4% cost-of-living adjustment to an annual SEPP distribution from an IRA **does not constitute a modification.** In addition, a retroactive "catch up" cost-of-living payment for prior years' payments made before the implementation of the 4% adjustment is not a modification.	Ltr. Rul. 199943050 (Aug. 3. 1999)
A bank's inadvertent transfer of assets into an IRA contrary to the account owner's directions **did not result in a modification** of the SEPPs from that IRA if the error is corrected by removing the amount transferred into the IRA along with the related earnings.	Ltr. Rul. 200929021 (Apr. 21, 2009)
A transfer of funds from an IRA that provided SEPPs to another funded IRA that resulted in larger payments because the taxpayer failed to provide instructions necessary to continue receiving only the SEPP amount **constitutes a modification.**	Ltr. Rul. 200631025 (May 12, 2006)
A reduction in the amount of SEPPs received by the taxpayer due to the division of the IRA under a divorce decree **does not constitute a modification.**	Ltr. Rul. 201030038 (May 5, 2010)
A distribution that is inconsistent with the amount of SEPPs from an IRA is **considered a modification** if the SEPP amount is changed by an account owner who wants to increase the amount of payment due to financial circumstances.	Ltr. Rul. 200716032 (Jan. 23, 2007)

Observation. Letter rulings cannot be used as precedent and are issued by the IRS to address the particular tax issue only in connection with the taxpayer who applied for the ruling. However, letter rulings are useful to predict how the IRS may decide a similar issue for another taxpayer.

Note. A one-time change from either the amortization method or the annuitization method to the RMD method is allowed without this change constituting a modification.[54] Once the taxpayer makes this change, the RMD method must be adhered to in order to avoid modification.

The IRS has indicated that a taxpayer may receive SEPPs from one or more IRAs while other IRAs belonging to that taxpayer do not generate any payments.[55] Moreover, if a decline in the IRA's value results in a depletion of IRA funds that serves to discontinue the SEPPs received by the taxpayer, **the cessation of payments does not constitute a modification.**[56]

If a modification occurs, the taxpayer's tax liability for the year in which the modification was made is increased by the amount of the penalty that would have originally been due on the distributions received, plus interest.[57] This is frequently referred to as the SEPP **"recapture tax."** The recapture tax only applies to payments received before the taxpayer attains age 59½.[58] Payments received after the taxpayer attains age 59½ are not subject to the recapture tax.[59]

54. Rev. Rul. 2002-62, 2002-42 IRB 710.
55. Ltr. Rul. 200030159 (May 11, 2000).
56. Rev. Rul. 2002-62, 2002-42 IRB 710.
57. Ibid.
58. IRC §72(t)(2)(A)(i).
59. IRC §72(t)(4)(B).

Example 22. Use the same facts as **Example 21,** except Julie attains age 50 in 2015. Instead of properly recalculating her SEPP distribution for 2015, Julie decides to take a lump-sum distribution of $10,000. The $10,000 is not a SEPP. Consequently, by receiving this distribution, Julie forfeits the SEPP exemption. Her 2015 tax liability is increased by the 10% penalty on the 2013 and 2014 distributions she received, plus applicable interest. This increase is the recapture tax. Her 2015 lump-sum payment is also subject to the 10% penalty because it was received before Julie attained age 59½.

Julie could avoid the recapture tax by continuing to take SEPPs (using the RMD method she originally chose) until she reaches age 59½.

Example 23. Use the same facts as **Example 22,** except Julie attains age 59½ in April 2014 and her 2014 SEPP was received after she attained age 59½. Although her $10,000 lump sum distribution in 2015 triggers the recapture tax because she modified the SEPPs within the 5-year period beginning with the 2013 date on which the first SEPP was made, only her payments received prior to the date she attained age 59½ are subject to the recapture tax. Accordingly, only her 2013 SEPP is subject to the recapture tax, plus applicable interest. Although Julie's post-age-59½ lump-sum distribution constitutes a modification that triggers the recapture tax, only her pre-age-59½ payments are subject to that tax and not the payments she receives after attaining age 59½.

