Chapter 1: Retirement

Please note. Corrections were made to this workbook through January of 2017. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

SMALL BUSINESS RETIREMENT PLANS

Small business owners have many options to consider when determining which type of retirement plan is most suitable. Each type of plan has its own rules and limitations. This section discusses three types of small business retirement plans.

1. Solo 401(k)
2. SEP IRA
3. SIMPLE IRA

SOLO 401(K) PLAN

Solo 401(k) plans are available to sole proprietors, partnerships, C corporations, and S corporations. A solo 401(k) plan is sometimes called a:

- One-participant 401(k) plan,
- Solo-k,
- Uni-k, or
- One-participant k.

A solo 401(k) plan has the same rules and requirements as any other 401(k) plan. It is a traditional 401(k) plan that may be suitable for a business that has no employees. Such a plan covers only:[1]

- The owner,
- The owner of a wholly owned trade or business (whether or not incorporated) and their spouse, or
- Partners (or partners and their spouses) of a business partnership.

1. *Form 5500 Corner*. Mar. 10, 2016. IRS. [www.irs.gov/Retirement-Plans/Form-5500-Corner] Accessed on May 12, 2016.

Establishing a Solo 401(K) Plan[2]

As mentioned earlier, a solo 401(k) plan has the same rules and requirements as any other traditional 401(k) plan. Therefore, the same basic actions are necessary to set up a solo 401(k) as are required for a multi-participant 401(k).

One of the first decisions that must be made is whether the owner wants to set up the plan or to consult a professional or financial institution (e.g., a bank, mutual fund provider, or insurance company) to establish and maintain the plan. After the owner makes that decision, the following actions are necessary for a tax-advantaged 401(k) plan.

1. Adopt a written plan
2. Arrange a trust fund for the plan's assets
3. Develop a recordkeeping system
4. Provide plan information to the participant

Note. For detailed information about each of these steps, go to **uofi.tax/16a1x5** [www.irs.gov/retirement-plans/irc-401-k-plans-establishing-a-401-k-plan].

Contribution Limits[3]

The business owner has two roles in a 401(k) plan: employer and employee. Plan contributions can be made in both capacities. The owner can contribute both of the following.

- **Elective deferrals** up to 100% of compensation, not to exceed the annual contribution limit (In 2016, the limit is $18,000 or $24,000 if the employee is age 50 or over and the plan allows catch-up contributions.)[4]
- **Employer nonelective contributions** up to 25% of compensation as defined by the plan (The limits for self-employed individuals are discussed later.)

The limits on elective deferrals are by person, not by plan. Therefore, a business owner who is also employed by another company and participates in its qualified retirement plan must consider the limit for **all** the elective deferrals they make during a year. (This is discussed in more detail in the section "Multiple Retirement Plans" later in this chapter.)

Example 1. Derek, age 36, is employed by Jones & Co., which has a 401(k) plan. He contributed $18,000 to his employer's 401(k) plan for 2016. He also has a side business, Smith & Co., that is organized as an S corporation, from which he received compensation of $230,000 in 2016. Derek set up a solo 401(k) plan for his S corporation. He would like to contribute the maximum amount to this plan. However, he cannot make elective deferrals to his solo 401(k) plan because he already contributed the maximum deferral amount to his employer's plan.

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2. *IRC 401(k) Plans — Establishing a 401(k) Plan.* Nov. 23, 2015. IRS. [www.irs.gov/retirement-plans/irc-401-k-plans-establishing-a-401-k-plan] Accessed on May 19, 2016.
3. *One-Participant 401(k) Plans.* Oct. 26, 2015. IRS. [www.irs.gov/Retirement-Plans/One-Participant-401%28k%29-Plans] Accessed on May 12, 2016.
4. IRS Ann. IR-2015-118 (Oct. 21, 2015).

The total contributions **(annual additions)** to a participant's account (elective deferrals and nonelective contributions) cannot exceed the lesser of:[5]

- $53,000 for 2016 or $59,000 including a $6,000 catch-up contribution, or
- 100% of the participant's compensation.

> **Note.** Elective deferrals are not treated as catch-up contributions until they exceed the 2016 annual limit of $18,000, the actual deferral percentage (ADP) test limit of IRC §401(k)(3), or the plan limit (if any).[6] For more information about the ADP test, see the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues.

This limit applies to **each plan separately.**[7]

Example 2. Courtney, age 55, earned $60,000 in wages from her S corporation in 2016. She contributed the maximum amount of $24,000 in elective deferrals to its solo 401(k) plan. The S corporation contributed 25% of her compensation to the plan, or $15,000. Total contributions to the 401(k) plan on Courtney's behalf for 2016 were $39,000 ($24,000 + $15,000). This is the maximum amount that could be contributed to the plan for Courtney in 2016.

Example 3. Use the same facts as **Example 1.** Derek received $230,000 of compensation from his S corporation, Smith & Co., in 2016. Smith & Co. can make a nonelective contribution up to 25% of compensation, which is $57,500. However, total annual additions are limited to $53,000 for 2016. This limit is not reduced by the elective deferrals Derek made under the Jones & Co. plan because the limit on annual additions applies to each plan separately.

Example 4. Use the same facts as **Example 3,** except Derek is 56 years old and eligible to make catch-up contributions. He can contribute an additional $6,000 of elective deferrals for 2016. His catch-up contributions can be split between the plans in any proportion he chooses. However, the maximum nonelective contribution to his solo 401(k) plan remains $53,000 even if he contributes the full $6,000 catch-up contribution to this plan.[8]

Limits for Self-Employed Individuals. Self-employed taxpayers must make a special calculation to determine the maximum amounts of elective deferrals and nonelective contributions they can make. When calculating such a contribution, the compensation amount used is the taxpayer's **earned income,** which is defined as net earnings from self-employment (SE) after deducting both of the following.[9]

- One-half of the SE tax
- Contributions for the self-employed taxpayer

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5. *Retirement Topics — 401(k) and Profit-Sharing Plan Contribution Limits.* Oct. 26, 2015. IRS. [www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-401k-and-Profit-Sharing-Plan-Contribution-Limits] Accessed on Nov. 11, 2015.

6. *Retirement Topics — Catch-Up Contributions.* Nov. 23, 2015. IRS. [www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-Catch-Up-Contributions] Accessed on May 12, 2016.

7. *Retirement Topics — 401(k) and Profit-Sharing Plan Contribution Limits.* Oct. 26, 2015. IRS. [www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-401k-and-Profit-Sharing-Plan-Contribution-Limits] Accessed on Nov. 11, 2015.

8. Adapted from Example 2 in *Retirement Topics — 401(k) and Profit-Sharing Plan Contribution Limits.* Oct. 26, 2015. IRS. [www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-401k-and-Profit-Sharing-Plan-Contribution-Limits] Accessed on Nov. 11, 2015.

9. *One-Participant 401(k) Plans.* Oct. 26, 2015. IRS. [www.irs.gov/Retirement-Plans/One-Participant-401%28k%29-Plans] Accessed on May 12, 2016.

The compensation amount and the amount of the taxpayer's plan contribution depend on each other (i.e., this is a circular calculation). One way to make the calculation is to use a reduced plan contribution rate, which is calculated by dividing the plan contribution rate by 100% plus the plan contribution rate.[10] This means that a solo 401(k) plan for a self-employed taxpayer is effectively limited to a nonelective contribution rate of 20% of compensation (25% maximum contribution rate ÷ (100% + 25% contribution rate)).

A worksheet in IRS Pub. 560, *Retirement Plans for Small Business,* can also be used to determine the maximum deductible contribution for a self-employed taxpayer.

Example 5. Langley, a 55-year old sole proprietor, has a $100,000 net profit on his 2016 Schedule C, *Profit or Loss From Business,* after deducting all expenses except his contribution to his solo 401(k) plan. The solo 401(k) plan provides for a 25% nonelective contribution.

To calculate his earned income, Langley's accountant, Phoebe, knows that she must subtract both of the following from Langley's $100,000 net profit.

- One-half of his SE tax, or $7,065 ($100,000 net profit × 92.35% taxable SE percentage × 15.3% SE tax rate × 50%)
- Langley's contribution to his solo 401(k)

To calculate the amount of Langley's nonelective contribution, Phoebe uses Langley's reduced plan contribution rate of 20% (25% plan contribution rate ÷ (100% + 25% plan contribution rate)).

Langley's allowed nonelective contribution amount is calculated as follows.

Schedule C net profit	$100,000
Less: ½ SE tax	(7,065)
Net profit reduced by ½ SE tax	$ 92,935
Multiplied by reduced plan contribution rate	× 20%
Langley's allowed nonelective contribution	$ 18,587

Langley's earned income for purposes of determining the maximum amount of annual additions to the solo 401(k) is $74,348 ($100,000 SE net earnings – $7,065 − $18,587 nonelective contribution).

Because Langley is over age 50, he can also make elective deferrals up to $24,000. He decides to make the maximum deferral; therefore, his total contribution to his solo 401(k) is $42,587 ($24,000 elective deferral + $18,587 nonelective contribution).

Reporting Requirements

An annual report must generally be filed for a solo 401(k) if it has $250,000 or more in assets at the end of the year. The annual report can be filed using either of the following methods.[11]

- Electronically using Form 5500-SF, *Short Form Annual Return/Report of Small Employee Benefit Plan*
- Using a paper Form 5500-EZ, *Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan*

A solo 401(k) plan that has less than $250,000 in assets at the end of the year is generally exempt from the annual filing requirement. However, for **every** solo 401(k) plan, a 5500-series return must be filed for the **final plan year** to indicate that all assets were distributed.[12]

10. *Self-Employed Individuals — Calculating Your Own Retirement-Plan Contribution and Deduction.* Feb. 22, 2016. IRS. [www.irs.gov/Retirement-Plans/Self-Employed-Individuals-Calculating-Your-Own-Retirement-Plan-Contribution-and-Deduction] Accessed on May 12, 2016.

11. Instructions for Form 5500-EZ.

12. Ibid.

Testing Requirements

A business owner who has no employees (other than lawfully **excludable employees)** does not need to perform nondiscrimination testing for the solo 401(k) plan. Nondiscrimination testing is required only if the business has employees who could have received disparate benefits.[13] An employee may be lawfully excluded from a 401(k) plan if they meet any of the following conditions.[14]

- Has not attained age 21
- Has not completed a year of service during which they worked at least 1,000 hours
- Is covered by a collective bargaining agreement that does not provide for participation in the plan, if retirement benefits were the subject of good-faith bargaining

However, the no-testing advantage vanishes if the business hires employees. If the business hires employees and they meet the plan eligibility requirements, they must be included in the plan. At that time, the solo 401(k) must be converted to a regular 401(k). When this occurs, the employees' elective deferrals are subject to nondiscrimination testing unless the 401(k) plan is a safe harbor plan or other plan exempt from testing.[15]

SEP IRA PLAN[16]

A simplified employee pension (SEP) plan allows the employer to set up SEP IRAs for the business and their eligible employees. The employer always contributes to this type of plan. Employees are only given the option to make voluntary contributions under a salary reduction simplified employee pension (SARSEP) plan. A SARSEP plan cannot be established after 1996.

The employer must contribute a uniform percentage of pay for each employee. However, under this type of plan, the employer is not required to make contributions every year. Because the employer can decide how much to put into a SEP each year, this plan gives the company the flexibility to deal with fluctuating business conditions.

Establishing a SEP IRA Plan

Most employers, including individuals who are self-employed, can establish SEP plans. SEPs have low start-up and operating costs and, in most cases, can be established by adopting an IRS model SEP using Form 5305-SEP, *Simplified Employee Pension — Individual Retirement Accounts Contribution Agreement*.

If an employer adopts an IRS model SEP using Form 5305-SEP, no prior IRS approval or determination letter is required. The employer keeps the Form 5305-SEP and does not file it with the IRS. Using Form 5305-SEP usually provides relief to the employer from annual filing requirements for retirement plan information returns.

13. *One-Participant 401(k) Plans.* Oct. 26, 2015. IRS. [www.irs.gov/Retirement-Plans/One-Participant-401%28k%29-Plans] Accessed on May 12, 2016.

14. *Operating a 401(k) Plan.* Jan. 6, 2016. IRS. [www.irs.gov/Retirement-Plans/Operating-a-401k-Plan] Accessed on May 12, 2016; IRC §410(a).

15. *One-Participant 401(k) Plans.* Oct. 26, 2015. IRS. [www.irs.gov/Retirement-Plans/One-Participant-401%28k%29-Plans] Accessed on May 12, 2016.

16. IRC §408(k); IRS Pub. 560, *Retirement Plans for Small Business.*

An employer cannot use Form 5305-SEP if any of the following applies.

1. The employer currently maintains another qualified retirement plan other than another SEP.
2. The employer has eligible employees for whom IRAs were not set up.
3. The employer uses the services of leased employees who are not the employer's common-law employees.
4. The employer is a member of any of the following unless all eligible employees of all the members of these groups, trades, or businesses participate under the SEP.
   a. An affiliated service group as described in IRC §414(m)
   b. A controlled group of corporations as described in IRC §414(b)
   c. Trades or businesses under common control as described in IRC §414(c)
5. The employer does not pay the cost of the SEP contributions.

The employer must give each eligible employee a copy of Form 5305-SEP, its instructions, and the other information listed in the Form 5305-SEP instructions. An IRS model SEP is not considered adopted until the employer provides this information to each employee.

A SEP IRA must be set up by or for each eligible employee. A SEP IRA can be established with a bank, insurance company, or other qualified financial institution. The employer sends SEP contributions to the financial institution where the SEP IRA is maintained.

The employer can set up a SEP for any year as late as the due date (including extensions) of its income tax return for that year.

Eligible Employees

The most significant downside to a SEP plan is the broad eligibility requirements. The plan must cover all employees who:

1. Are at least 21 years of age,
2. Were employed by the employer for three of the last five years, and
3. Received compensation of $600 or more during the year (for 2016).

An employer can use less restrictive participation requirements than these but not more restrictive requirements.

> **Note.** An employee who meets these three requirements during the year in question must be covered regardless of whether they were temporary, part time, or not employed at yearend. This includes employees who are over age 70½.

The following employees can be excluded from coverage under a SEP.

- Employees covered by a union agreement and whose retirement benefits were bargained for in good faith by the employees' union and the employer
- Nonresident alien employees who have received no U.S. source wages, salaries, or other personal services compensation from the employer

Contributions

The employer has until the due date of the tax return, including extensions, to make contributions to the plan. The contributions are deductible for the year for which they are made, even if the employer uses the cash basis for tax reporting.

Employer contributions are not taxable to the employee until withdrawn. In addition, they are not reported on the employee's Form W-2, *Wage and Tax Statement.* However, the "retirement plan" box (box 13 on the 2016 Form W-2) must be checked.

Elective deferrals by an employee in a SARSEP plan reduce the wages reported in box 1 of Form W-2 and are reported in box 12 using code "F."[17]

Employer contributions for 2016 are limited to the **lesser** of:

- 25% of the employee's compensation (based only on the first $265,000 of compensation per participant), or
- $53,000.[18]

The deduction limit for a self-employed individual is calculated using the same method discussed earlier for a solo 401(k) plan.