Note. For additional guidance on SEPPs as an exception to the 10% penalty, see **www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-regarding-Substantially-Equal-Periodic-Payments#6.**

Use of Multiple Exceptions

During the time the taxpayer is receiving SEPPs for the first 5-year period, another distribution may be made under the educational expense exception to the 10% penalty without the educational expense distribution constituting a modification of the SEPP arrangement.[60]

Example 24. Dr. Benz was within the first 5-year period of receiving SEPPs from her IRA. During this 5-year period, Dr. Benz also received a lump-sum distribution under the educational expense exception to provide some funds for her son's college education. The educational expense distribution was considered an entirely separate transaction from the SEPPs and was not a modification of Dr. Benz's SEPPs, because the method of calculating her SEPPs does not change as a result of the educational expense distribution.

Observation. The facts in **Example 24** are based on *Benz v. Comm'r.*[61] Although the holding of this case specifically addressed the use of the educational expense exemption during the initial 5-year SEPP period, this case may also provide precedent for the use of other exemptions during a 5-year SEPP period.

SEPARATION FROM EMPLOYER AFTER AGE 55

A distribution received by a taxpayer is exempt from the 10% penalty if:

- The taxpayer is an employee who separates from service with an employer,
- The qualified plan from which the distribution is made was maintained by the employer from whom the taxpayer separated, and
- The taxpayer separated from the employer during or after the year in which the taxpayer attained age 55.[62]

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60. IRC §72(t)(2)(E).

61. *Benz v. Comm'r,* 132 TC 15 (2009).

62. IRC §72(t)(2)(A)(v); and IRS Notice 87-13, 1987-1 CB 432.

This exception **does not apply** to the taxpayer's IRA or SEP IRA.[63]

> **Example 25.** Michael retired from employment at age 53. He waited until the year he reached age 56 to withdraw a lump sum from the qualified retirement plan that he established through his former employer. Because Michael was younger than age 55 when he separated from service, the distribution does not qualify for this exception.[64]

> **Example 26.** Gwendolyn will attain age 55 on December 12, 2014. She officially retired from employment on March 31, 2014, and received a distribution in June 2014 from the qualified retirement plan established with her employer. The distribution qualifies for an exception from the 10% penalty because the distribution was made after Gwendolyn separated from employment from the employer maintaining the plan and her separation occurred during the year in which she attained age 55.[65]

This exception also applies to distributions from a government qualified plan for public safety employees who separate from employment service during or after the year in which they attain **age 50.**[66] "Public safety employee" is defined as a state employee who provides police, firefighting, or emergency medical services.[67]

MEDICAL EXPENSE EXCEPTION

Generally, distributions from a qualified plan or IRA are exempt from the 10% penalty up to the amount of medical expenses that the taxpayer may deduct for the year. For purposes of the exception, the deductible amount includes only those medical expenses in excess of the taxpayer's percentage-of-AGI limitation that may be deducted (even if the taxpayer does not itemize deductions but instead claims the standard deduction).[68]

In addition, an IRA, SEP, or SIMPLE distribution may be exempt from the 10% penalty if used to pay for medical insurance. This rule applies without regard to the AGI limitation on medical expense deductions and applies only if the following conditions are met.[69]

- The taxpayer received federal or state unemployment compensation for a period of at least 12 consecutive weeks.
- The distribution is made either during the year in which unemployment compensation is received or in the following year.

However, distributions made once the taxpayer is re-employed for 60 days or longer do not qualify for the exception.[70]

A self-employed individual not eligible for state or federal unemployment benefits may still qualify for this exception if the taxpayer's self employment is the only reason they do not receive unemployment benefits.[71]

> **Note.** For 2013 onward, itemized medical expenses are generally deductible only to the extent that they exceed 10% of the taxpayer's AGI. However, a lower 7.5% threshold applies through 2016 for taxpayers who are age 65 or older before the close of the tax year.[72] MFJ filers qualify for the lower 7.5% threshold even if only one spouse meets the age-65 requirement.[73]

63. IRC §72(t)(3)(A); and Joint Committee on Taxation report JCS-10-87, *General Explanation of the Tax Reform Act of 1986.*
64. See *Williams v. Comm'r,* TC Summ. Op. 2008-53 (May 19, 2008).
65. IRS Notice 87-13, 1987-1 CB 432.
66. IRC §72(t)(10)(A).
67. IRC §72(t)(10)(B).
68. IRC §72(t)(2)(B).
69. IRC §72(t)(2)(D).
70. IRC §72(t)(2)(D)(ii).
71. IRC §72(t)(2)(D)(iii).
72. IRC §213(f).
73. IRS Pub. 502, *Medical and Dental Expenses*.

ESOP DIVIDEND EXEMPTION

Cash dividend employee stock ownership plan (ESOP) distributions deductible by the employer are exempt from the 10% penalty when they are received by the employee.[74] Generally, a corporation may deduct ESOP dividends paid to employees if the following requirements are met.[75]

- The dividends are distributed to the employees in cash.
- The dividends are paid to the plan during a plan year and subsequently distributed to employees in cash no later than 90 days after the plan year closes.

A corporation also may deduct distributions that are received by the employee in cash and reinvested into the ESOP if the employee makes a specific election to do so.[76]

> **Note.** For further information about a corporation's deduction for ESOP distributions to employees, see IRC §404(k) and IRS Notice 2002-2.[77]

Example 27. SpyroMatic Genetic Corporation (SpyroMatic) provides an ESOP for its employees. The plan accumulates dividends each year and provides for distribution of those dividends to employee-participants during the final 90 days of each tax year. For 2013, participating employees could elect to either receive their respective distributions in cash or have their distributions reinvested into SpyroMatic common shares in the first 90 days of 2014.

All of the dividends that employees elect to reinvest into the plan are, in fact, reinvested within the first 90 days of 2014. SpyroMatic may deduct dividends that are either paid in cash in 2013 or reinvested in early 2014 under the terms of IRC §404(k). None of the distributions are subject to the 10% penalty.

QDRO EXCEPTION

For federal tax purposes, a domestic relations order is a state court order related to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, or dependent of the taxpayer.[78]

In order for the domestic relations order to be considered a "qualified" domestic relations order (QDRO), it must provide one or more alternate payees with the right to receive payments from the taxpayer's retirement plan. In addition, the following items must be indicated within the court order.[79]

- The name and last known mailing address of the taxpayer and alternate payee or payees
- The amount or percentage (or method used to determine the amount or percentage) of the taxpayer's benefits to be paid to each alternate payee
- The number of payments or the duration to which the court order applies
- The specific plan or plans to which the order applies

In addition, the court order may not require the retirement plan to provide any benefit beyond the provisions of the plan, and the order may not grant payment rights for an alternate payee for payments already awarded to another alternate payee under a prior QDRO.

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74. IRC §72(t)(2)(A)(vi).
75. IRC §§404(k)(2)(A)(i), (ii).
76. IRC §404(k)(2)(A)(iii); and IRS Notice 2002-2, 2002-1 CB 285.
77. IRS Notice 2002-2, 2002-1 CB 285.
78. IRC §414(p)(1)(B).
79. IRC §§414(p)(2) and 414(p)(3).

Payments made under a QDRO to an alternate payee who has not attained age 59½ are not subject to the 10% penalty.[80] This exception only applies to qualified plans and **does not apply** to IRAs.[81] Although QDROs are not used for IRAs, the transfer of an individual's interest in an IRA to a spouse or former spouse **under a decree of divorce or separate maintenance agreement (or a written instrument incident to divorce)** is **not** a taxable event to either spouse. The IRA assets are transferred by changing the name on the IRA or via a direct trustee-to-trustee transfer of assets.

> **Caution.** Withdrawing funds from an IRA to satisfy a divorce judgment causes the IRA owner to be taxed on the distribution and also potentially subjected to the 10% early withdrawal penalty. The IRA funds should be transferred directly to the other spouse's IRA under a decree of divorce or separate maintenance agreement.

IRS PLAN LEVIES

A distribution made because of an IRS levy on the qualified retirement plan or IRA is exempt from the 10% penalty.

> **Note.** An IRS levy involves the legal seizure of property in order to satisfy a tax debt of the taxpayer.

The IRS has broad power to place a levy on a taxpayer's property, including retirement plans and payment rights under a retirement plan. Some property is exempt from an IRS levy, including the following.