Example 6. Blake is the sole proprietor of a successful consulting business. She has one employee, Ryan. The company has a SEP plan.

In 2016, Ryan's wages are $35,000. Blake's net income on Schedule C is $150,000 before taking into account any SEP contributions. After meeting with her accountant, Blake decides to make the maximum contributions to her and to Ryan's SEP accounts.

The amount that Blake can contribute to Ryan's SEP IRA is $8,750 ($35,000 × 25%). Blake can deduct this contribution on her 2016 Schedule C even though she does not remit the money until after the end of the year. She has until the due date of her return, including extensions, to make the contribution.

The amount that Blake can contribute to her SEP IRA is $26,402, which is calculated as follows.

Net profit from self-employment before SEP contributions	$150,000
Less: Contribution to Ryan's SEP IRA	(8,750)
Net profit from self-employment after SEP contribution	$141,250
Less: ½ SE tax	(9,239)
Net profit reduced by ½ SE tax	$132,011
Multiplied by reduced plan contribution rate ((25% plan contribution rate ÷ (100% + 25% plan contribution rate))	× 20%
Blake's SEP IRA contribution	$ 26,402

17. General Instructions for Forms W-2 and W-3.

18. *Operating a SEP.* Oct. 26, 2015. IRS. [www.irs.gov/Retirement-Plans/Operating-a-SEP] Accessed on Nov. 16, 2015.

Reporting Requirements

As mentioned earlier, the employer must give eligible employees certain information about the SEP when it is established. In addition, the employer must give eligible employees an annual statement showing any contributions made to their SEP IRAs.

> **Note.** For further details about the information that must be provided to employees, see the instructions to Form 5305-SEP.

Testing Requirements

SEP IRA plans are subject to the top-heavy rules of IRC §416. These rules are designed to ensure that lower-paid employees receive at least a minimum benefit in plans in which higher-paid employees (referred to as **key employees)** own most of the assets. Top-heavy plans are subject to additional requirements, such as faster vesting and minimum contributions for participants who are not key employees.

Although a SEP IRA plan must provide for immediate vesting regardless of the top-heavy rules, a SEP plan is treated as a defined contribution plan for purposes of the minimum contribution top-heavy requirements under §416.[19] A SEP IRA plan generally is top-heavy if the sum of the IRA balances of the key employees[20] is more than 60% of the sum of the IRA balances of all employees.[21] The minimum employer contribution required in a top-heavy plan year for each non-key employee eligible to participate in the SEP plan is the lesser of 3% of the employee's compensation or the percentage that is equal to the highest percentage of compensation allocated to any key employee.[22]

> **Note.** For more information about the top-heavy requirements, see IRS Pub. 7002, *Employee Benefit Plans.*

SIMPLE IRA PLAN[23]

A savings incentive match plan for employees (SIMPLE) IRA plan is a retirement plan option for an employer with 100 or fewer employees. This plan allows the **employee** to contribute a percentage of their salary each pay period. It also requires the **employer** to contribute a certain minimum amount.

Establishing a SIMPLE IRA Plan

A SIMPLE IRA plan is easy to set up. Form **5304-**SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) — Not for Use With a Designated Financial Institution,* is used if the plan participants are allowed to select the financial institution at which the SIMPLE IRA is established. Form **5305**-SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) — for Use With a Designated Financial Institution,* is used if all the contributions under the plan are deposited initially at a designated financial institution of the employer's choosing.

The SIMPLE IRA plan is adopted when the appropriate form is completed and signed by the employer (and the designated financial institution, if any). The employer should retain a copy of the form; it is not filed with the IRS.

To make a SIMPLE IRA effective for the current tax year, the employer must adopt the SIMPLE by October 1 of that tax year.

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19. IRM 4.72.17.8 (Mar. 10, 2014).

20. See IRC §416(i)(1).

21. IRC §§408(k)(1)(B), 416(c)(2)(A), and 416(g)(1)(A)(ii).

22. IRS Pub. 7002, *Employee Benefit Plans.*

23. IRS Pub. 560, *Retirement Plans for Small Business.*

A SIMPLE IRA is the individual retirement account or annuity into which the contributions are deposited. A SIMPLE IRA must be established for each eligible employee. Form 5305-S, *SIMPLE Individual Retirement Trust Account,* and Form 5305-SA, *SIMPLE Individual Retirement Custodial Account,* are model trust and custodial account documents, respectively, that the participant and the trustee or custodian can use for this purpose.

A SIMPLE IRA cannot be a Roth IRA. Contributions to a SIMPLE IRA do not affect the amount an individual can contribute to a Roth or traditional IRA.

Eligible Employees

The eligibility requirements for SIMPLE IRA plans are more employer friendly than those for SEP IRA plans. Any employee who received at least $5,000 in compensation during any two years preceding the current calendar year and who is reasonably expected to receive at least $5,000 during the current calendar year is eligible to participate. Here, the term **employee** includes a self-employed individual who realizes a profit from their sole proprietorship.

The employer can use less restrictive eligibility requirements by eliminating or reducing the prior-year compensation requirements, the current-year compensation requirements, or both. However, the employer cannot impose requirements that are more restrictive.

If the plan provides for it, the employer can choose to automatically enroll employees in a SIMPLE IRA plan. However, the employees must be allowed to choose the amount of their salary reduction contributions or to contribute nothing.

The following employees can be excluded from coverage under a SIMPLE IRA plan.

- Employees covered by a union agreement and whose retirement benefits were bargained for in good faith by the employees' union and the employer
- Nonresident alien employees who have received no U.S. source wages, salaries, or other personal services compensation from the employer

Contributions

Under a SIMPLE IRA plan, an employee can contribute up to $12,500 in 2016 ($15,500 if age 50 or older) by payroll deduction. Employer contributions may be made using either of the following methods.

1. **Matching Contributions.** Match employee contributions dollar for dollar **up to 3% of an employee's compensation** (not subject to annual compensation limits).
2. **Nonelective Contributions.** Make a **fixed contribution of 2% of compensation** (up to $265,000 in compensation for 2016) for each eligible employee, even an employee who chooses **not** to contribute.

> **Note.** Employers are liable for matching contributions up to 3% of each participant's anual compensation, even if the plan is adopted later in the tax year (prior to the October 1 deadline).[24]

If the employer chooses a matching contribution of less than 3%, the percentage **cannot** be less than 1%. In addition, employees must be notified of the lower match within a reasonable period before they must determine their elective deferrals for the calendar year. Furthermore, the employer **cannot** choose a percentage less than 3% for more than two years during the 5-year period that ends with the year for which the choice is effective.

For a **self-employed** taxpayer, **compensation** is defined as net SE earnings before subtracting any contributions made to the SIMPLE IRA plan.

24. IRC §408(p)(2)(A)(iii).

The SIMPLE IRA contributions made by the employer are not taxable to the employee until withdrawn. On the employee's Form W-2, voluntary salary deferrals are deducted from the wages reported in box 1. The deferral amount is reported in box 12 using code "S."[25] The "retirement plan" box (box 13 on the 2016 Form W-2) must also be checked.

An employer's SIMPLE IRA contributions are deductible in the tax year during which the calendar year for which contributions were made ends. Matching and nonelective contributions for a particular tax year must be made by the due date, including extensions, of the employer's income tax return. The employer must make the salary reduction contribution to the SIMPLE IRA within 30 days after the end of the month in which the amount was withheld from the employee's pay.

Example 7. The fiscal year for Cumberland Water Works Inc. (Cumberland) ends on June 30. Contributions made under the company's SIMPLE IRA plan for calendar year 2016 (including contributions made in 2016 before July 1, 2016) are deductible by Cumberland in the tax year ending June 30, 2017.

Example 8. Use the same facts as **Example 6,** except Blake has a SIMPLE IRA plan instead of a SEP. In October 2015, Blake notified Ryan that she would match employee contributions up to 3% of compensation in 2016. Ryan chose to contribute the maximum amount allowed; he is under age 50 in 2016, so his voluntary payroll deduction is $12,500 for 2016.

Ryan's 2016 wages are $35,000; therefore, Blake's 3% match into Ryan's SIMPLE IRA is $1,050. Blake has 30 days after withholding Ryan's voluntary contributions to deposit them into his SIMPLE IRA account. She has until the due date of her return, including extensions, to deposit the matching contribution of $1,050.

Blake is over age 50, so her maximum deferral for 2016 is $15,500. The calculation of her matching contribution of $4,127 follows.

Net profit from self-employment before SIMPLE contributions	$150,000
Less: contribution to Ryan's SIMPLE IRA	(1,050)
Net profit from self-employment after SIMPLE matching contribution	$148,950
Multiplied by taxable SE percentage	× 92.35%
Net SE earnings (from Schedule SE, line 4)	$137,555
Multiplied by matching percentage	× 3%
Blake's SIMPLE IRA matching contribution	$ 4,127

Observations for Example 8

1. SE income is determined differently in **Example 6** and **Example 8.** SE income under the SEP plan is based on IRC §401(c)(2), while SE income under the SIMPLE plan is based on IRC §1402(a).[26] There are two distinguishing factors in the calculations.
   a. The SEP calculation subtracts the self-employed person's IRA contribution from qualified earnings, while the SIMPLE calculation does not.
   b. The SEP calculation includes a deduction for the employer's portion of SE taxes, while the SIMPLE calculation adjusts for this factor by multiplying earnings by 92.35%.
2. In **Example 6,** Blake is permitted to contribute **$26,402** to her own retirement funds, while in **Example 8,** her maximum contribution is only **$19,627** ($15,500 elective deferral + $4,127 matching contribution). Which plan is better for Blake depends in part on how much available cash she has each year to fund the plan.
3. The SEP plan is subject to top-heavy requirements, but the SIMPLE plan is not.

25. General Instructions for Forms W-2 and W-3.

26. IRC §408(p)(6)(A)(ii).

Reporting Requirements

The employer is required to provide the following information to each employee before the beginning of the election period.

1. The employee's opportunity to make or change a salary reduction choice
2. The employer's decision to make either matching contributions or nonelective contributions
3. A summary description provided by the financial institution
4. Written notice that the employee's balance can be transferred without cost or penalty if they use a designated financial institution

The **election period** is generally the 60 days immediately preceding January 1 (November 2 to December 31 of the preceding calendar year). However, these dates are modified if the employer establishes a SIMPLE IRA plan midyear or if the 60-day period falls before the first day an employee becomes eligible to participate in the plan. (For more information, see IRS Pub. 560.)

An employer is not required to file an annual Form 5500 for a SIMPLE IRA plan.

Testing Requirements

No nondiscrimination testing is required for a SIMPLE IRA plan.

COMPARISON OF PLANS

The following chart provides a comparison of key rules for the retirement plans discussed in this section.[27] The limits apply to 2016 deferrals and contributions.

	Solo 401(k)	SEP IRA	SIMPLE IRA
Employee elective deferrals	$18,000	Not permitted	$12,500
Catch-up contributions	$6,000	Not permitted	$3,000
Employer contributions	Up to 25% of compensation	Lesser of 25% of employee's compensation or $53,000	Matching contributions up to 3% of each participant's compensation, or nonelective contributions of 2% of each eligible employee's compensation
Last day for contribution	Due date of employer's return (including extensions)	Due date of employer's return (including extensions)	**Salary reduction contributions:** 30 days after the end of the month for which the contributions are to be made **Matching or nonelective contributions:** due date of employer's return (including extensions)
When to set up plan	By Dec. 31 of the year for which contributions/deferrals are made	Any time up to due date of employer's return (including extensions)	Any time between Jan. 1 and Oct. 1; for a new employer coming into existence after Oct. 1, as soon as feasible
Loans from plan allowed[28]	Yes, if permitted by plan documents	No	No

27. Modified from a table in IRS Pub. 560, *Retirement Plans for Small Business*.

28. *Retirement Plans FAQs Regarding Loans*. Jan. 22, 2016. IRS. [www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-regarding-Loans#3] Accessed on May 12, 2016.

MULTIPLE RETIREMENT PLANS[29]

A taxpayer often invests in more than one retirement plan. Limits apply to the aggregate annual contributions made to multiple plans. Elective deferrals (or salary reduction contributions) that a taxpayer makes to the following types of retirement plans must be aggregated to determine whether an excess contribution has been made.

- 401(k) plan
- 403(b) plan
- SIMPLE plans (SIMPLE IRA and SIMPLE 401(k) plans)
- SARSEP plan

ELECTIVE DEFERRAL LIMIT

The amount that a taxpayer who is under age 50 can defer (including pretax and Roth contributions) to all the preceding plans is $18,000 in 2016. Although a plan's terms may place lower limits on contributions, the total amount allowed by tax law does not depend on how many plans a taxpayer participates in or who sponsors the plans.

Note. The elective deferral limit applies only to employee contributions. Separate limits apply to employer contributions.

Note. The maximum amount that an individual who is under age 50 can contribute to a SIMPLE IRA or SIMPLE 401(k) plan for 2016 is $12,500. For a taxpayer who participates in any other qualified plan during the year, the contributions made under a SIMPLE plan count toward the overall annual limit of $18,000 for 2016.[30]

Example 9. Connor is 40 years old in 2016. From January through June 2016, he is employed by Alpha University and contributes $8,000 to its 403(b) plan. In July 2016, he terminates his employment with Alpha and begins to work for Beta Corporation. He immediately begins to participate in Beta's 401(k) plan. The maximum amount that Connor can contribute to Beta's plan in 2016 is $10,000 ($18,000 annual limit − $8,000 contributed to Alpha's plan).

Catch-Up Contributions

A taxpayer who is age 50 or older by the end of the year may be able to make an additional catch-up contribution to their retirement plan. For a 401(k), 403(b), 457(b), or SARSEP plan, the maximum catch-up contribution for 2016 is $6,000. This means that the limit for a taxpayer age 50 and older for 2016 is $24,000 ($18,000 + $6,000).

For a SIMPLE plan, the maximum catch-up contribution for 2016 is $3,000.[31] Therefore, the limit for a taxpayer age 50 and older for 2016 is $15,500 ($12,500 + $3,000).

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29. *How Much Salary Can You Defer if You're Eligible for More Than One Retirement Plan?* Oct. 23, 2015. IRS. [www.irs.gov/Retirement-Plans/How-Much-Salary-Can-You-Defer-if-You're-Eligible-for-More-than-One-Retirement-Plan] Accessed on Nov. 13, 2015.

30. IRS Pub. 560, *Retirement Plans for Small Business.*

31. *Retirement Topics — Catch-Up Contributions.* Nov. 23, 2015. IRS. [www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-Catch-Up-Contributions] Accessed on Jan. 25, 2016.

A taxpayer who is 50 or older and participates in more than one plan may contribute a total that exceeds $18,000 by an amount that does not exceed the catch-up limit even if neither employer plan allows catch-up contributions.[32] The contributions for a taxpayer age 50 and older cannot exceed:

1. The individual limit for the tax year plus the amount of age-50 catch-up contributions, or
2. The maximum contribution allowed by the employer plan.