- Clothing and schoolbooks necessary for the taxpayer or members of the taxpayer's family
- The taxpayer's principal residence (unless the levy is approved in writing by a federal district court)[82]

> **Note.** If the IRS initiates a court proceeding to place a levy on the taxpayer's principal residence, the IRS must notify the taxpayer. If the amount of the levy is $5,000 or less, the principal residence of the taxpayer and any other real estate owned by the taxpayer that is rented and used by another person as a residence are exempt.[83]

- Tangible personal property or nonrental real property used in the taxpayer's trade or business, unless an IRS area director approves the levy or it is determined that the collection may be in jeopardy[84]

> **Note.** An IRS area director may not approve this levy unless it is first determined that the taxpayer's other nonexempt assets are not sufficient to pay the amount of tax liability owed and the sale expenses.[85]

- Books and tools necessary for the taxpayer's business or profession, up to $4,470 for 2014[86]
- Household personal effects, furniture, provisions, and fuel up to $8,940 for 2014[87]

> **Note.** For additional types of property exempt from levy, see IRC §6334(a). Some exemptions involve amounts that are subject to inflation indexing each year. Such amounts for 2014 can be found in Rev. Proc. 2013-35.[88]

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80. IRC §72(t)(2)(C).
81. IRC §72(t)(3)(A).
82. IRC §§6334(a)(13)(B)(i) and 6334(e)(1)(A).
83. IRC §6334(a)(13)(A); and Treas. Reg. §301.6334-1(a)(13)(i).
84. IRC §§6334(a)(13)(B)(ii), 6334(e)(2); and Treas. Reg. §301.6334-1(e).
85. IRC §6334(e)(2).
86. Rev. Proc. 2013-35, 2013-47 IRB 537.
87. IRC §6334(a)(2); and Rev. Proc. 2013-35, 2013-47 IRB 537.
88. Rev. Proc. 2013-35, 2013-47 IRB 537.

FIRST-TIME HOMEBUYER DISTRIBUTIONS

A qualified first-time homebuyer distribution from an IRA is exempt from the 10% penalty.[89] There is a **lifetime limit** of $10,000 per individual that may qualify for this exemption.[90] A **qualified first-time homebuyer distribution** is any IRA distribution received by a first-time homebuyer to the extent it is used to pay for qualified acquisition costs for a principal residence. In order to qualify for the exemption, the distribution must be used to pay qualified acquisition costs before the end of the 120th day after the date on which the taxpayer receives the distribution. **Qualified acquisition costs** are defined as the costs of acquiring, constructing, or reconstructing a residence. This includes any reasonable financing, closing, or settlement expenses.[91]

The first-time homebuyer may be the taxpayer who owns the plan from which the distribution is received; the taxpayer's spouse; or any child, grandchild, or ancestor of the taxpayer or taxpayer's spouse. In order for an individual to qualify as a **first-time homebuyer,** neither the individual who is acquiring the residence nor that individual's spouse can have owned a principal residence for the 2-year period preceding the **acquisition date** of the principal residence for which the distribution was made.[92] The acquisition date is the date on which a binding contract is entered into for the purchase of the principal residence or the date on which construction or reconstruction commences.

Note. For purposes of this rule, "principal residence" is defined in the same manner as it is under IRC §121 (relating to the capital gains exclusion for the sale of a principal residence).

Observation. The rules for the qualified first-time homebuyer exception are structured so that the first-time homebuyer does not need to be the same person as the individual receiving the distribution from a retirement account. The qualified first-time homebuyer may be a child, grandchild, or ancestor of the taxpayer who owns the retirement plan or the taxpayer's spouse.

Example 28. Tom and Tina have a son, Thurman. Thurman recently graduated from school and now has his first job. He is saving money for a downpayment on his first home. Tom and Tina want to help Thurman with his downpayment. Neither parent has ever used a qualified first-time homebuyer distribution from their retirement portfolio. Tom and Tina both receive a $10,000 distribution from their respective IRAs and gift the funds to Thurman.

As long as Thurman uses the money for qualified acquisition costs within the 120-day time frame required under the rules to make a qualifying purchase as a first-time homebuyer, the distributions received by Tom and Tina qualify for the exception. Tom and Tina incur income tax liability on the withdrawal but are not subject to the 10% penalty.

Observation. The $10,000 from each parent may also be gifted to Thurman without incurring a liability for gift tax because their gift was less than the annual gift tax exclusion of $14,000 for 2014.

89. IRC §72(t)(2)(F).

90. IRC §72(t)(8)(B).

91. IRC §72(t)(8)(C).

92. IRC §72(t)(8)(D)(i)(I).

QUALIFIED RESERVIST DISTRIBUTIONS

A qualified reservist is an individual who is a member of one of the following branches of military service.[93]

- The Army or Air National Guard
- The reserve unit of the Army, Navy, Marine Corps, or Air Force
- The Coast Guard Reserve
- The Public Health Service Reserve Corps

A qualified reservist may receive a distribution from an IRA or from amounts attributable to employer contributions pursuant to elective deferrals under a 401(k) plan or 403(b) plan if the following conditions are satisfied.[94]

- The qualified reservist is called to active duty for a period of more than 179 days.
- The distribution is made during the period that begins on the date the reservist is called to active duty and ends on the date that the period of active duty closes.

Distributions under these conditions are not subject to the 10% penalty. In addition, reservists taking these distributions have the opportunity to replenish their retirement funds after the period of active duty ends.

Reservists may replenish their retirement funds by making contributions in excess of the usual limits into their traditional or Roth IRAs during the 2-year period beginning on the day after the active duty period closes. These excess contributions (or repayments) may not total more than the distributions taken while on active duty. Repayments are not eligible for a tax deduction. They may be made in a single lump sum or through a series of contributions.

If repayments are made to a Roth IRA, no additional reporting is required. If repayments are made to a traditional IRA, the reservist should file Form 8606 to track the basis created by the repayments.[95]

Observation. Under military rules, "short-tour opportunities" are typically limited to 179 days or less. These rules preclude the reservist from taking a qualified reservist distribution if they are on active duty on a short-tour opportunity. A longer active-duty period is required.

FEDERAL EMPLOYEE RETIREMENTS

Early distributions made after July 6, 2012, to a taxpayer retiring under a phased retirement annuity program structured by the Office of Personnel Management (OPM) are not subject to the 10% penalty.[96]

Observation. This exception to the 10% penalty was established by the Highway Investment, Job Creation, and Economic Growth Act of 2012.[97]

93. 37 USC 101(24); and IRC §72(t)(2)(G)(iii)(II).
94. IRC §72(t)(2)(G)(iii).
95. IRS Pub. 590, *Individual Retirement Arrangements.*
96. IRC §72(t)(2)(A)(viii).
97. PL 112-141.

This federal phased-in retirement program for certain qualified federal employees allows partial retirement from full-time work hours. Generally, under the terms of this program, the employee can work between 20% and 80% of their usual full-time work schedule. The employee receives a prorated salary and pension credit for the reduced full-time hours worked. The employee can receive pension income during this period of partial retirement (a "phased retirement annuity"). Upon full retirement, the employee receives a full pension benefit (a "composite retirement annuity"). Generally, the phased or composite retirement annuity payments are exempt from the 10% penalty if received by employees prior to attaining age 59½.

> **Note.** The current retirement system for federal employees is the Federal Employees Retirement System (FERS), which replaced the Civil Service Retirement System (CSRS) for all employees who began federal employment service on or after January 1, 1987. Under FERS, many employees may qualify for retirement before age 59½, making this exception necessary for those employees in order to avoid the 10% penalty if they choose to retire early. For additional information on FERS and retirement eligibility, see **www.opm.gov/retirement-services/fers-information/eligibility.**

CLAIMING AN EXEMPTION TO THE 10% PENALTY

Generally, the exemptions mentioned in this chapter are claimed by the taxpayer using Form 5329. Many of the exemptions have a code that identifies the type of exemption being claimed by the taxpayer for some or all of the distribution amount received. The following codes are indicated in the Form 5329 instructions.

No.	Exception
01	Qualified retirement plan distributions (does not apply to IRAs) you receive after separation from service in or after the year you reach age 55 (age 50 for qualified public safety employees).
02	Distributions made as part of a series of substantially equal periodic payments (made at least annually) for your life (or life expectancy) or the joint lives (or joint life expectancies) of you and your designated beneficiary (if from an employer plan, payments must begin after separation from service).
03	Distributions due to total and permanent disability. You are considered disabled if you can furnish proof that you cannot do any substantial gainful activity because of your physical or mental condition. A physician must determine that your condition can be expected to result in death or to be of long, continued, and indefinite duration.
04	Distributions due to death (does not apply to modified endowment contracts).
05	Qualified retirement plan distributions up to the amount you paid for unreimbursed medical expenses during the year **minus** 10% (or 7.5% if you or your spouse are age 65 or older) of your adjusted gross income for the year.
06	Qualified retirement plan distributions made to an alternate payee under a qualified domestic relations order (does not apply to IRAs).
07	IRA distributions made to unemployed individuals for health insurance premiums.
08	IRA distributions made for higher education expenses.
09	IRA distributions made for purchase of a first home, up to $10,000.
10	Distributions due to an IRS levy on the qualified retirement plan.
11	Qualified distributions to reservists while serving on active duty for at least 180 days.
12	Other (see *Other* below). Also, enter this code if more than one exception applies.