Example 10. Veronda turns 50 years old in 2016. She is employed by Clef University from January through June 2016. Clef University's 403(b) plan permits maximum contributions of $18,000 in 2016 and does not allow catch-up contributions. Veronda contributes $18,000 to Clef's 403(b) plan before leaving the university for a job at the National Secrecy Lab (NSL) in July 2016. NSL's 401(k) plan permits maximum contributions of $18,000 in 2016 and does not allow catch-up contributions. Veronda can contribute a maximum of $6,000 ($24,000 age-50 limit − $18,000 contributed to Clef's plan) to NSL's 401(k) plan in 2016.

Deferrals Limited by Compensation

Although a plan can set a lower deferral limit, the maximum amount that a taxpayer can contribute to a plan cannot exceed 100% of their eligible compensation (as defined by plan terms) for the year. For a self-employed taxpayer, **compensation** is defined as net earnings from self-employment.

Example 11. Cooper turns 58 years old in 2016. He participates in a 401(k) plan through his employer, Silver Linings Inc. He also has a SIMPLE IRA through an unrelated employer, Dark Clouds Company. In 2016, Cooper receives $8,000 in compensation from Silver Linings and another $8,000 in compensation from Dark Clouds. Cooper cannot defer more than $8,000 to either plan because his deferrals to each employer's plan cannot exceed 100% of his compensation from that employer. Therefore, his maximum total contribution for the year is $16,000.

403(b) Plan Catch-Up Deferrals

If permitted by a 403(b) plan, an employee who has at least 15 years of service with certain types of organizations may have their individual deferral limit increased by as much as $3,000. The 15-year catch-up is separate from the age-50 catch-up. If a taxpayer is eligible and the 403(b) plan allows both types of catch-ups, their contributions above the annual limit are considered to have been made first under the 15-year catch-up and then under the age-50 catch-up.[33]

> **Note.** For more information about 403(b) plans, see IRS Pub. 571, *Tax-Sheltered Annuity Plans (403(b) Plans).*

32. Treas. Reg. §1.402(g)-2.

33. Treas. Reg. §1.403(b)-4(c)(3)(iii).

457(b) Plan Deferrals

Section 457(b) plans are generally provided by certain state and local governments and nongovernmental entities that are tax exempt under IRC §501.[34] Separate deferral limits apply to participants in a 457(b) plan. **Deferrals made to a 457(b) plan are not combined with deferrals made to other plans.**

In 2016, a participant can defer the lesser of $18,000 or 100% of their eligible compensation to a 457(b) plan. The plan may also permit catch-up contributions.

- A governmental 457(b) plan may allow age-50 catch-up contributions of an additional $6,000 in 2016.
- A 457(b) plan may allow a special "last-3-year catch-up," which allows a participant to defer the **lesser of the following amounts in the three years before they reach the plan's normal retirement age.**
    - Twice the annual 457(b) limit (In 2016, this is $18,000 × 2 = $36,000.)
    - The annual 457(b) limit, plus amounts allowed in prior years not contributed to the plan by the participant

If a **governmental** 457(b) plan allows both the age-50 catch-up and the last-3-year catch-up, a participant can use the one that allows the largest deferral but not both.

Example 12. Astrelle, who turns 45 in 2016, is employed by Lincoln State University. She has worked there for eight years. Lincoln State offers both a 457(b) plan and a 403(b) plan, and Astrelle participates in both. Her eligible compensation is $100,000. Astrelle can defer $18,000 to each plan in 2016.

Example 13. Use the same information as **Example 12,** except Astrelle is 62 years old. Lincoln State's 457(b) and 403(b) plans both permit age-50 catch-up contributions. For 2016, Astrelle can contribute $24,000 to the 403(b) plan and $24,000 to the 457(b) plan.

Example 14. Use the same information as **Example 13,** except the university's 457(b) plan also has a last-3-year catch-up provision and Astrelle is within three years of the plan's normal retirement age. She has contributed the maximum amount to the university's 403(b) and 457(b) plans every year that she has been eligible, except 2014. In 2014, she did not contribute anything to either plan because she helped her son buy a new house.

For 2016, Astrelle can contribute $24,000 to the 403(b) plan. In addition, she can contribute the lesser of the following amounts to her 457(b) plan.

- Twice the annual 457(b) limit, or $18,000 × 2 = $36,000
- The annual 457(b) limit plus amounts allowed in prior years that were not contributed, or $18,000 contribution for 2016 + $17,500 maximum contribution for 2014[35] = $35,500

Accordingly, Astrelle's maximum contribution to her 457(b) plan for 2016 is $35,500.

Note. For more information about 457(b) plans for both governmental and nongovernmental employers, see IRS Pub. 4484, *Choose a Retirement Plan.*

34. *IRC 457(b) Deferred Compensation Plans.* Oct. 30, 2015. IRS. [www.irs.gov/Retirement-Plans/IRC-457b-Deferred-Compensation-Plans] Accessed on May 13, 2016.

35. *IRS Announces 2014 Pension Plan Limitations; Taxpayers May Contribute up to $17,500 to Their 401(k) Plans in 2014.* Sep. 18, 2015. IRS. [www.irs.gov/uac/IRS-Announces-2014-Pension-Plan-Limitations%3b-Taxpayers-May-Contribute-up-to-$17%2c500-to-their-401%28k%29-plans-in-2014] Accessed on Mar. 2, 2016.

Excess Deferrals[36]

If an employee's total elective deferrals are more than the limit for that year, the employee should notify the plan and ask that the excess deferral be paid out of any of the plans that permit these distributions. The plan must then pay the employee that amount plus earnings on the amount through the end of the tax year, by April 15 of the following year (or an earlier date specified in the plan).

Excess Withdrawn by April 15. If the employee withdraws the excess deferral by April 15, the amount is not reported again as part of their gross income for the year of withdrawal. Any income earned on the withdrawal is reported as gross income for the tax year in which it is withdrawn, but the distribution is not subject to the additional 10% tax on early distributions.[37]

Excess Not Withdrawn by April 15. If the employee does not withdraw the excess deferral by April 15, the excess amount, although taxable in the year of deferral, is not included in the employee's cost basis when calculating the taxable amount of any eventual benefits or distributions under the plan. Effectively, an excess deferral left in the plan is taxed twice: once when it is contributed and again when it is distributed.[38]

Employer Responsibilities.[39] If an employee's elective deferrals from the same employer exceed the annual limit, the plan is disqualified. To avoid plan disqualification, the excess amount plus earnings must be refunded to the employee by April 15 of the following year.

The employer is responsible for determining whether a participant has excess deferrals under all the retirement plans it maintains. However, a participant's excess deferral does not disqualify a plan if the excess is due to the aggregation of the participant's deferrals to a plan maintained by an unrelated employer.

If an employer plan violates the elective deferral limitation, the employer may avoid plan disqualification by correcting the failure through the employee plans compliance resolution system (EPCRS). Under EPCRS, the plan may avoid disqualification even though it failed to correct excess deferrals by the April 15 deadline. The permitted correction method involves distributing the excess deferral to the employee and reporting the amount as taxable income in the year of deferral and in the year distributed. Therefore, if the corrective distribution is made later than the April 15 deadline, the employee is subject to double taxation on the excess deferral. EPCRS does not provide relief from this double taxation.

> **Note.** For more information about the EPCRS, go to **uofi.tax/16a1x1** [www.irs.gov/Retirement-Plans/EPCRS-Overview].

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36. *Retirement Topics — What Happens When an Employee Has Elective Deferrals in Excess of the Limits?* Nov. 23, 2015. IRS. [www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-What-Happens-When-an-Employee-has-Elective-Deferrals-in-Excess-of-the-Limits%3F] Accessed on May 16, 2016.

37. See IRC §72(t).

38. *Retirement Topics — 401(k) and Profit-Sharing Plan Contribution Limits.* Oct. 26, 2015. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-401k-and-profit-sharing-plan-contribution-limits] Accessed on May 19, 2016.

39. *Fixing Common Plan Mistakes — Excess Deferrals.* Jan. 22, 2016. IRS. [www.irs.gov/Retirement-Plans/Fixing-Common-Plan-Mistakes---Excess-Deferrals] Accessed on May 12, 2016.

INDIVIDUAL RETIREMENT ARRANGEMENTS

IRAs are most often established independently of employer-sponsored plans. However, an employer may set up and fund IRA-type accounts for their employees or withhold and deposit employees' authorized contributions through payroll deductions. IRAs can be established at many different financial institutions, including banks, insurance companies, and brokerage firms.

TRADITIONAL IRA

A traditional IRA is a personal savings vehicle that offers tax advantages for retirement savings. Eligible IRA contributions are generally deducted from a taxpayer's adjusted gross income (AGI) in the year for which the contribution is designated and taxed in the year distributed. Contributions can be made until the due date of the taxpayer's return, not including extensions.

To contribute to a traditional IRA, the taxpayer must be under the age of 70½ at the end of the tax year and must have taxable compensation, which includes the following types of income.[40]

- Wages, salaries, tips, professional fees, bonuses, and other amounts received for providing personal services
- Commissions
- Self-employment income
- Taxable alimony and separate maintenance payments
- Nontaxable combat pay

A spousal IRA can be set up for the benefit of a nonworking or low-earning spouse.

For 2016, the maximum amount that a taxpayer can contribute to all their **traditional and Roth** IRAs is the lesser of:

- $5,500, with a $1,000 catch-up contribution allowed for a taxpayer age 50 or older by the end of the year; or
- The taxpayer's taxable compensation for the year.[41]

Contributions to a traditional IRA are fully deductible if the taxpayer and the taxpayer's spouse, if married, are not eligible to participate in an employer-sponsored retirement plan and are under age 70½ at the end of the tax year. The deductible contribution is reduced if the taxpayer is eligible to participate in an employer-sponsored plan and if the taxpayer's modified adjusted gross income (MAGI) falls within a certain range, based on their filing status.

To calculate MAGI, the following items are added to the taxpayer's AGI.[42]

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

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40. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*.
41. *Traditional and Roth IRAs*. Feb. 19, 2016. IRS. [www.irs.gov/Retirement-Plans/Traditional-and-Roth-IRAs] Accessed on May 16, 2016.
42. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*.

The following table shows the 2016 phaseout ranges for **deductible IRA contributions** for a taxpayer who **is covered by an employer-sponsored retirement plan.**[43]

Taxpayer Covered by Employer-Sponsored Plan

Filing Status	2016 MAGI Phaseout Range
Single or head of household (HoH)	$61,000–$ 71,000
Married filing jointly (MFJ) or qualifying widow(er) (QW)	98,000– 118,000
Married filing separately (MFS) [a]	0– 10,000

[a] If a taxpayer files separately and did not live with their spouse at any time during the year, their IRA deduction is determined under the "single" filing status.

If a married couple files jointly and only one of the spouses is eligible to participate in an employer's qualified retirement plan, deductible contributions are limited for the noncovered spouse if the MAGI falls within a certain range. The following table shows the 2016 phaseout range for a taxpayer who **is not covered** but has a **spouse who is covered by an employer-sponsored retirement plan.**

Taxpayer Not Covered but Spouse Covered by Employer-Sponsored Plan

Filing Status	2016 MAGI Phaseout Range [44]
MFJ	$184,000–$194,000

If a taxpayer's MAGI exceeds the lower end of the phaseout range, the deductible contribution is calculated as follows.

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

Step 2. The result of Step 1 is divided by the difference between the upper and lower limits of the phaseout range.

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

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

43. *2016 IRA Contribution and Deduction Limits — Effect of Modified AGI on Deductible Contributions If You Are Covered by a Retirement Plan at Work.* Dec. 23, 2015. IRS. [www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/2016-IRA-Contribution-and-Deduction-Limits-Effect-of-Modified-AGI-on-Deductible-Contributions-If-You-ARE-Covered-by-a-Retirement-Plan-at-Work] Accessed on May 16, 2016.

44. *2016 IRA Contribution and Deduction Limits — Effect of Modified AGI on Deductible Contributions If You Are Not Covered by a Retirement Plan at Work.* Dec. 23, 2015. IRS. [www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/2016-IRA-Contribution-and-Deduction-Limits-Effect-of-Modified-AGI-on-Deductible-Contributions-if-You-are-NOT-Covered-by-a-Retirement-Plan-at-Work] Accessed on May 16, 2016.

Example 15. Troy is age 45 and single. In 2016, he earns wages of $68,000. He has no other income and is covered by his employer's retirement plan. He asks his tax professional, Melissa, to help him plan for his IRA contribution. Melissa determines that Troy can contribute $5,500 to his IRA for 2016 but can deduct only $1,650.

Step 1. $68,000 MAGI − $61,000 MAGI phaseout range lower amount = $7,000

Step 2. $7,000 ÷ ($71,000 MAGI phaseout range upper limit − $61,000 lower limit) = 70%

Step 3. $5,500 contribution limit × 70% = $3,850

Step 4. $5,500 − $3,850 = $1,650 deductible contribution

Example 16. Randolph is age 45 and married. In 2016, he earns wages of $185,000 and participates in his employer's 401(k) plan. Randolph and his wife, Madison, have no other income and file a joint return. They each contribute $5,500 to an IRA for 2016. Randolph cannot deduct his contribution because he is an active participant in his employer's retirement plan and the couple's joint income exceeds the top end of the phaseout range ($118,000).

Madison can deduct $4,950, which is calculated as follows.

Step 1. $185,000 MAGI − $184,000 = $1,000

Step 2. $1,000 ÷ ($194,000 MAGI phaseout range upper limit − $184,000 lower limit) = 10%

Step 3. $5,500 contribution limit × 10% = $550

Step 4. $5,500 − $550 = $4,950 deductible contribution

A taxpayer with income exceeding the top of the phaseout range can **still make contributions to an IRA,** but they **cannot deduct the contribution** from their MAGI. Regardless of the deductibility of the contributions, earnings on the amounts deposited in a traditional IRA are not taxed until they are distributed.

Distributions[45]

Distributions from a traditional IRA may be fully or partly taxable, depending on whether the taxpayer made any nondeductible contributions to the IRA.

Fully Taxable. If the taxpayer made only deductible contributions to their traditional IRA (or IRAs, if the taxpayer has more than one), they have no basis in the IRA. Because the taxpayer has no basis, any distributions are fully taxable when received.

Partly Taxable. If the taxpayer made nondeductible contributions or rolled over after-tax amounts to any of their traditional IRAs, the taxpayer has a basis equal to the amount of those contributions. The nondeductible contributions are not taxed when they are distributed to the taxpayer because they are a return of the taxpayer's investment.

Only the part of the distribution that represents basis is nontaxable. If the taxpayer made nondeductible contributions or rolled over after-tax amounts to their IRA, distributions consist partly of basis and partly of deductible contributions, earnings, and gains, if any. **Until all the taxpayer's basis has been distributed, each distribution is partly nontaxable and partly taxable.** Form 8606, *Nondeductible IRAs,* is used to calculate and report the taxable portion of the distribution.

> **Note. Example 24,** later in this chapter, includes a completed Form 8606.

45. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs).*

Caution. If a taxpayer has a self-directed IRA, they may need to file a Form 990-T, *Exempt Organization Business Income Tax Return,* for any IRA investments that generate unrelated business taxable income (UBTI). UBTI is defined as gross income derived by an organization from any unrelated trade or business regularly carried on by the exempt organization (e.g., the self-directed IRA) less the deductions directly connected with carrying on the trade or business.[46]

In order for the income to be subject to tax as UBTI, the following conditions must be satisfied.

- The income is generated by a trade or business.
- The trade or business activity is regularly carried on.
- The trade or business activity is not substantially related to the exempt status.

See IRS Pub. 598 and the instructions for Form 990-T for more information.

ROTH IRA

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

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

Whether a taxpayer qualifies to make contributions to a Roth IRA depends on their MAGI and filing status. For purposes of a Roth IRA, **MAGI** is defined as follows.[47]

	AGI
−	Income resulting from the conversion of a traditional IRA to a Roth IRA
−	Income resulting from the rollover of a qualified retirement plan to a Roth IRA
+	Traditional IRA deduction
+	Student loan interest deduction
+	Tuition and fees deduction
+	Domestic production activities deduction
+	Foreign-earned income exclusion and/or housing exclusion
+	Foreign housing deduction
+	Excludable qualified savings bond interest
+	Excluded employer-provided adoption benefits
	MAGI

46. IRS Pub. 598, *Tax on Unrelated Business Income of Exempt Organizations.*

47. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs).*

A taxpayer's eligibility **to make contributions** to a Roth IRA is phased out depending on their filing status and MAGI, as shown in the following table.

Roth IRA Contribution MAGI Phaseout Ranges

Filing Status	2016 MAGI Phaseout Range [48]
Single, HoH, or MFS and did not live with spouse during year	\$117,000–\$132,000
MFJ or QW	184,000– 194,000
MFS and lived with spouse at any time during year	0– 10,000

If the taxpayer's MAGI is between the upper and lower limits of the phaseout range, the allowable Roth IRA contribution is calculated as follows.

Step 1. The taxpayer's MAGI is subtracted from the upper limit of the phaseout range.

Step 2. The result of Step 1 is divided by the difference between the upper and lower limits of the phaseout range.

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

Example 17. Juanita is age 40 and single. Her 2016 MAGI is \$118,000. She can contribute \$5,133 to her Roth IRA, which is calculated as follows.

Step 1. \$132,000 MAGI upper limit − \$118,000 MAGI = \$14,000

Step 2. \$14,000 ÷ (\$132,000 MAGI upper limit − \$117,000 lower limit) = 93.33%

Step 3. \$5,500 full-contribution limit × 93.33% = \$5,133

Distributions

A distribution from a Roth IRA is not includable in the taxpayer's gross income to the extent that it is a **return of the owner's contributions** to the Roth IRA. The IRS treats distributions from a Roth IRA as being made in the following order.[49]

- Regular contributions
- Conversion and rollover contributions on a first-in, first-out basis
- Earnings on contributions

> **Note.** For more information about the ordering rules for distributions from a Roth IRA, see IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs).*

Example 18. Denzel, age 35, contributed \$5,000 to a Roth IRA in 2013 and then made no further contributions to the account. In August 2016, when the balance in the Roth IRA is \$6,200, Denzel takes a distribution of \$5,000 from it to make a down payment on a new car. Because the amount withdrawn is a return of Denzel's contribution, no taxes are due on the distribution.

48. *Amount of Roth IRA Contributions That You Can Make for 2016.* Dec. 23, 2015. IRS. [www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Amount-of-Roth-IRA-Contributions-That-You-Can-Make-for-2016] Accessed on Jul. 18, 2016.

49. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs).*

As mentioned earlier, qualified distributions are not taxable. To be considered qualified, distributions must be withdrawn **after the 5-year period that begins with the first tax year for which a contribution was made.** In addition, one of the following circumstances must apply.[50]

- The taxpayer is age 59½ or older.
- The distribution is made because of the taxpayer's disability.
- The proceeds are paid to a beneficiary or estate after the taxpayer's death.
- The taxpayer uses the proceeds to buy, build, or rebuild a first home. The qualifying distribution for this purpose cannot exceed $10,000.

CONVERTING A TRADITIONAL IRA TO A ROTH IRA

For tax years beginning in 2010, a taxpayer can convert a traditional IRA to a Roth IRA regardless of their income and filing status. This allows a taxpayer to make **nondeductible** contributions to a traditional IRA and then convert it to a Roth IRA without any tax consequence, which effectively eliminates the income limit for contributing to a Roth IRA. This is sometimes called a "backdoor" Roth contribution.

Caution. Some analysts suggest that a backdoor Roth contribution violates the step-transaction doctrine. The step-transaction doctrine is considered an extension of the substance-over-form doctrine. Under the step-transaction doctrine, a particular step in a transaction can be disregarded for tax purposes if the taxpayer could have achieved its objective more directly but instead included the step for no purpose other than to avoid taxation.[51] Establishing a backdoor Roth requires taking two steps that are independently allowable — a nondeductible contribution to a traditional IRA followed by a Roth IRA conversion — to accomplish something that higher-income taxpayers cannot do directly.

One expert recommends that if the goal is to demonstrate that there was no deliberate intent to avoid the Roth IRA contribution limits, the tax professional should avoid calling it a "backdoor" Roth contribution. He also recommends separating the two steps by putting a deliberate time gap (perhaps up to a year) between them. Doing so would make it easier to claim that the sole intent of the Roth conversion was not to circumvent the rules.[52] Other financial planners argue that such precautions are unnecessary as long as the conversion is accomplished by following the IRS rules for Roth conversions described in IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*.[53]

A conversion of a traditional IRA to a Roth IRA is treated as a rollover. If the assets are withdrawn from the traditional IRA and reinvested in a Roth IRA within 60 days, the 10% additional tax on early distributions does not apply. However, part or all of the distribution from the traditional IRA may be included in the taxpayer's gross income and subjected to ordinary income tax. The taxpayer must include in their gross income distributions from a traditional IRA that they would have had to include in income if they had not converted them into a Roth IRA. These amounts are included in income for the year that the taxpayer converted them from a traditional IRA to a Roth IRA. The taxpayer does **not** include in gross income any part of a distribution from a traditional IRA that is a return of basis.[54]

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50. Ibid.

51. CCM 20123401F (Aug. 24, 2012).

52. *How to Do a Backdoor Roth IRA Contribution (Safely) and Avoid the IRA Aggregation Rule and Step Transaction Doctrine.* Kitces, Michael. Aug. 12, 2015. [www.kitces.com/blog/how-to-do-a-backdoor-roth-ira-contribution-while-avoiding-the-ira-aggregation-rule-and-the-step-transaction-doctrine/] Accessed on Dec. 8, 2015.

53. *It's Not about Timing: IRS on Backdoor Roth Conversions.* Marsh, Ann. Jun. 9, 2015. Financial Planning. [www.financial-planning.com/news/portfolio/its-not-about-timing-irs-on-backdoor-roth-conversions-2693153-1.html] Accessed on Dec. 8, 2015.

54. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs).*

Potential Consequences of Roth Conversions

In addition to the income taxes due on a taxable conversion from a traditional IRA to a Roth, several other potential financial consequences should be considered.

Increased Medicare Part B Premiums. Medicare Part B premiums paid by individuals are based on the MAGI reported on the tax return **filed** the previous year. Therefore, the 2016 monthly premium is based on the 2014 tax return filed in 2015. For purposes of Medicare, MAGI is AGI plus tax-exempt interest income.

The standard Medicare Part B premium for 2016 is $121.80. However, most social security recipients pay the same rate that they paid in 2015. This is because there was no cost-of-living adjustment (COLA) for 2016 social security benefits. Higher-income individuals pay higher Part B premiums, as shown in the following table.[55]

If taxpayer's 2014 income was...			2016 Medicare Part B premium is...
Single	**MFJ**	**MFS**	
$ 0–85,000	$ 0–170,000	$ 0–85,000	$121.80 [a]
85,001–107,000	170,001–214,000	N/A	170.50
107,001–160,000	214,001–320,000	N/A	243.60
160,001–214,000	320,001–428,000	85,001–129,000	316.70
Over 214,000	Over 428,000	Over 129,000	389.80

[a] Capped at $104.90 (the 2015 rate) for most participants.

> **Note.** Certain other individuals pay 2016 Medicare Part B premiums that are higher than the rates they paid in 2015. For more information, see the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 6: New Developments.

An individual who converts a traditional IRA to a Roth IRA may have to pay higher Medicare Part B premiums because of the income from the conversion.

Example 19. Shannon and Jason are married and file joint tax returns. Their 2014 MAGI was $100,000. Of this amount, $80,000 was from private pensions and $20,000 was from social security retirement benefits. Both Shannon and Jason have Medicare Part B premiums withheld from their monthly social security benefits. In 2015, each paid a monthly premium of $104.90, and because there was no COLA, their 2016 monthly premiums are also $104.90.

In 2016, Shannon and Jason are considering converting their traditional IRAs (currently valued at $500,000) to Roth IRAs. They have no basis in the IRAs. Before taking any action, they meet with their tax professional, Kate, to discuss their options. They ask her if it might be better to convert the IRAs over two years, rather than converting the entire balance in 2016.

Shannon and Jason tell Kate that their estimated 2016 income — without taking a potential IRA conversion into account — is $100,000. They expect their 2017 income to be at the same level.

Tax Result A. Shannon and Jason report the entire $500,000 conversion on their 2016 return. Their 2016 MAGI is $600,000 ($500,000 + $100,000). Assuming the 2018 Medicare Part B premiums remain the same as the 2016 rates, Shannon and Jason will each pay a monthly premium of $389.80. This is $284.90 more per month than the $104.90 they would have paid without the 2016 Roth conversion. The total additional Part B premium cost for 2018 will be $6,837.60 ($284.90 × 2 people × 12 months).

55. *Part B Costs.* Centers for Medicare & Medicaid Services. [www.medicare.gov/your-medicare-costs/part-b-costs/part-b-costs.html] Accessed on Dec. 15, 2015.

Tax Result B. Shannon and Jason convert half of their traditional IRAs in 2016 and the other half in 2017. Their other income for these years will not change; therefore, their MAGI for both 2016 and 2017 will be $350,000 ($250,000 IRA conversion + $100,000 other income).

Assuming that the Part B premiums remain at the 2016 levels, in 2018 and 2019, Shannon and Jason will each pay a monthly Part B premium of $316.70. This is $211.80 more per month than the $104.90 they would have paid without the Roth conversion income. The total additional cost for both years will be $10,166.40 ($211.80 × 2 people × 24 months).

Increased Medicare Part D Premiums. In addition to the Part B premium adjustments that are based on MAGI, higher-income Medicare beneficiaries who enroll in Medicare Part D prescription drug coverage must also pay higher adjusted premium amounts. Part D prescription drug plans are available only through private insurers that establish the premiums for their individual plans subject to approval by the Centers for Medicare & Medicaid Services. Therefore, all taxpayers are not subject to the same Part D base premium. The Part D premium adjustments for higher-income taxpayers, however, are based on the taxpayer's MAGI without reference to their base Part D premiums. Although the MAGI ranges are the same as for the Part B income-related premium adjustments, the **amounts** of the Part D premium adjustments are not the same as the adjustments for Part B.

Like the Part B premiums, the Part D premiums paid by an individual are based on the MAGI reported on the tax return **filed** the previous year. If the taxpayer's income is above a certain limit, they pay an income-related monthly adjustment amount in addition to their plan premium, which is shown in the following table. This extra amount is paid directly to Medicare, not to the private insurer.[56]

If taxpayer's 2014 income was...			2016 Medicare Part D premium is...
Single	MFJ	MFS	
$ 0–85,000	$ 0–170,000	$ 0–85,000	plan premium
85,001–107,000	170,001–214,000	N/A	$12.70 + plan premium
107,001–160,000	214,001–320,000	N/A	32.80 + plan premium
160,001–214,000	320,001–428,000	85,001–129,000	52.80 + plan premium
Over 214,000	Over 428,000	Over 129,000	72.90 + plan premium

An individual who converts a traditional IRA to a Roth IRA may have to pay a higher Medicare Part D premium because of the income from the conversion, as occurs with a Part B premium.

Example 20. Use the same facts as **Example 19.** When discussing Shannon and Jason's options regarding a Roth conversion, Kate, their tax professional, informs them that the conversion will increase their Medicare Part D premiums.

Tax Result A. Shannon and Jason report the entire $500,000 conversion on their 2016 return. Their 2016 MAGI is $600,000 ($500,000 + $100,000). Assuming the 2018 Medicare Part D adjustments remain at the same levels as the 2016 rates, Shannon and Jason will each pay an income-related monthly adjustment amount of $72.90 in addition to the Part D plan premium. The total additional Part D cost for 2018 will be $1,749.60 ($72.90 × 2 people × 12 months).

Tax Result B. Shannon and Jason convert half of their traditional IRAs in 2016 and the other half in 2017. Their other income for these years will not change; therefore, their MAGI for both 2016 and 2017 will be $350,000 ($250,000 IRA conversion + $100,000 other income).

Assuming that the Part D adjustment amounts remain at the 2016 levels, in 2018 and 2019, Shannon and Jason will each pay an income-related monthly adjustment amount of $52.80 in addition to the Part D plan premium. The total additional cost for both years will be $2,534.40 ($52.80 × 2 people × 24 months).

56. *Monthly Premium for Drug Plans.* Centers for Medicare & Medicaid Services. [www.medicare.gov/part-d/costs/premiums/drug-plan-premiums.html] Accessed on Mar. 2, 2016.

Taxation of Social Security Benefits. When deciding whether to convert a traditional IRA to a Roth IRA, the taxpayer needs to consider the effect that the decision will have on taxation of their social security retirement benefits.

If the sum of the social security recipient's provisional income exceeds statutory thresholds, up to 85% of social security benefits can be taxable. **Provisional income** is the total of:

1. One-half of social security benefits, plus
2. MAGI. For this purpose, MAGI is calculated by adding the following items to the taxpayer's AGI.[57]
   a. Exclusions for interest from U.S. savings bonds used to pay higher-education expenses
   b. Exclusions for employer-provided adoption assistance
   c. Deductions for interest on qualified educational loans
   d. Deductions for domestic production activities
   e. Deductions for qualified tuition and related expenses
   f. Exclusions for foreign-earned income or foreign housing
   g. Exclusions for income earned by bona fide residents of Guam, American Samoa, the Northern Mariana Islands, or Puerto Rico
   h. Tax-exempt interest

If provisional income is below the base amount of the first tier, none of the benefit is taxable. The **first-tier base amounts** are as follows.

- $25,000 for single, head of household, or qualifying widow(er) with a dependent child
- $25,000 for a married individual filing separately who did not live with their spouse at any time during the year
- $32,000 for a married couple filing jointly
- $0 for a married person filing separately who lived with their spouse at some time during the year

If provisional income is above the base amount of the first tier but below the base amount for the second tier, up to 50% of the benefit is taxable. The **second-tier adjusted base amounts** are as follows.

- $34,000 for single, head of household, or qualifying widow(er)
- $34,000 for a married individual filing separately who did not live with their spouse at any time during the year
- $44,000 for a married couple filing jointly
- $0 for a married person filing separately who lived with their spouse at some time during the year

> **Note.** None of the above threshold amounts are indexed for inflation.