Example 29. Milena is a single filer and is employed as a civil engineer. She is 44 years old. During 2013, Milena incurred medical expenses of $10,000. Milena realized that she would need to withdraw some funds from her IRA to help pay for the medical expenses. She contacted her bank, Elm Street Bank and Loan, to arrange a $10,000 withdrawal from her IRA. She received the $10,000 distribution before the end of 2013 and later received the following Form 1099-R in connection with the distribution.

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city or town, province or state, country, and ZIP or foreign postal code **Elm Street Bank & Loan** **123 Elm Street** **Chicago, IL 63303**		1 Gross distribution $ **10000.00** 2a Taxable amount $	OMB No. 1545-0119 **2013** Form **1099-R**	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
		2b Taxable amount not determined ☒	Total distribution ☐	**Copy 1 For State, City, or Local Tax Department**
PAYER'S federal identification number **37-5000211**	RECIPIENT'S identification number **999-99-9999**	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $ **1000.00**	
RECIPIENT'S name **Milena Mareno**		5 Employee contributions /Designated Roth contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	
Street address (including apt. no.) **3456 Stuart Street**		7 Distribution code(s) **1** — IRA/ SEP/ SIMPLE ☒	8 Other $ %	
City or town, province or state, country, and ZIP or foreign postal code **Chicago, IL 63303**		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** www.irs.gov/form1099r Department of the Treasury - Internal Revenue Service

Milena brings the Form 1099-R, the receipts for her medical expenses, and the following Form W-2, *Wage and Tax Statement*, to Vicky, her tax preparer.

a Employee's social security number **999-99-9999**	OMB No. 1545-0008	This information is being furnished to the Internal Revenue Service. If you are required to file a tax return, a negligence penalty or other sanction may be imposed on you if this income is taxable and you fail to report it.	
b Employer identification number (EIN) **37-5665555**		1 Wages, tips, other compensation **63000.00**	2 Federal income tax withheld **7500.00**
c Employer's name, address, and ZIP code **Parsons & Parsons Civil Engineers LLC** **6868 Lewis Avenue** **Chicago, IL 63303**		3 Social security wages **63000.00**	4 Social security tax withheld **3906.00**
		5 Medicare wages and tips **63000.00**	6 Medicare tax withheld **913.50**
		7 Social security tips	8 Allocated tips
d Control number		9	10 Dependent care benefits
e Employee's first name and initial **Milena** Last name **Mareno** Suff.		11 Nonqualified plans	12a See instructions for box 12 Code **C** **197.50**
3456 Stuart Street **Chicago, IL 63303**		13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	12b Code **DD** **8960.21**
		14 Other	12c Code
f Employee's address and ZIP code			12d Code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
IL	**37-5665555**	**63000.00**	**2355.00**			

Form **W-2** **Wage and Tax Statement** **2013** Department of the Treasury—Internal Revenue Service

Copy C—For EMPLOYEE'S RECORDS (See *Notice to Employee* **on the back of Copy B.)**

Safe, accurate, FAST! Use IRS e-file

Milena's AGI is as follows.

Employment income	$63,000
IRA distribution	10,000
AGI	$73,000

Vicky determines that all $10,000 of medical expenses Milena incurred during 2013 are qualified medical expenses. She also determines that Milena should claim the standard deduction instead of itemizing her deductions for the year. She realizes that some of Milena's IRA distribution is not subject to the 10% penalty. The distribution is exempt from the penalty for the amount of Milena's qualified medical expenses in excess of 10% of her AGI (which is the amount Milena could deduct if she were to itemize). Vicky informs Milena that she does not actually have to itemize to claim the 10% exemption on the applicable portion of the distribution. Vicky calculates this amount as follows.

Amount of qualified medical expenses for 2013	$10,000
Less: 10% of $73,000 AGI	(7,300)
Deductible amount of medical expenses if Milena itemized	$ 2,700

Vicky completes Milena's 2013 tax return. Milena's Form 1040 and Form 5329 follow.

Observation. If Milena had made a $5,500 IRA contribution (the maximum amount allowable for 2013 for individuals under age 50), this would reduce her AGI by that amount and increase the amount of the distribution that is not subject to the 10% penalty.

Note. Although Milena did not itemize in **Example 29,** it should be noted that premiums paid for health insurance are qualified medical expenses that may be deducted on Schedule A. This particular expense is increasingly important starting with the 2014 tax year because of the mandate for individuals to maintain "minimum essential coverage" unless they fall under one of the exemptions for health insurance coverage. For further details on the ACA individual mandate, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3, Affordable Care Act Update.

For Example 29

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return **2013** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2013, or other tax year beginning , 2013, ending , 20 See separate instructions.

Your first name and initial	Last name	Your social security number
Milena	Mareno	999 99 9999
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.	Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
3456 Stuart Street		
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).		**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Chicago, IL 63303		
Foreign country name	Foreign province/state/county	Foreign postal code

Filing Status

Check only one box.

1 ☒ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**
Boxes checked on 6a and 6b: **1**

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see instructions)
			☐
			☐
			☐
			☐

If more than four dependents, see instructions and check here ▶ ☐

No. of children on 6c who:
• lived with you
• did not live with you due to divorce or separation (see instructions)
Dependents on 6c not entered above

d Total number of exemptions claimed — Add numbers on lines above ▶ **1**

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

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

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	63,000
8a	**Taxable** interest. Attach Schedule B if required	8a	
b	**Tax-exempt** interest. **Do not** include on line 8a — 8b		
9a	Ordinary dividends. Attach Schedule B if required	9a	
b	Qualified dividends — 9b		
10	Taxable refunds, credits, or offsets of state and local income taxes	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐	13	
14	Other gains or (losses). Attach Form 4797	14	
15a	IRA distributions — 15a; b Taxable amount	15b	10,000
16a	Pensions and annuities — 16a; b Taxable amount	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits — 20a; b Taxable amount	20b	
21	Other income. List type and amount	21	
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	73,000

Adjusted Gross Income

23	Educator expenses — 23		
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ — 24		
25	Health savings account deduction. Attach Form 8889 — 25		
26	Moving expenses. Attach Form 3903 — 26		
27	Deductible part of self-employment tax. Attach Schedule SE — 27		
28	Self-employed SEP, SIMPLE, and qualified plans — 28		
29	Self-employed health insurance deduction — 29		
30	Penalty on early withdrawal of savings — 30		
31a	Alimony paid b Recipient's SSN ▶ — 31a		
32	IRA deduction — 32		
33	Student loan interest deduction — 33		
34	Tuition and fees. Attach Form 8917 — 34		
35	Domestic production activities deduction. Attach Form 8903 — 35		
36	Add lines 23 through 35	36	0
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶	37	73,000

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2013)