57. IRC §86(b)(2).

For a taxpayer with provisional income between the first and second tiers, the amount of social security benefits subject to taxation is the lesser of:

- One-half of social security benefits, or
- One-half of provisional income in excess of the first-tier base amount.

If provisional income is above the second-tier adjusted base amounts, the social security benefit subject to taxation is the lesser of:

1. 85% of total social security benefits, or
2. 85% of provisional income above the second-tier adjusted base amount, plus the lesser of:
   a. $4,500 (a single, HoH, QW, or MFS individual who did not live with their spouse) or $6,000 (an MFJ taxpayer), or
   b. One-half of social security benefits.

Traditional IRA distributions increase a taxpayer's provisional income, but qualified Roth distributions (discussed earlier) do not. This means that if a taxpayer converts their traditional IRA to a Roth IRA before they begin receiving social security benefits, subsequent qualified distributions from the Roth IRA, if any, will not affect the taxability of their social security benefits. A taxpayer who has a traditional IRA must take a required minimum distribution (RMD) starting at age 70½. Depending on the amount in the IRA, this can have a significant effect on the taxability of social security benefits.

Example 21. Rosalie is single and turns 69 in 2016. Her 2016 income is $24,000, which consists entirely of social security retirement benefits. Because her income is below the first-tier base amount, none of her social security benefit is taxable.

Rosalie has a traditional IRA valued at $700,000. Because she will reach age 70½ in 2017, she will need to start taking an RMD. Using the IRS's RMD worksheet,[58] Rosalie's accountant, Elmer, informs her that the 2017 RMD will be $25,547 if her IRA balance on December 31, 2016, is still $700,000. Rosalie can delay her first RMD until April 1, 2018, but that will mean that she will be required to take two RMDs in 2018.

Elmer informs Rosalie that up to 85% of her 2017 social security income will be taxable if she takes her first RMD in 2017. This is because her provisional income will be above the second-tier adjusted base amount (($24,000 social security benefits × 50%) + $25,547 RMD = $37,547).

Elmer calculates the taxable portion of Rosalie's social security benefit as the lesser of the following two amounts.

- 85% of total social security benefits, or $24,000 × 85% = $20,400
- 85% of provisional income above the second-tier adjusted base amount, or $3,015 (($37,547 provisional income − $34,000 second-tier adjusted base amount) × 85%), plus the lesser of:
  - $4,500 for single taxpayers, or
  - $12,000 ($24,000 social security benefits × 50%)

Therefore, Rosalie's taxable social security benefit is $7,515 ($3,015 + $4,500). At the 15% tax rate, this is additional tax of $1,127.

58. *IRA Required Minimum Distribution Worksheet.* IRS. [www.irs.gov/pub/irs-tege/uniform_rmd_wksht.pdf] Accessed on Dec. 16, 2015.

Net Investment Income Tax. A taxpayer with income above a certain threshold may be subject to the 3.8% net investment income tax (NIIT). The NIIT applies to the **lesser** of:[59]

- The taxpayer's **net investment income (NII)** for the year, or
- **MAGI** in excess of the taxpayer's **threshold amount.**

MAGI for purposes of the NIIT is defined as AGI plus the taxpayer's foreign earned income exclusion (FEIE) less the deductions or exclusions that are omitted from AGI because they are related to FEIE. For most taxpayers, MAGI is the same as AGI.

The taxpayer's **threshold amount** depends on their filing status.

Filing Status	NIIT Threshold Amount
MFJ, QW	$250,000
MFS	125,000
Single, HoH	200,000

NII includes several types of income and capital gains the taxpayer receives during the year. Under IRC §1411(c)(5), taxable distributions from retirement accounts — including IRAs and Roth conversions — are specifically **excluded** from the definition of investment income for purposes of the NIIT. However, a Roth conversion can increase a taxpayer's overall income such that it exceeds the threshold amount for the year. Thus, some or all of the taxpayer's NII may be subject to the NIIT after a Roth conversion.

Example 22. Braeden is single and earns a salary of $175,000 in 2016. His 2016 income also includes $20,000 of dividends and interest. Braeden consults with his tax advisor, Randall, about the advisability of converting his $100,000 traditional IRA to a Roth in 2016. Braeden has no basis in the traditional IRA.

During their conversation, Randall informs Braeden that his dividend and interest income is NII. Without the Roth conversion, Braeden will not be subject to the NIIT because his 2016 MAGI is projected to be $195,000 ($175,000 + $20,000), which is under the $200,000 threshold amount for a single taxpayer.

If Braeden proceeds with the conversion, one of the consequences will be that his NII will be subject to the NIIT. Randall calculates the potential liability as follows.

1. NII for the year		$20,000
MAGI after conversion ($175,000 + $20,000 + $100,000)	$295,000	
Less: threshold amount for single taxpayers	(200,000)	
2. MAGI in excess of threshold	$ 95,000	95,000
Lesser of 1 or 2		$20,000

With a 2016 Roth conversion, Braeden's NIIT liability will be $760 ($20,000 × 3.8%).

Note. For more information about NII and the NIIT, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Affordable Care Act Update. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

[59] IRC §1411(a)(1).

Other Pros and Cons of Converting an IRA. In determining whether converting a traditional IRA to a Roth IRA will benefit a particular taxpayer's situation, many additional factors must be weighed. These include the following.

- What is the taxpayer's present income tax rate versus the rate expected during retirement? If the taxpayer expects to be in a higher tax bracket after retirement, the option of converting from a traditional IRA to a Roth IRA should be given serious consideration.
- Does the taxpayer need to take distributions from the IRA, or do they prefer to pass on the investment to heirs? With a Roth, there is no requirement to take mandatory distributions, whereas with a traditional IRA, distributions must generally begin by age 70½.
- Has the taxpayer made deductible or nondeductible contributions to a traditional IRA? If the contributions are mostly nondeductible, the tax impact of converting to a Roth is lessened because the investment earnings and deductible contributions are the only items taxed at conversion.
- What is the taxpayer's current income tax rate? If it is lower than usual, it might be a good time to convert the IRA, provided the taxpayer has enough funds available outside the IRA to pay the applicable taxes. On the other hand, if converting to a Roth IRA pushes the taxpayer into a higher tax bracket, it might be advisable to wait until a later year to convert or to make only a partial conversion in the current year.
- How many years does the taxpayer have before retirement? Generally, the more years until retirement, the more beneficial the conversion will be, given that there are more years to "earn back" the taxes due at conversion.
- Does the taxpayer have non-IRA funds to pay the taxes due after conversion? If so, the tax-free growth on the Roth IRA can be dramatic compared to investments subject to tax. If not, the conversion may end up costing the taxpayer money.

Example 23. Sasha, age 35, has $50,000 in a traditional IRA. She wants to convert this IRA to a Roth IRA but does not have enough money to pay the taxes. She decides to proceed with the conversion and retains some of the money from the IRA to pay the taxes.

Sasha is in the 15% tax bracket. She owes $7,500 in taxes on the conversion ($50,000 × 15%). She also owes a 10% penalty on the amount she keeps from the conversion to pay the taxes. Including the penalty, Sasha needs to retain $8,333 ($7,500 ÷ (100% − 10%)) from the conversion. She can convert the balance of $41,667 ($50,000 − $8,333) to a Roth IRA.

If Sasha leaves the converted balance of $41,667 in the Roth IRA for 30 years, assuming an average return of 7%, her balance will be $317,180. If she had not converted and left the money in the traditional IRA, she would have $323,521 after paying taxes at 15%. The Roth conversion did not provide a good opportunity for Sasha because she took funds from the IRA to pay the taxes and therefore lost the ability to earn a return on that money over the subsequent 30 years.

If Sasha had used non-IRA funds to pay the taxes, she would have saved the 10% penalty, and the entire $50,000 would have earned a tax-free return in the Roth IRA. The balance after 30 years would be $380,613.

Conversions of Plans with Basis

A traditional IRA may be funded with after-tax dollars, which gives the taxpayer **basis** in the IRA. When these funds are converted to a Roth IRA, the basis must be considered when calculating the taxable portion of the conversion. The conversion is reported on Form 8606.

The nontaxable portion of the conversion is based on the pro-rata share of basis to the total value of **all** the taxpayer's IRAs.[60] If all the traditional IRAs are converted, then the entire basis is used to reduce the taxable portion. However, the taxpayer does not get the benefit of the entire basis if only a portion of the traditional IRAs are converted. In addition, the growth of the traditional IRAs during the year of conversion diminishes the effect of the basis on the conversion.

60. Treas. Reg. §1.408A-4, Q&A-7; IRC §408(d)(2).

Example 24. Sable had $400,000 in her traditional IRAs as of December 31, 2014. Her cumulative nondeductible contributions were $40,000. In 2015, she converted $200,000 to Roth IRAs. As of December 31, 2015, the value of her traditional IRAs was $210,000.

As shown on the following Form 8606, the nontaxable portion of the conversion is 9.756% (line 10). This is calculated by dividing Sable's IRA basis of $40,000 by the total amount converted during 2015 plus the value of her traditional IRAs on December 31, 2015 ($200,000 + $210,000). The nontaxable amount of the conversion is $19,512 (line 13), and the taxable portion is $180,488 (line 18).

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

2015

Attachment Sequence No. 48

Name. If married, file a separate form for each spouse required to file Form 8606. See instructions.
Sable Black

Your social security number
111-22-9999

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.

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 2015.
- You took distributions from a traditional, SEP, or SIMPLE IRA in 2015 **and** you made nondeductible contributions to a traditional IRA in 2015 or an earlier year. For this purpose, a distribution does not include a rollover, 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 2015 (excluding any portion you recharacterized) **and** you made nondeductible contributions to a traditional IRA in 2015 or an earlier year.

1	Enter your nondeductible contributions to traditional IRAs for 2015, including those made for 2015 from January 1, 2016, through April 18, 2016 (see instructions)			1	
2	Enter your total basis in traditional IRAs (see instructions)			2	40,000
3	Add lines 1 and 2			3	40,000
	In 2015, did you take a distribution from traditional, SEP, or SIMPLE IRAs, or make a Roth IRA conversion? **No** ▶ Enter the amount from line 3 on line 14. Do not complete the rest of Part I. **Yes** ▶ Go to line 4.				
4	Enter those contributions included on line 1 that were made from January 1, 2016, through April 18, 2016			4	0
5	Subtract line 4 from line 3			5	40,000
6	Enter the value of **all** your traditional, SEP, and SIMPLE IRAs as of December 31, 2015, plus any outstanding rollovers (see instructions)	6	210,000		
7	Enter your distributions from traditional, SEP, and SIMPLE IRAs in 2015. **Do not** include rollovers, a one-time distribution to fund an HSA, conversions to a Roth IRA, certain returned contributions, or recharacterizations of traditional IRA contributions (see instructions)	7			
8	Enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2015. **Do not** include amounts converted that you later recharacterized (see instructions). Also enter this amount on line 16	8	200,000		
9	Add lines 6, 7, and 8 — 9: 410,000				
10	Divide line 5 by line 9. Enter the result as a decimal rounded to at least 3 places. If the result is 1.000 or more, enter "1.000"	10	× .09756		
11	Multiply line 8 by line 10. This is the nontaxable portion of the amount you converted to Roth IRAs. Also enter this amount on line 17	11	19,512		
12	Multiply line 7 by line 10. This is the nontaxable portion of your distributions that you did not convert to a Roth IRA	12	0		
13	Add lines 11 and 12. This is the nontaxable portion of all your distributions			13	19,512
14	Subtract line 13 from line 3. This is **your total basis in traditional IRAs for 2015 and earlier years**			14	20,488
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	0
	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** (2015)

For Example 24

Form 8606 (2015) Page 2

Part II **2015 Conversions From Traditional, SEP, or SIMPLE IRAs to Roth IRAs**

Complete this part if you converted part or all of your traditional, SEP, and SIMPLE IRAs to a Roth IRA in 2015 (excluding any portion you recharacterized).

16	If you completed Part I, enter the amount from line 8. Otherwise, enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2015. **Do not** include amounts you later recharacterized back to traditional, SEP, or SIMPLE IRAs in 2015 or 2016 (see instructions)	16	200,000
17	If you completed Part I, enter the amount from line 11. Otherwise, enter your basis in the amount on line 16 (see instructions)	17	19,512
18	**Taxable amount.** Subtract line 17 from line 16. If more than zero, also include this amount on Form 1040, line 15b; Form 1040A, line 11b; or Form 1040NR, line 16b	18	180,488

Part III **Distributions From Roth IRAs**

To avoid creating excessive taxable income, a taxpayer who has an employer-sponsored qualified retirement plan (such as a 401(k)) may be able to roll over all **deductible** IRAs **(**including earnings) into the retirement plan (if the plan permits this). Under IRC §408(d)(3)(A)(ii), a transfer from an IRA to an employer retirement plan cannot exceed the amount of the IRA that would be includable in income if it were distributed to the taxpayer. A special rule treats a distribution into an eligible retirement plan as including only otherwise taxable amounts if the amount the taxpayer leaves in their IRAs or does not roll over is at least equal to the taxpayer's basis.[61]

Example 25. Lily has a balance of $305,500 in her traditional IRA, which includes $5,500 of after-tax contributions. She cannot roll the entire balance into her employer's 401(k) plan even though the plan permits IRA rollovers. Instead, the maximum amount that she can roll into the 401(k) is the $300,000 that would be includable in gross income if it were distributed to her.

After such a rollover, only nondeductible funds plus earnings remain in the taxpayer's IRAs. The taxpayer can then convert the nondeductible funds into a Roth IRA, and the only amount that is taxable is the earnings from the time of the rollover until the time of conversion.

Example 26. Waylon earns $200,000 each year and is covered by his employer's 401(k) plan. Waylon made nondeductible contributions to his IRA of $5,000 per year for 2013, 2014, and 2015. For many years prior to 2013, Waylon made deductible contributions to his IRA. Therefore, his basis in the traditional IRA is $15,000.

In 2015, Waylon converts the traditional IRA to a Roth IRA, when its value is $300,000. The taxable amount of the conversion is $285,000 ($300,000 − $15,000).

Example 27. Use the same facts as **Example 26,** except Waylon rolls over $285,000 from his traditional IRA to his employer's 401(k) plan. He pays no tax on the rollover. He then converts $15,000 to a Roth IRA. Because Waylon's basis is $15,000, he pays no tax on the conversion to the Roth IRA.

Each year, Waylon can continue to make a nondeductible contribution to his traditional IRA and then convert that amount into a Roth IRA.

Limitation on IRA Rollovers

Beginning in 2015, a taxpayer can make only one tax-free rollover from an IRA to another IRA in any 1-year period. This is true regardless of the number of IRAs the taxpayer owns. However, the taxpayer can make unlimited trustee-to-trustee transfers between IRAs because they are not considered rollovers. A **trustee-to-trustee transfer** occurs when the financial institution holding the IRA makes the distribution directly from the taxpayer's IRA to another IRA or to a retirement plan.[62]

61. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs).*

62. *Rollovers of Retirement Plan and IRA Distributions.* Feb. 19, 2016. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/rollovers-of-retirement-plan-and-ira-distributions] Accessed on May 19, 2016.

Furthermore, **rollovers from a traditional IRA to a Roth IRA (conversions) are not limited.**[63]

Example 28. Kaylynn has three traditional IRAs: IRA-1, IRA-2, and IRA-3. She did not take any distributions from any of her IRAs in 2015. On January 1, 2016, she took a distribution from IRA-1 and rolled it over into IRA-2 on the same day. For the remainder of 2016, Kaylynn cannot roll over any other IRA distributions, including a rollover distribution involving IRA-3.

Example 29. Mason has three traditional IRAs: IRA-1, IRA-2, and IRA-3. On January 1, 2016, he rolled over IRA-1 into a Roth IRA. On February 1, 2016, he rolled over IRA-2 into the Roth IRA. On March 1, 2016, he rolled over IRA-3 into the Roth IRA. This is allowable because conversions from a traditional IRA to a Roth IRA are not limited.

RECHARACTERIZATIONS[64]

A taxpayer may be able to treat a contribution made to one type of IRA as having been made to a different type of IRA. This is called **recharacterizing the contribution.**

To recharacterize a contribution, a taxpayer generally must have the contribution transferred from the first IRA (the one to which it was made) to the second IRA in a trustee-to-trustee transfer. If the taxpayer makes the transfer by the due date (including extensions) of the tax return for the tax year during which the contribution was made, they can elect to treat the contribution as having been originally made to the second IRA instead of the first IRA. The taxpayer must do all of the following.

- In making the transfer, the taxpayer must include the amount of the original contribution plus any related earnings or less any related losses.
- The taxpayer must report the recharacterization on their tax return for the year during which the contribution was made.
- The taxpayer must treat the contribution as having been made to the second IRA on the date that it was actually made to the first IRA.

Example 30. LaShandra converted her traditional IRA to a Roth IRA in January 2015. At that time, the value of the IRA was $85,000. At the end of 2015, the IRA had a value of $65,000. LaShandra recharacterized the Roth IRA back to a traditional IRA in March 2016 to avoid paying tax on $20,000 of nonexistent income.

The taxpayer cannot take a deduction for a contribution to a traditional IRA if they later recharacterize the amount.

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

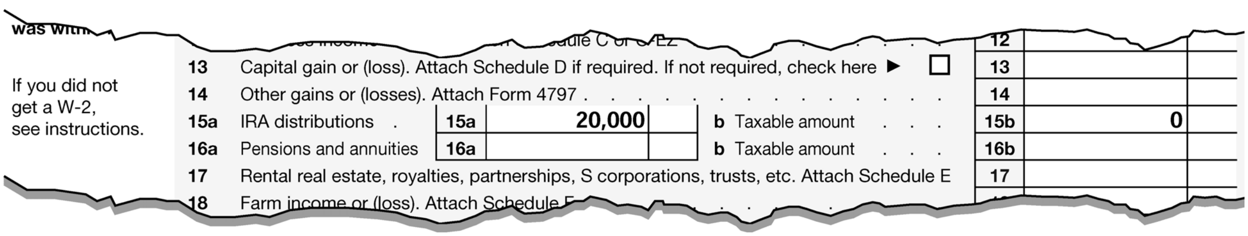
1. **Conversion and recharacterization.** This occurs when an amount is converted from a traditional, SEP, or SIMPLE IRA to a Roth IRA and all or part of the amount is later recharacterized in a trustee-to-trustee transfer to a traditional, SEP, or SIMPLE IRA. If only part of the amount converted is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

63. Ibid.

64. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs);* Instructions for Form 8606.

Example 31. Boyce and Reva's filing status is married filing jointly. They converted $20,000 from their traditional IRA to a new Roth IRA on May 20, 2015. On April 7, 2016, they recharacterized the conversion back to a traditional IRA. The value of the IRA on that date was $19,000.

Boyce and Reva recharacterized the conversion by transferring the $19,000 balance to a traditional IRA in a trustee-to-trustee transfer. They report $20,000 on their 2015 Form 1040, line 15a (as shown below). They do not include the $19,000 on line 15a because the conversion did not occur in 2015. They also do not report the $19,000 on their 2016 return because it does not apply to the 2016 tax year. The couple attaches a statement to Form 1040 explaining that they made a conversion of $20,000 from a traditional IRA on May 20, 2015, and that they recharacterized the entire Roth IRA balance, which was then valued at $19,000, back to a traditional IRA on April 7, 2016.



If you did not get a W-2, see instructions.	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 20,000	b Taxable amount	15b	0
	16a	Pensions and annuities 16a	b Taxable amount	16b	
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	

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

Example 32. Trina is single and covered by an employer retirement plan. She contributed $4,000 to a new traditional IRA on May 27, 2015. On February 24, 2016, Trina learned that her 2015 MAGI limits her traditional IRA deduction to $1,000. The value of her traditional IRA on that date was $4,400.

Trina decided to recharacterize $3,000 of the traditional IRA contribution as a Roth IRA contribution, and then transfers $3,300 ($3,000 contribution + $300 of related earnings) from her traditional IRA to a Roth IRA in a trustee-to-trustee transfer. She deducts the $1,000 traditional IRA contribution on her 2015 Form 1040.

Trina is not required to file Form 8606, but she must attach a statement to her return explaining the recharacterization. The statement indicates that Trina contributed $4,000 to a traditional IRA on May 27, 2015; that she recharacterized $3,000 of that contribution on February 24, 2016, by transferring $3,000 plus $300 of related earnings from her traditional IRA to a Roth IRA in a trustee-to-trustee transfer; and that all $1,000 of the remaining traditional IRA contribution is being deducted on Form 1040.

Trina does not report the distribution on her 2016 Form 1040 because the recharacterization was related to 2015 and was explained in an attachment to her 2015 return.

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

Example 33. Barton is single and covered by an employer retirement plan. He contributed $4,000 to a new Roth IRA on June 16, 2015. On December 29, 2015, Barton determined that his 2015 MAGI allows him to take a full traditional IRA deduction.

Barton decided to recharacterize the Roth IRA contribution as a traditional IRA contribution and transferred $4,200, the balance in the Roth IRA account ($4,000 contribution + $200 related earnings), from his Roth IRA to a traditional IRA in a trustee-to-trustee transfer. He deducted the $4,000 traditional IRA contribution on his 2015 Form 1040.

Barton is not required to file Form 8606. However, he must attach a statement to his return explaining the recharacterization. The statement indicates that he contributed $4,000 to a new Roth IRA on June 16, 2015; that he recharacterized that contribution on December 29, 2015, by transferring $4,200, the balance in the Roth IRA, to a traditional IRA in a trustee-to-trustee transfer; and that $4,000 of the traditional IRA contribution is deducted on Form 1040. Barton includes the $4,200 distribution on his 2015 Form 1040, line 15a, and enters zero on line 15b.

4. **Rollover and recharacterization.** This occurs when an amount is rolled over from a qualified retirement plan to a Roth IRA and all or part of the amount is later recharacterized in a trustee-to-trustee transfer to a traditional IRA. Neither the rollover nor the recharacterization is reported on Form 8606. A statement is attached to the return that explains the recharacterization. The amount of the original rollover is included on Form 1040, line 16a ("pensions and annuities"). If the recharacterization occurred in the same tax year as the rollover, the amount transferred from the Roth IRA is also included on Form 1040, line 15a. If the recharacterization occurred in the year following the year of the rollover, the amount transferred from the Roth IRA is reported only on the attached statement. It is not reported on the tax return for either year.

Example 34. Liza is single. She rolled over $50,000 from her 401(k) plan to a new Roth IRA on July 20, 2015.

On March 25, 2016, Liza decided to recharacterize the rollover. The value of the Roth IRA on that date is $49,000.

Liza recharacterized the rollover by transferring the entire amount to a traditional IRA in a trustee-to-trustee transfer. She reported $50,000 on her 2015 Form 1040, line 16a, and entered zero on line 16b. She did not include the $49,000 on line 15a because the recharacterization did not occur in 2015. She also does not report that amount on her 2016 return because the recharacterization does not apply to the 2016 tax year. Liza attached a statement to her 2015 Form 1040 explaining that she made a rollover of $50,000 from a 401(k) plan to a Roth IRA on July 20, 2015, and that she recharacterized the entire amount (which was then valued at $49,000) to a traditional IRA on March 25, 2016.

Effect of Previous Tax-Free Transfers

If an amount has been moved from one IRA to another in a tax-free transfer (such as a rollover), the taxpayer cannot recharacterize the amount that was transferred. However, if a taxpayer mistakenly rolls over or transfers an amount from a traditional IRA to a SIMPLE IRA, they can later recharacterize the amount as a contribution to another traditional IRA.

Recharacterization Not Counted as a Rollover

The recharacterization of an IRA contribution is not treated as a rollover for purposes of the 1-year waiting period described earlier.

SOCIAL SECURITY PLANNING

QUALIFYING FOR RETIREMENT BENEFITS

To qualify for social security retirement benefits, an individual generally must have 40 quarters, or 10 years, of posted earnings.[65] For 2016, the amount of earnings needed to earn one quarter of coverage is $1,260.[66] The maximum number of quarters of coverage available in one year is four; therefore, an employee earning $5,040 in 2016 will receive credit for four quarters of coverage.

> **Note.** The Food, Energy, and Conservation Act of 2008 allows taxpayers who elect the optional method of reporting net earnings from self-employment to increase the amount of earnings credited for self-employment to the amount needed for four quarters of social security coverage ($5,040 in 2016). A self-employed taxpayer can generally use the optional method only five times; however, a farmer can use the optional reporting method every year.[67]

ESTIMATING SOCIAL SECURITY BENEFITS

The Social Security Administration (SSA) offers a variety of online benefit calculators that can be used to estimate an individual's potential benefit amounts using different retirement dates and levels of future earnings. These calculators estimate disability and survivor benefit amounts as well as retirement benefit amounts. The three calculators available at **uofi.tax/16a1x2** [www.ssa.gov/planners/benefitcalculators.htm] are the following.

1. The **Quick Calculator** gives a simple, rough estimate based on the individual's date of birth and current year's earnings. The individual must be age 21 or older for this calculator to work correctly.
2. The **Online Calculator** requires the user to input their date of birth and complete earnings history to obtain a benefit estimate. The user may project future earnings until their anticipated retirement date.
3. The **Detailed Calculator** provides the most precise estimate. It must be downloaded and installed on the user's computer.

None of these calculators is linked to the user's actual social security earnings record but instead uses the earnings amounts entered.

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65. *Benefits Planner: Social Security Credits*. Social Security Administration. [www.ssa.gov/planners/credits.html#&a0=1] Accessed on Dec. 4, 2015.

66. *Quarter of Coverage*. Social Security Administration. [www.socialsecurity.gov/oact/cola/QC.html] Accessed on Dec. 4, 2015.

67. *If You Are Self-Employed.* January 2016. Social Security Administration. [www.ssa.gov/pubs/10022.html] Accessed on Dec. 4, 2016.

The **Retirement Estimator,** available at **uofi.tax/16a1x3** [www.ssa.gov/retire/estimator.html], uses social security earnings records and projected future earnings to estimate the individual's retirement benefit. The actual benefit amount cannot be provided until the individual applies for benefits.

FULL RETIREMENT AGE

It is important to determine the taxpayer's **full retirement age** (FRA) (also called the **normal retirement age)** because that determines when they will receive full social security benefits. FRAs are shown in the following table.[68]

Year of Birth	Full Retirement Age
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943–1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

PRIMARY INSURANCE AMOUNT

The **primary insurance amount** (PIA) is the benefit a person receives if they begin receiving benefits at their FRA. At this age, the benefit is neither reduced for early retirement nor increased for delayed retirement.[69]

The PIA is the sum of three separate percentages applied to portions of **average indexed monthly earnings** (AIME).[70] The percentages of the PIA formula are fixed by law, and the dollar amounts in the formula are adjusted annually for changes in the national average wage index. These dollar amounts, called **bend points,** govern the portions of the AIME.[71]

The bend points in the 2016 PIA formula are $856 and $5,157, and they apply to individuals who first become eligible for retirement benefits in 2016. Such an individual's PIA is the sum of:[72]

- 90% of the first $856 of the individual's AIME, plus
- 32% of the AIME over $856 and through $5,157, plus
- 15% of the AIME over $5,157.

68. *Retirement Planner: Full Retirement Age.* Social Security Administration. [www.socialsecurity.gov/planners/retire/retirechart.html] Accessed on Dec. 4, 2015.

69. *Primary Insurance Amount.* Social Security Administration. [www.ssa.gov/oact/cola/piaformula.html] Accessed on Dec. 4, 2015.

70. Up to 35 years of a worker's earnings are indexed to reflect the change in general wage levels that occurred during their years of employment. The indexing series for the years 1951–2014 is available from the Social Security Administration on the web page *National Average Wage Index* [www.socialsecurity.gov/OACT/COLA/AWI.html] Accessed on Dec. 4, 2015.

71. *Social Security Benefit Amounts.* Social Security Administration. [www.socialsecurity.gov/OACT/COLA/Benefits.html#aime] Accessed on Dec. 4, 2015.

72. *Primary Insurance Amount.* Social Security Administration. [www.ssa.gov/oact/cola/piaformula.html] Accessed on Dec. 4, 2015.

Example 35. Isabel retires in 2016 at age 66, which is her FRA. Her AIME is $6,200. Her PIA is calculated as follows.

- 90% × $856 = $770
- 32% × ($5,157 − $856) = $1,376
- 15% × ($6,200 − $5,157) = $156

Isabel's PIA is $2,302 ($770 + $1,376 + $156).

An eligible individual can start receiving social security retirement benefits as early as age 62 or as late as age 70. The individual's monthly benefit is different depending on the age at which they start receiving it.

Receiving Benefits Early

If an individual starts receiving benefits early (before their FRA), the benefits are **reduced** based on the number of months they receive benefits before reaching FRA. Taxpayers born between 1943 and 1954 receive 75% of their PIAs if they elect to start receiving benefits at age 62.[73] This percentage gradually decreases for taxpayers born after 1954 but before 1960. Taxpayers born in 1960 and later receive 70% of their PIAs if they elect to start receiving benefits at age 62.[74]

Delaying Benefits

If an individual delays retirement beyond their FRA, social security benefits are **increased** by a certain percentage (depending on the individual's date of birth). The benefit reaches a maximum once the individual reaches age 70. It will not increase further, even if the individual continues to delay taking benefits. For taxpayers born in 1943 and later, the credit for each year of delayed retirement after reaching the FRA is 8%.[75]

Example 36. Use the same facts as **Example 35.** If Isabel delays the date that she begins receiving social security benefits until she reaches age 67, her monthly benefit will be $2,486 ($2,302 × 108%).

FAMILY BENEFITS

Certain family members of an individual who receives social security retirement benefits are also entitled to benefits, which are often called **auxiliary benefits.** These family members include the following.[76]

- A spouse who is age 62 or older
- A spouse who is younger than age 62 if they are taking care of a child who is younger than age 16 or disabled
- A former spouse who is age 62 or older
- A child up to age 18 or up to age 19 if they are a full-time student who has not yet graduated from high school
- A disabled child of any age

73. *Full Retirement Age: If You Were Born Between 1943 and 1954.* Social Security Administration. [www.ssa.gov/planners/retire/1943.html] Accessed on Dec. 4, 2015.