For Example 29

Form 1040 (2013) Page 2

Tax and Credits	38	Amount from line 37 (adjusted gross income)		38	73,000
	39a	Check if: ☐ **You** were born before January 2, 1949, ☐ Blind. ☐ **Spouse** was born before January 2, 1949, ☐ Blind. } **Total boxes checked** ▶ **39a**			
Standard Deduction for—	b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ **39b** ☐			
• People who check any box on line 39a or 39b **or** who can be claimed as a dependent, see instructions.	40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		40	6,100
• All others:	41	Subtract line 40 from line 38		41	66,900
Single or Married filing separately, $6,100	42	**Exemptions.** If line 38 is $150,000 or less, multiply $3,900 by the number on line 6d. Otherwise, see instructions		42	3,900
Married filing jointly or Qualifying widow(er), $12,200	43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		43	63,000
Head of household, $8,950	44	**Tax** (see instructions). Check if any from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐		44	11,685
	45	**Alternative minimum tax** (see instructions). Attach Form 6251		45	0
	46	Add lines 44 and 45 ▶		46	11,685
	47	Foreign tax credit. Attach Form 1116 if required	47		
	48	Credit for child and dependent care expenses. Attach Form 2441	48		
	49	Education credits from Form 8863, line 19	49		
	50	Retirement savings contributions credit. Attach Form 8880	50		
	51	Child tax credit. Attach Schedule 8812, if required	51		
	52	Residential energy credits. Attach Form 5695	52		
	53	Other credits from Form: **a** ☐ 3800 **b** ☐ 8801 **c** ☐	53		
	54	Add lines 47 through 53. These are your **total credits**		54	
	55	Subtract line 54 from line 46. If line 54 is more than line 46, enter -0- ▶		55	11,685
Other Taxes	56	Self-employment tax. Attach Schedule SE		56	
	57	Unreported social security and Medicare tax from Form: **a** ☐ 4137 **b** ☐ 8919		57	
	58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required		58	730
	59a	Household employment taxes from Schedule H		59a	
	b	First-time homebuyer credit repayment. Attach Form 5405 if required		59b	
	60	Taxes from: **a** ☐ Form 8959 **b** ☐ Form 8960 **c** ☐ Instructions; enter code(s)		60	
	61	Add lines 55 through 60. This is your **total tax** ▶		61	12,415
Payments	62	Federal income tax withheld from Forms W-2 and 1099	62 8,500		
If you have a qualifying child, attach Schedule EIC.	63	2013 estimated tax payments and amount applied from 2012 return	63		
	64a	**Earned income credit (EIC)**	64a		
	b	Nontaxable combat pay election 64b			
	65	Additional child tax credit. Attach Schedule 8812	65		
	66	American opportunity credit from Form 8863, line 8	66		
	67	Reserved	67		
	68	Amount paid with request for extension to file	68		
	69	Excess social security and tier 1 RRTA tax withheld	69		
	70	Credit for federal tax on fuels. Attach Form 4136	70		
	71	Credits from Form: **a** ☐ 2439 **b** Reserved **c** ☐ 8885 **d** ☐	71		
	72	Add lines 62, 63, 64a, and 65 through 71. These are your **total payments** ▶		72	8,500
Refund	73	If line 72 is more than line 61, subtract line 61 from line 72. This is the amount you **overpaid**		73	
	74a	Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐		74a	
Direct deposit? See instructions. ▶	b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings			
▶	d	Account number			
	75	Amount of line 73 you want **applied to your 2014 estimated tax** ▶	75		
Amount You Owe	76	**Amount you owe.** Subtract line 72 from line 61. For details on how to pay, see instructions ▶		76	3,915
	77	Estimated tax penalty (see instructions)	77		

Third Party Designee — Do you want to allow another person to discuss this return with the IRS (see instructions)? ☒ **Yes.** Complete below. ☐ **No**

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here — Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

Form **1040** (2013)

For Example 29

Form **5329**

Department of the Treasury
Internal Revenue Service (99)

Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts

▶ Attach to Form 1040 or Form 1040NR.

▶ Information about Form 5329 and its separate instructions is at *www.irs.gov/form5329*.

OMB No. 1545-0074

2013

Attachment Sequence No. 29

Name of individual subject to additional tax. If married filing jointly, see instructions.
Milena Mareno

Your social security number
999-99-9999

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

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

City, town or post office, state, and ZIP code. If you have a foreign address, also complete the spaces below (see instructions).

If this is an amended return, check here ▶ ☐

Foreign country name | Foreign province/state/county | Foreign postal code

If you **only** owe the additional 10% tax on early distributions, you may be able to report this tax directly on Form 1040, line 58, or Form 1040NR, line 56, without filing Form 5329. See the instructions for Form 1040, line 58, or for Form 1040NR, line 56.

Part I **Additional Tax on Early Distributions**

Complete this part if you took a taxable distribution before you reached age 59½ from a qualified retirement plan (including an IRA) or modified endowment contract (unless you are reporting this tax directly on Form 1040 or Form 1040NR—see above). You may also have to complete this part to indicate that you qualify for an exception to the additional tax on early distributions or for certain Roth IRA distributions (see instructions).

1	Early distributions included in income. For Roth IRA distributions, see instructions	1	10,000
2	Early distributions included on line 1 that are not subject to the additional tax (see instructions). Enter the appropriate exception number from the instructions: 05	2	2,700
3	Amount subject to additional tax. Subtract line 2 from line 1	3	7,300
4	**Additional tax.** Enter 10% (.10) of line 3. Include this amount on Form 1040, line 58, or Form 1040NR, line 56	4	730

Caution: *If any part of the amount on line 3 was a distribution from a SIMPLE IRA, you may have to include 25% of that amount on line 4 instead of 10% (see instructions).*