74. *Social Security Benefits: Early or Late Retirement?* Social Security Administration. [www.ssa.gov/OACT/quickcalc/early_late.html#calculator] Accessed on Dec. 4, 2015.

75. Ibid.

76. *Social Security: Retirement Benefits.* Social Security Administration. [www.socialsecurity.gov/pubs/EN-05-10035.pdf] Accessed on Dec. 4, 2015.

Benefits for Spouses[77]

When an individual becomes eligible for retirement benefits, their spouse may be eligible for a benefit based on the worker's earnings. To be eligible, the spouse must be at least age 62 or have a qualifying child in their care. A **qualifying child** for this purpose is one who is under age 16 or who receives social security disability benefits.

A spouse is paid a retirement benefit based on their own earnings if that benefit is **higher** than the spousal benefit. Otherwise, they receive the spousal benefit.

The spousal benefit can be as much as half of the worker's PIA, depending on the spouse's age at retirement. If the spouse begins receiving retirement benefits before reaching their FRA, they receive a reduced benefit. However, the spousal benefit is **not** reduced if the spouse is caring for a qualifying child.

A spouse can begin receiving reduced benefits as early as age 62. A spousal benefit is reduced $^{25}/_{36}$ of 1% (0.0069) for each month before reaching the FRA, up to 36 months. If the number of months before reaching the FRA is greater than 36, the benefit is further reduced $^{5}/_{12}$ of 1% (0.0042) per month. This reduction factor is applied to the base spousal benefit, which is 50% of the worker's PIA.

> **Note.** Relatively few people can begin receiving social security retirement benefits at exactly age 62 because a person must be 62 throughout the first month of retirement. Thus, most early retirees can begin receiving benefits at age 62 and 1 month.[78]

Example 37. Darrell retires at his FRA, and his PIA is $1,600. His wife, Layla, plans to start drawing her spousal benefit the month after she reaches age 62, which is 47 months before her FRA. Her spousal benefit is calculated as follows.

	Formula	Calculation	Result
Base spousal benefit	PIA × 50%	$1,600 × 50%	$800
Reduction: first 36 months	36 months × $^{25}/_{36}$ × 1% = 25%	$800 × 25%	(200)
Reduction: next 11 months	11 months × $^{5}/_{12}$ × 1% = 4.58%	$800 × 4.58%	(37)
Final spousal benefit			$563

An individual who has reached their FRA and is eligible for their own retirement benefit and a spousal benefit may be able to choose to receive only the spousal benefit. By doing this, the spouse can delay receiving their own retirement benefit until a later date to take advantage of delayed retirement credits.[79] However, because of recent changes enacted in the Bipartisan Budget Act of 2015, this option is available only to individuals who reached age 62 before January 1, 2016. For more information, see the "Deemed Filing" section later in this chapter.

77. *Social Security Benefits: Benefits for Spouses.* Social Security Administration. [www.socialsecurity.gov/OACT/quickcalc/spouse.html] Accessed on Dec. 4, 2015.

78. *Social Security Benefits: Benefit Reduction for Early Retirement.* Social Security Administration. [www.ssa.gov/oact/quickcalc/earlyretire.html] Accessed on Dec. 4, 2015.

79. *Retirement Planner: Benefits for You as a Spouse.* Social Security Administration. [www.ssa.gov/planners/retire/applying6.html#&a0=1] Accessed on Dec. 4, 2015.

Benefits for Former Spouses[80]

A divorced spouse is eligible for benefits based on a worker's social security record if the marriage lasted at least 10 years. To qualify, the divorced spouse must be at least age 62 and **unmarried.**

The retirement benefit a divorced spouse receives has no effect on the benefit amount that the worker and their current spouse are entitled to receive.

If a worker and their ex-spouse are both age 62 or older and have been divorced for at least two years, the ex-spouse can get benefits even if the worker has not retired.

Benefits for Children[81]

A child of an individual receiving social security benefits can be eligible for benefits. To be eligible for benefits, a child must have:

- A parent who is disabled or retired and entitled to social security benefits, or
- A parent who died after working long enough in a job in which they paid social security taxes. (See the "Survivor Benefits" section later in this chapter.)

The eligible child can be a biological child, adopted child, or dependent stepchild. In some cases, a child can also be eligible for benefits based on their grandparents' earnings. The child must be unmarried and be one of the following.

- Younger than age 18
- 18−19 years old and a full-time student (no higher than grade 12)
- Disabled (The disability must have started prior to age 22.)

A child may receive up to 50% of a parent's PIA or disability benefit. If the parent is deceased, the child may receive up to 75% of the deceased parent's PIA. However, a child's benefit is subject to the maximum family benefit limit, which is discussed next.

Maximum Family Benefit[82]

There is a limit to the monthly amount that family members can be paid on a worker's earning record. The family maximum is computed using a formula similar to that used to compute the PIA. The formula combines four separate percentages applied to portions of the worker's PIA. For 2016, the bend points used in this formula are $1,093, $1,578, and $2,058.

The maximum benefit payable to the family of a worker who attains age 62 or dies in 2016 before attaining age 62 is the sum of:

- 150% of the first $1,093 of the worker's PIA, plus
- 272% of the worker's PIA over $1,093 through $1,578, plus
- 134% of the worker's PIA over $1,578 through $2,058, plus
- 175% of the worker's PIA over $2,058.

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80. *Retirement Planner: If You Are Divorced.* Social Security Administration. [www.ssa.gov/planners/retire/divspouse.html] Accessed on Dec. 4, 2015.

81. *Benefits for Children.* Social Security Administration. [www.ssa.gov/pubs/EN-05-10085.pdf] Accessed on Dec. 7, 2015.

82. *Formula for Family Maximum Benefit.* Social Security Administration. [www.ssa.gov/oact/cola/familymax.html] Accessed on Dec. 14, 2015.

If the sum of benefits payable to family members is greater than the family maximum amount, the benefits are reduced proportionately. However, the worker's benefit is never reduced because of the family maximum. In addition, the benefit for a divorced spouse (including a surviving divorced spouse) is never reduced.[83]

Example 38. Ajay Sine; his wife, Dana; and their four children (ranging in age from 6 to 12) are entitled to social security benefits. Ajay's PIA is $2,300. The Sines' maximum family benefit for 2016 is computed as follows.

- 150% × $1,093 = $1,640
- 272% × ($1,578 − $1,093) = $1,319
- 134% × ($2,058 − $1,578) = $643
- 175% × ($2,300 − $2,058) = $424

The Sines' maximum family benefit is $4,026 ($1,640 + $1,319 + $643 + $424).

After Ajay's PIA is subtracted from the maximum family benefit, a total of $1,726 ($4,026 family maximum − $2,300 PIA) remains to be divided among Dana and the four children. Each of them has an unadjusted benefit of $1,150 ($2,300 PIA × 50%). Applying the family maximum, each will receive $345 ($1,726 ÷ 5 family members).

The family maximum benefit is **always** calculated based on the worker's PIA, which is the benefit a person receives if they begin receiving benefits at their FRA. This is true even if the worker's benefits are reduced because they begin receiving benefits prior to their FRA.

Example 39. Use the same facts as **Example 38,** except Ajay begins receiving retirement benefits when he turns age 62 in 2016. His retirement benefit is 75% of his PIA, or $1,725 ($2,300 PIA × 75%). However, because the family maximum benefit is always calculated based on the worker's PIA, the total that is split between Dana and the four children is still $1,726, as calculated in **Example 38.**

SURVIVOR BENEFITS

Certain family members are eligible for survivor benefits after the death of an individual who has worked and paid social security taxes. The length of time a worker must work for their survivors to be eligible for benefits depends on the worker's age at time of death.

The required length of time increases with the worker's age, but no more than 10 years of work (40 credits) is needed to be covered for all benefits. However, benefits can be paid to the deceased worker's children and the surviving spouse who is caring for the children even if the worker did not have the required number of credits. They can get benefits if the worker has credit for one and one-half years of work (six credits) in the three years prior to the worker's death.[84]

83. *Understanding the Social Security Family Maximum.* Social Security Administration. [www.ssa.gov/policy/docs/ssb/v75n3/v75n3p1.html] Accessed on Dec. 7, 2015.

84. *Survivors Planner: If You Are the Survivor.* Social Security Administration. [www.ssa.gov/planners/survivors/ifyou.html] Accessed on Dec. 7, 2015.

Eligible Relatives

Survivor benefits can be paid to the following persons.[85]

- A **surviving spouse** may receive full benefits at their FRA or reduced benefits as early as age 60. If the surviving spouse is disabled, benefits can begin as early as age 50.
- A **surviving spouse** can receive benefits at any age if they take care of a child of the deceased who is under the age of 16 or disabled and who is receiving social security benefits.
- An **unmarried child** of the deceased who is under age 18 (or up to age 19 if they are a full-time student at an elementary or secondary school) can receive benefits. A disabled child can receive benefits at any age if they were disabled before age 22.
- A **dependent parent** of the deceased can receive benefits if they are at least age 62. For the parent to qualify as a dependent, the deceased had to provide at least half of their support.
- An **ex-spouse** of the deceased who is at least age 60 (or age 50 if disabled) can receive benefits if the marriage lasted at least 10 years. However, the ex-spouse does not have to meet the age or length-of-marriage requirements if they are caring for a child who is younger than age 16 or disabled and is also entitled to benefits based on the deceased's earnings. The child must be the natural or legally adopted child of the ex-spouse.

If a surviving spouse remarries before reaching age 60, their survivor benefits generally cease. However, if the remarriage occurs after age 60 (or age 50 if disabled), the benefit payments based on the former spouse's work are not affected. At age 62 or older, the surviving spouse may get benefits based on their new spouse's earnings, if that benefit is higher.

Amount of Benefits

The amount of the survivor benefits is based on the deceased individual's earnings. If the deceased individual was receiving reduced benefits, the survivor benefits are based on that amount. The SSA uses the deceased individual's PIA and calculates the percentage payable to the survivors. The percentage depends on the survivors' ages and relationship to the deceased. The most typical situations are as follows.[86]

- A surviving spouse who has attained their FRA generally receives 100% of the deceased individual's PIA.
- A surviving spouse who is at least age 60 but under their FRA receives approximately 71–99% of the deceased individual's PIA.

> **Note.** A chart with the precise percentages based on the survivor's age at the time they begin receiving benefits is available at **uofi.tax/16a1x4** [www.ssa.gov/planners/survivors/1945s.html].

> **Note.** A widow(er) can switch from their own retirement benefit to a deceased spouse's benefit without carrying over any early retirement penalty from taking their own benefit prior to reaching their FRA. Conversely, a widow(er) can collect a survivor's benefit as early as age 60 and then later switch to their own retirement benefit to take advantage of delayed retirement credits.

- A surviving spouse of any age who has a child younger than age 16 receives 75% of the deceased individual's PIA.
- A child receives 75% of the deceased parent's PIA.

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85. *Social Security: Survivors Benefits*. Social Security Administration. [www.ssa.gov/pubs/10084.html] Accessed on Dec. 7, 2015.

86. Ibid.

Maximum Family Benefit

The same formula that is used to calculate the maximum family benefit for a retired worker is used to calculate the maximum benefit for a deceased worker's family. When a worker dies, the benefits payable to their spouse and children, if any, increase. This is because the worker's PIA is no longer subtracted from the maximum family benefit.

> **Example 40.** Use the same facts as **Example 38,** except Ajay dies in 2016. The Sines' maximum family benefit is still \$4,026, which is now divided among Dana and the four children. Because Dana is caring for children under age 16, she is entitled to 75% of Ajay's PIA before any reduction for the maximum family benefit. Each of the four children is also entitled to 75% of Ajay's PIA before the reduction. Accordingly, their unadjusted benefit amount is \$1,725 each (\$2,300 PIA × 75%). After applying the maximum family benefit formula, each family member will receive \$805 (\$4,026 ÷ 5 family members).

WORKING WHILE RECEIVING SOCIAL SECURITY BENEFITS

Many people continue to work after they start receiving social security retirement or survivor benefits. A worker who reaches their FRA or is older may keep all of their social security benefits, no matter how much they earn.

However, a **retirement earnings test** (RET) applies to a beneficiary who is younger than their FRA. The RET reduces benefits for workers who are younger than their FRAs and who earn more than certain amounts.[87] The RET reduction is not prorated throughout the year. Instead, the entire amount of the monthly retirement benefit is withheld until the full amount has been withheld. The amount of the reduction depends on the worker's age when they begin receiving benefits, as follows.

1. For a worker who is younger than their FRA **during all of 2016,** the SSA deducts \$1 for each \$2 in earnings above \$15,720.

> **Example 41.** Philip files for social security benefits in January 2016 at age 62. His unadjusted benefit will be \$600 per month, or \$7,200 for the entire year. During 2016, Philip anticipates that he will earn \$20,800, which is \$5,080 above the \$15,720 limit.
>
> The SSA withholds \$2,540 of Philip's social security benefit (half of his earnings over the limit). The SSA accomplishes this by withholding all of Philip's benefit payments from January through May 2016. Thus, the SSA withholds \$3,000 of Philip's benefit payments (\$600 × 5 months), which is \$460 more than is required to be withheld (\$3,000 − \$2,540) based on earnings of \$20,800.
>
> Starting in June 2016, Philip receives his \$600 benefit, and this amount is paid to him each month for the remainder of 2016. In 2017, the SSA will pay Philip the additional \$460 it withheld in May 2016.

2. For workers who reach FRA **during 2016,** the SSA deducts \$1 for each \$3 in earnings above \$41,880 until the month the worker reaches their FRA.

> **Example 42.** Hadlee files for social security benefits in January 2016. She reaches her FRA of 66 in November 2016. Her benefit is \$600 per month. She earned \$42,900 from January through October 2016.
>
> During this period, the SSA withholds \$340 from her benefit ((\$42,900 − \$41,880 limit) ÷ \$3). The SSA does this by withholding Hadlee's first check of the year. Beginning in February 2016, she receives her \$600 benefit, and this amount is paid to her each month for the remainder of 2016. In January 2017, the SSA will pay Hadlee the remaining \$260 (\$600 withheld in January 2016 − \$340 required deduction).

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[87] *Social Security: How Work Affects Your Benefits.* Social Security Administration. [www.ssa.gov/pubs/10069.html] Accessed on Dec. 7, 2015; *Exempt Amounts under the Earnings Test.* Social Security Administration. [www.ssa.gov/OACT/COLA/rtea.html] Accessed on Dec. 8, 2015.

Special Rule for First Year of Retirement[88]

A special rule applies to earnings for one year, which is usually the first year in which a person receives social security benefits. Under this rule, a retiree who starts receiving benefits in a month other than January can get a full social security check for any whole month they are retired, even though their yearly income is more than the annual earnings limit.

A person is considered retired if their monthly earnings are not more than one-twelfth of the annual earnings limit.

- In 2016, a person who is under their FRA for the entire year is considered retired if their monthly earnings are \$1,310 or less (\$15,720 annual limit ÷ 12 months).
- A person who reaches their FRA in 2016 is considered retired in any month that their earnings are \$3,490 or less (\$41,880 annual limit ÷ 12 months).

Example 43. Ruth retired at age 62 on October 30, 2016. She had worked full time and earned \$45,000 through October. In November, she takes a part-time job that pays her \$500 per month.

Although Ruth's earnings for the year substantially exceed the 2016 annual limit of \$15,720, there is no reduction in her social security benefit for November or December. This is because Ruth's earnings for these months are less than \$1,310, which is the monthly limit for someone younger than their FRA. Beginning in 2017, only the yearly limit for someone younger than their FRA will apply to Ruth.

For a self-employed individual, the SSA considers the time they spent working in the business to determine whether they are entitled to full retirement benefits. The following general guidelines are used in making this determination.

- An individual who works more than 45 hours per month in self-employment is not considered retired.
- An individual who works less than 15 hours per month is considered retired.
- An individual who works between 15 and 45 hours per month is not considered retired if they work in a highly skilled occupation or manage a sizable business.

Example 44. Gabriel retired and applied for social security benefits in June 2016 at age 62. He earned \$37,000 that year before he retired. On October 1, 2016, Gabriel started his own business. He worked at least 15 hours a week for the rest of the year and earned an additional \$3,000 after expenses. His total earnings for 2016 are \$40,000.

Although Gabriel's earnings for the year substantially exceed the 2016 annual limit for someone under their FRA (\$15,720), he receives social security benefits for July, August, and September. This is because he was not self-employed during that period, and his earnings in these three months are less than \$1,310 — the limit for someone younger than their FRA.

Gabriel will not receive benefits for October, November, or December 2016 because he worked in his business more than 45 hours in each of these months. Beginning in 2017, the deductions will be based solely on Gabriel's annual earnings limit.

88. *Retirement Planner: Special Earnings Limit Rule.* Social Security Administration. [www.socialsecurity.gov/planners/retire/rule.html] Accessed on Dec. 7, 2015; *Exempt Amounts under the Earnings Test.* Social Security Administration. [www.ssa.gov/OACT/COLA/rtea.html] Accessed on Dec. 8, 2015.

What Income Counts?[89]

The wages of an employee who works for an employer count toward their social security earnings limits. Wages count when they are earned, rather than when they are paid. For example, accumulated sick or vacation pay that is earned in one year but not paid until the following year is counted as earnings for the year it is earned. An employee's contributions to a pension or retirement plan **do** count toward the earnings limit if the contribution amount is included in their gross wages.

For a self-employed person, only the net earnings from their self-employment count toward the earnings limits. Income from self-employment generally counts toward the earnings limit when it is received, rather than when it is earned. However, income that is earned prior to the time the self-employed person becomes entitled to social security but that is not paid until after the individual becomes entitled to benefits is not counted toward the earnings limit.

The following types of income are **not** counted toward the social security earnings limits.

- Other government benefits
- Investment earnings
- Interest income
- Pensions
- Annuities
- Capital gains

Effect on Family Members

When a worker's earnings reduce their social security retirement benefits, the reduction may also affect other family members. If a spouse and/or child receives benefits based on the worker's record, excess earnings reduce the worker's benefit payment, which also decreases the amount payable to family members.

> **Example 45.** Perry, age 63, is entitled to social security retirement benefits of $1,200 per month before a reduction for excess earnings. His wife, Paula, who is also 63, receives half of Perry's retirement benefit, or $600 per month before a reduction for excess earnings.
>
> Perry's earnings in 2016 are $16,720, which is $1,000 over the earnings limit. Therefore, his benefit is reduced by $500 ($1 for every $2 over the limit). Paula's spousal benefit is reduced by $250 (½ of $500).

In addition, any excess earnings of the spouse affect the spouse's benefits but not the primary worker's benefits.

> **Example 46.** Use the same facts as **Example 45,** except Paula also works. Her 2016 earnings are $16,120, which is $400 over the earnings limit. Therefore, her spousal benefit is reduced by $200 ($1 for every $2 over the limit). After reductions, her monthly spousal benefit is $150 ($600 unadjusted spousal benefit − $250 reduction for Perry's excess earnings − $200 reduction for Paula's excess earnings).
>
> Paula's earnings do not affect Perry's social security retirement benefits because he is not drawing benefits based on her earnings record.

89. *Social Security: How Work Affects Your Benefits.* 2016. Social Security Administration. [www.socialsecurity.gov/pubs/EN-05-10069.pdf] Accessed on Dec. 7, 2015.

Effect of Earnings on Later Retirement Benefits

A less well-understood aspect of the RET is that benefits are only temporarily withheld from the beneficiary. When a beneficiary reaches their FRA, any benefits that were withheld because of the RET are restored through a permanent increase in the monthly benefit for the retired worker.[90] However, a spouse or survivor who receives benefits because they have a minor or disabled child in their care does not receive increased benefits at their FRA if benefits were withheld because of the RET.[91]

Example 47. In January 2016, Rue began claiming social security retirement benefits at age 62. After adjusting for early retirement, she is entitled to a monthly benefit of $1,000. However, Rue continues to work and earns $24,000 in 2016, which is $8,280 over the earnings limit ($24,000 − $15,720). Accordingly, her annual benefit is reduced by $4,140 ($1 for every $2 over the limit).

Rue continues to work until she reaches age 66 and earns $24,000 each year. Without taking into account annual cost-of-living adjustments and RET exempt amounts, her monthly benefit will increase to $1,070 at her FRA of 66. As shown in the following table, if Rue lives to age 86, she will recoup all the benefits the SSA withheld because of her excess earnings before reaching her FRA.[92]

Age	Formula	Result
62–65	4 years × $4,140 annual reduction for excess earnings	$16,560 withheld
66–86	240 months × $70 monthly benefit increase	$16,800 restored

The SSA reviews the records each year for each social security recipient who works. If the latest year of earnings is one of the worker's highest years, the SSA recalculates their benefits and pays any additional benefit in December of the following year. For example, an increase is paid in December 2016 for an individual whose 2015 earnings raised their benefit. Such an increase is retroactive to January 2016.[93]

RECENT CHANGES TO SOCIAL SECURITY[94]

On November 2, 2015, President Obama signed into law the Bipartisan Budget Act of 2015 (BBA). The BBA contains provisions that alter the options previously available to social security beneficiaries. It refers to changes in the following areas as the "closure of unintended loopholes."

1. File and suspend
2. Deemed filing

90. *Modeling Behavioral Responses to Eliminating the Retirement Earnings Test.* Olsen, Anya, and Romig, Kathleen. 2013. Social Security Administration, Office of Retirement and Disability Policy. [www.ssa.gov/policy/docs/ssb/v73n1/v73n1p39.html] Accessed on Dec. 8, 2015.

91. *Social Security: How Work Affects Your Benefits.* 2016. Social Security Administration. [www.socialsecurity.gov/pubs/EN-05-10069.pdf] Accessed on Dec. 8, 2015.

92. *Retirement Earnings Test.* June 2015. Social Security Administration, Office of Retirement Policy. [www.socialsecurity.gov/retirementpolicy/program/retirement-earnings-test.html] Accessed on Dec. 8, 2015.

93. *Social Security: How Work Affects Your Benefits.* 2016. Social Security Administration. [www.socialsecurity.gov/pubs/EN-05-10069.pdf] Accessed on Dec. 8, 2015.

94. PL 114-74 §831; *Social Security Legislative Bulletin.* Nov. 3, 2015. Social Security Administration. [www.ssa.gov/legislation/legis_bulletin_110315.html] Accessed on Dec. 9, 2015.

File and Suspend

Under the **file and suspend strategy,** an individual who reached their FRA could apply for social security retirement benefits and then request to have the payments suspended. This entitled the individual's spouse and other family members to receive benefits based on the individual's earnings record while the individual continued to earn delayed social security retirement benefits at the rate of 8% per year up to age 70. The BBA changed the rule so that if an individual suspends the receipt of benefits, no one can claim benefits based on their earnings record except for a divorced spouse.[95]

This provision is effective for benefits payable beginning six months after the enactment of the BBA. This means that an individual who has been using the file and suspend strategy is "grandfathered" and therefore can continue to do so. However, as of April 30, 2016 (six months after enactment), any new request to suspend benefit payments will stop **all** benefit payments — including spousal and other family benefits — until the individual who suspended the benefits has their benefits reinstated.

An individual can still voluntarily suspend their retirement benefits. This is an option for someone who began receiving benefits early and wants to halt their benefits temporarily to earn delayed retirement credits. However, such an individual will no longer be able to request a lump-sum payment of all of their retroactive benefits if they decide they want their benefits reinstated.

Note. For more information on the file and suspend strategy, see the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 6: New Developments.

Deemed Filing

The BBA eliminates the file and suspend strategy by extending the **deemed filing** concept. According to this concept, if a married person files for social security benefits, they are deemed to file for both their own retirement benefit and their spousal benefit. The SSA will pay only the larger of the two benefits.

The deemed filing concept applies only if the person filing for benefits is **eligible** for more than one benefit. A married person cannot be deemed to file for a spousal benefit unless their spouse has already filed for their own benefit. Eligibility for a spousal benefit is determined only in the month that a person files for benefits.[96]

Example 48. Callie applies for social security retirement benefits on her 62nd birthday in January 2016. Her husband, Larry, is still working and does not plan to file for social security benefits until his 70th birthday, which will be in 2020. Callie is not deemed to apply for a spousal benefit because Larry has to file for his own retirement benefit before she will be eligible for a spousal benefit.

The deemed filing rule does not apply to survivor benefits. A surviving spouse can file for survivor benefits without being deemed to file for their own retirement benefit. In addition, a person who is caring for a child under age 16 or for a disabled adult child who is entitled to child's benefits is not deemed to have filed for their own retirement benefit if they file for a spousal benefit.[97]

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95. *Retirement Planner: Suspending Retirement Benefit Payments.* Social Security Administration. [www.ssa.gov/planners/retire/suspend.html] Accessed on Sep. 7, 2016.

96. *Program Operations Manual System (POMS): GN 00204.004 Considering Possible Entitlement to Retirement Insurance Benefits (RIB) when a Spouse's Application Is Filed.* Feb. 22, 2013. Social Security Administration. [https://secure.ssa.gov/poms.nsf/lnx/0200204004] Accessed on Dec. 10, 2015.

97. *Program Operations Manual System (POMS): GN 00204.020 Scope of the Application.* Aug. 26, 2015. Social Security Administration. [https://secure.ssa.gov/poms.nsf/lnx/0200204020] Accessed on Dec. 10, 2015.

Prior to the BBA's enactment, deemed filing ended at an individual's FRA. Under the BBA, deemed filing is extended to age 70. Before the BBA, an individual could defer their own benefit at their FRA to continue to earn delayed retirement credits (8% per year up to age 70) and collect only the spousal benefit instead. Under the BBA, this option is no longer available. Because social security pays only the larger of the individual's own retirement benefit or their spousal benefit, the requirement to take both benefits means that the individual loses the smaller of the two benefits.[98]

The changes to the deemed filing provisions are effective for individuals who reach age 62 after December 31, 2015. Individuals who were 62 before that date can still file a **restricted application** for a spousal benefit only when they attain their FRA.

Example 49. Use the same information as **Example 48.** Larry's 66th birthday is July 1, 2016. Because he has attained his FRA on that date, he can apply for a spousal benefit without being deemed to file for his own retirement benefit.

DECIDING WHEN TO DRAW SOCIAL SECURITY BENEFITS

There is no easy answer to the question every prospective retiree faces: What is the best age to start receiving social security retirement benefits? Deciding that age is a personal matter and everyone should make an informed decision based on their individual and family circumstances.

As discussed earlier, an individual's monthly benefit differs based on the age at which they start receiving benefits. The general guidelines are summarized as follows.

- An individual who starts receiving benefits before their FRA will have smaller payments but will receive them for a longer period.
- An individual who starts receiving benefits at or after reaching their FRA will have larger monthly payments for a shorter period.
- The amount an individual gets when they start receiving benefits establishes the base amount for the payments they will receive for the rest of their life.

Many factors should be considered in deciding when to claim retirement benefits. Some of the most important considerations follow; however, this list is not intended to be comprehensive.[99]

1. **Does the individual plan to continue working?** As discussed earlier in this chapter, if an individual continues to work before reaching their FRA, some of their benefit payments may be reduced. However, when the individual reaches their FRA, their monthly benefit payments are permanently increased.
2. **How long can the individual reasonably expect to live?** It is important to plan for the long term. A man who turned 65 in 2014 could expect to live another 19.3 years, while a woman of the same age could expect to live another 21.6 years. Someone who expects to live a long life may need the extra money that comes from delaying social security benefits. On the other hand, someone with a chronic illness or a genetic predisposition to a shorter-than-average life may be better off drawing their social security benefits as soon as permitted.
3. **Does the individual have health insurance?** Many people who stop working lose their employer-provided health insurance in addition to their paychecks. Although there are some exceptions, most people are not covered by Medicare until they reach age 65.

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98. *New Budget Deal Is Cutting Your Social Security Benefits and It's a Good Thing.* Hopkins, Jamie. Oct. 29, 2015. Forbes. [www.forbes.com/sites/jamiehopkins/2015/10/29/new-budget-deal-is-cutting-your-social-security-benefits-and-its-a-good-thing/] Accessed on Oct. 30, 2015.

99. *Retirement Planner: Other Things to Consider.* Social Security Administration. [www.ssa.gov/planners/retire/otherthings.html] Accessed on Jan. 26, 2016.

Note. Most people should sign up for Medicare when they become eligible at age 65, even if they are covered by other health insurance. A delay past the initial enrollment period (which begins three months before the 65th birthday and ends three months after that birthday) may cause a delay in coverage and result in higher premiums.[100]

4. **Is the individual eligible for benefits based on someone else's record?** As explained earlier, changes recently enacted under the BBA have eliminated some options. However, an individual who qualifies as a widow(er) or surviving divorced spouse may choose to apply for survivor benefits now and delay their own retirement benefit until later, when it will be a higher amount.

5. **Does the individual have other income to live on if they delay taking their benefit?**

   a. If an individual does not need the benefit immediately, they may decide to wait until a later time and take advantage of delayed retirement credits. On the other hand, an individual may decide to choose to receive retirement benefits early and increase the value of the benefit by investing the payments instead of spending them.

   b. Some people take early social security benefits out of necessity, due to unemployment or another financial difficulty. However, doing so may mean that their financial problems will continue or even worsen as they struggle to live on permanently reduced benefits.

6. **Will other family members qualify for benefits based on the worker's record?** If an individual begins receiving benefits early, their surviving spouse will not receive a full benefit based on the deceased's earnings record. On the other hand, an individual may want to receive benefits early if they have children under age 18 (or under age 19 for full-time elementary or high school students) who can also receive benefits.

100. *Social Security: Medicare.* Social Security Administration. [www.ssa.gov/pubs/10043.html#generalEnrollment] Accessed on Dec. 14, 2015.